



Discount rate policy under the Classical Gold Standard: Core versus periphery (1870s–1914)[☆]



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ABSTRACT

Drawing on a new data set of monthly observations, this paper investigates similarities and differences in the discount rate policy of 12 European countries under the Classical Gold Standard. It asks, in particular, whether the bank rate policy followed different patterns in core and peripheral countries. Based on OLS, ordered probit and pooled estimations of central bank discount rate behaviour, two main findings emerge: firstly, the discount rate decisions of core countries were motivated by a desire to keep the exchange-rate within the gold points. In stark contrast, the discount rate decisions of peripheral countries reflected changes in the domestic cover ratio. The main reason for the difference in behaviour was the limited effectiveness of the discount rate tool for peripheral countries, which resulted in more frequent gold point violations. Consequently, peripheral countries relied on high reserve levels and oriented their discount rate policy towards maintaining the reserve level. Secondly, interest rate decisions were influenced by Berlin and London to a similar degree, suggesting that the European branch of the Classical Gold Standard was less London-centred than had been hitherto assumed. In establishing general patterns of discount rate policy, this paper aims to contribute to the wider discussion on monetary policy under the gold standard and the core–periphery dichotomy.

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1. Introduction

The Classical Gold Standard (1870s–1914) has attracted the interest of economists, economic historians and policy-makers ever since its foundation. The exchange-rate stability among most countries of the world for some forty years was unprecedented and remained an inspiration to policy-makers after both world wars. At the time, adherence to gold was not entirely uncontroversial, as the international bimetallic movement of the mid-1870s to mid-1890s demonstrates (Reti, 1998). However, the perspective soon changed as a result of monetary instability following World War I and high exchange-rate volatility in the 1930s. Policy-makers came to regard the pre-World War I gold standard as the benchmark against which any international monetary system should be measured – hence the label Classical Gold Standard.

Economists and economic historians, aware of the costs and benefits of adhering to a system of fixed exchange-rates, have tended to avoid the eulogistic tone of policy-makers. They have contributed to the gold standard myth, however, by producing a highly stereotypical account of its workings. Some of the stereotypes have surely been overturned by more recent research. Following

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Hume's price-specie mechanism (1752), the textbook account of the gold standard had it that gold was physically shipped between countries to settle balance-of-payments disequilibria. Recent research, following earlier leads (Lindert, 1969), has demonstrated the importance and sophistication of foreign exchange policy (Jobst, 2009). Other scholars have provided the empirical basis to verify or reject some of the claims made in the earlier gold standard literature, as in the discussion of the benefits of gold standard adherence which are seen in improved access to global capital markets and reduced transaction costs with other gold standard countries (Bordo and Rockoff, 1996; López-Córdova and Meissner, 2003). Yet another strand of the recent literature has highlighted conditions crucial to the workings of the Classical Gold Standard which had been neglected so far, such as the importance of labour mobility and remittances in smoothing the adjustment mechanism (Esteves and Khoudour-Castéras, 2009; Khoudour-Castéras, 2005).

While the gold standard myth has given way to a broader empirical analysis in some debates, in other areas it stubbornly persists. One of these areas is the alleged core-periphery dichotomy. It is argued that the adjustment process to balance-of-payments disequilibria was much smoother for the industrialised core countries of North-western Europe as opposed to the peripheral economies. Different factors have been emphasized in an effort to explain the alleged advantages of the core countries in the adjustment process. Drawing on the theory of optimum currency areas, one school of thought has argued that core countries were better suited to monetary integration (Martín Aceña and Reis, 2000). Others have argued that the central banks¹ of core countries helped each other in times of crisis, but did not help peripheral economies for the lack of self-interest (Eichengreen, 1995²). More recently, differences in credibility have been emphasized (Hallwood et al., 1996; Bordo and MacDonald, 2005), whereas an older school of thought highlighted the peripheral countries' role as debtors in the global financial system, which made them vulnerable to sudden withdrawals of funds in times of financial strain (de Cecco, 1974).

Although the existing literature alludes to the core-periphery dichotomy, it is surprising to see that little effort has gone into analysing what exactly these differences consist of. A number of publications in recent years on the experiences of individual countries have greatly expanded our knowledge of the European periphery under the Classical Gold Standard (Esteves et al., 2009; Jobst, 2009; Reis, 2007; Tattara, 2003; Ögren and Oksendal, 2012). However, case studies, by design, can never be a substitute for a cross-country study analysing the similarities and differences between countries based on the same methodology. Such comparative studies on different aspects of monetary policy under the Classical Gold Standard exist, but they are mostly confined to comparing core countries (Giovannini, 1986; Contamin and Denise, 1999).

This paper aims to provide the first systematic comparison of discount rate policy under the Classical Gold Standard based on the concept of a central bank reaction function. The discount rate was the most important monetary policy instrument at the time; Bagehot's famous description of the London money market, for instance, is almost exclusively concerned with the discount rate (Bagehot, 1878). Modern research, going back to Bloomfield's ground-breaking 1959 study (Bloomfield, 1959, p. 27), has followed this approach. Drawing on a sample of 12 European countries (Austria-Hungary, Belgium, Bulgaria, England, France, Germany, Italy, the Netherlands, Norway, Romania, Serbia, and Sweden) and relying on monthly data (the highest frequency available for all countries) we will analyse the determinants of discount rate policy; in particular, we will ask whether core and peripheral countries followed different patterns and, if so, explain why this was the case.

In the process of collecting the data required for this analysis, it became clear why a comparative study of similar size and data frequency had never been conducted before. With the exception of England, Italy and Norway, the central banks did not make their historical balance sheet data publicly available. Most of the data (though not all) could be found in the Annual Reports of the time, copies of which can nowadays only be found in the archives of the respective central banks. Hence intensive collaboration with the central banks' historical archives was needed to reconstruct the time series.³

Which countries do we view as core and which ones as periphery? This dichotomy is often used in the literature but rarely defined based on rigorous foundations. A classification based on GDP per capita appears problematic in this context, as some countries generally considered peripheral would need to be classified as core (Argentina comes to mind and Ford's famous comparison with the UK (Ford, 1962)). In our context, any definition should rather capture the position in the international economy and, in particular, the international financial system. Liquidity in the foreign exchange market, for instance, provides evidence of the ability to attract short-term capital. Another potential indicator might relate to the ability to attract long-term capital: raising long-term capital is more difficult for countries suffering from original sin than for those able to access global capital markets in domestic currency.

Classifying countries as core and periphery using these two or similar criteria might lead to conflicting results; the example of the US comes to mind, which Morgenstern and Schwartz classify as core, while Bordo and Eichengreen view it as peripheral in the pre-WWI financial architecture.⁴ Fortunately, our sample of 12 countries poses little risk of unclear classification. Based on an analysis of foreign exchange-market liquidity, Flandreau and Jobst (2005, p. 997) classify England, France, Germany, Belgium and the Netherlands as "key countries"⁵ of the international monetary system in 1880, a year which conveniently coincides with the beginning of our estimation period. We would choose the same five countries if we looked at the second criterion alluded to above, that is, the ability to issue sovereign bonds in terms of their own currency. From the 12 countries in our sample, Bordo and Flandreau

¹ We will use the word "central bank" in the following, even though the transition to modern central banking had not yet been completed and the terminology "banks of note issue" would be more appropriate.

² For a sceptical view towards this argument see Flandreau (1998).

³ For a full acknowledgment see p. 1.

⁴ We thank Michael Bordo for the discussion on how the view of the US in the pre-World War I financial architecture has changed over time in historiography.

⁵ Flandreau and Jobst have a classification into key-intermediary-periphery in mind rather than a dichotomy between core and periphery; the implication for our research is that we merge the second and the third group into a single group labelled "periphery".

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