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Willman, Alpo. 1988. The collapse of the fixed exchange rate regime with sticky wages and imperfect substitutabilities between domestic and foreign bonds. *European Economic Review* 32:1817–38.

Comment Michael D. Bordo

In this fascinating paper, Eichengreen and Jeanne extend the logic of the recent second-generation currency crisis models to explain the sterling crisis of 1931, a crisis that precipitated the demise of the interwar gold exchange standard. In simplest terms, the story they tell is that the United Kingdom abandoned gold convertibility on 20 September 1931 because the monetary authorities were unwilling to raise the discount rate sufficiently to defend convertibility. The authorities were concerned that such actions would increase the level of unemployment from its already high level. The explanation works through a model in which the monetary authority has a loss function that balances the costs of rising unemployment against the costs of lost credibility (including the benefits from sterling's role as a reserve currency and London's position as a financial center).

As unemployment rises the costs of abandoning convertibility decline relative to the political costs of not doing so. Exchange market participants understand this, so that the probability of devaluation increases. The level of unemployment is driven by the external shocks of the Great Depression via two channels: the effect of deflation on real wages in the face of nominal rigidities and the effect of deflation on ex post real interest rates via a credit market channel. Estimating the model and solving for the probability of devaluation gives the result of a marked jump in the probability of devaluation in the late summer of 1931, thus anticipating the crisis. A counterfactual displayed in figure 1.12 shows that in the absence of the external deflationary shocks of the Great Depression, the probability of sterling devaluation in 1931 would have been negligible.

The model is neat, easy to understand, and, if you believe the assumptions on which it is based, very compelling. The problem is that I am not convinced that it *was* the authorities' concern over rising unemployment that led them to throw in the towel on parity at $4.86. This is not to say that it was not the shocks of the Great Depression that pushed the United Kingdom over the edge.

My first concern is over the issue of credibility. It is not obvious that the 1992 U.K. loss function—that the authorities were unwilling to persist

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in maintaining a high Bank rate to defend sterling during the Exchange Rate Mechanism crisis because of the effects high interest rates would have on mortgage rates and the level of unemployment—applies to the United Kingdom in 1931.

The interwar gold standard was an attempt to reconstruct (although modified into a gold exchange standard) the pre–World War I classical gold standard. That regime, for the United Kingdom and other key players, was based on a credible commitment to gold parity. One can view the gold standard as a contingent rule, as I do in an article with Finn Kydland (Bordo and Kydland 1995) and as Eichengreen does in his recent book *Globalizing Capital* (1996). Under the rule, member countries stick to gold parity except in the event of a well-understood dire emergency, such as a war. In that case, you abandon convertibility and follow expansionary financial policies on the understanding that after the emergency is over you go back to gold at the previous parity. Another contingency, which is less clear-cut, is a financial crisis—not one produced by the monetary authorities' own actions—that is, a domestic banking crisis and a currency crisis together (referred to in an earlier literature as an internal and an external drain). In that case, you temporarily leave gold, as was the case for a number of crises in the nineteenth century when the Bank of England invoked a Treasury Letter. Rising unemployment was *not* one of those contingencies. It was not in the loss function. When unemployment went up, people emigrated to North America or Australia.

After World War I, the United Kingdom returned to gold at the prewar parity of $4.86. To do so, it put the British economy through the wringer. The return to gold reflected the victory of the "City" view that only a return to the original parity would recapture the credibility of the prewar regime and the benefits that accrued to the City of London. Keynes and others opposed the policy, but they represented a minority position.

Evidence provided by a number of scholars, including Eichengreen (1992), suggests that the interwar gold exchange standard, at least the dollar-sterling exchange rate, was indeed credible at least up to the summer of 1931. So the question that arises is, What changed between 1925 and 1931 to justify using a late-twentieth-century loss function instead of the nineteenth-century loss function that lay behind the 1925 resumption? True, Eichengreen in *Golden Fetters* (1992) and in section 1.2 of this paper discusses the growing power of the labor movement, universal suffrage, the rise of socialism, and so forth. But to make the case for this paper, the authors need to come up with more convincing qualitative evidence than the "hints" that are given in section 1.2 that the U.K. monetary authorities in the period under consideration viewed rising unemployment increasingly as their primary objective.

My reading of the history of the crisis, based on Sayers (1976), Cairncross and Eichengreen (1983), and others, is that it is not clear that rising unemployment and the unwillingness to raise Bank rate because of what it would do to unemployment was the key reason for the crisis. The literature focuses on two other factors. The first is the basic overvaluation of sterling since 1925 and the resultant weakness in the current account of the balance of payments. Thus the United Kingdom was continuously threatened with being forced off the gold standard for an old-fashioned first-generation currency crisis model reason. Indeed, two earlier sterling crises, in 1927 and 1929, when unemployment did not spike above its interwar level, were averted by rescue packages arranged with the Federal Reserve and the Bank of France.

The second factor in the received account of the crisis is the budget deficit, which, although not large by modern standards and on a full employment basis may have been a surplus, was perceived by contemporaries who believed in fiscal orthodoxy as inconsistent with adherence to the gold standard. According to Sayers, the budget deficit (and the May committee report in July 1931, which forecast that it would rise) was the key factor driving the attack on sterling. The budget deficit also may explain the unwillingness to raise the discount rate because it would increase debt service. It is true that raising unemployment by raising unemployment benefits was interrelated with the deficit. But we need to know why the national government formed in August 1931, which did not include the Labour Party, would have been hamstrung in the attempt to balance the budget because of the issue of rising unemployment.

These points suggest that in addition to qualitative evidence for the main assumption of the paper, we need to see evidence that a simpler explanation for the crisis, based on the fundamentals of the balance of payments and the government's fiscal stance, with the timing of the attack related to the European banking crisis, does not explain the events of September 1931.

One point in the authors' favor, however, is that there exists no convincing explanation for the failure of the Bank of England to raise Bank rate in the following two months before abandoning gold, after doing so in July 1931. That the Bank was seriously committed to staying on gold is evident from the efforts made to obtain credits from the United States and France. Possibly the Bank did not raise Bank rate so as to put pressure on the government to balance the budget as Cairncross and Eichengreen suggest, or to frighten holders of sterling as Sayers posits, but the answer to the question, unless the authors are correct, seems still to be a mystery.

On the other hand, why is it that the Bank of England, once it was released from convertibility constraints, did not immediately relax monetary policy in order to combat unemployment? Instead, it waited several months.

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