

because all purchases under the military assistance programs are made within the United States. The merchandise export figures shown in the chart may be too inclusive because some of the transfers are not for cash. The margin of error, however, is relatively small and for purposes of analyzing the balance of payments as a whole may be ignored.

International balance under the free gold standard

Before analyzing the current balance-of-payments problem it is necessary to understand how international balance used to be achieved under the old free gold standard system which prevailed prior to World War I. Since the balancing mechanism at that time was largely automatic countries were not conscious of such a thing as a "balance of international payments."

The leading currencies of the world were convertible into gold which moved freely from country to country. Unrestricted price changes within countries and the free international movement of gold provided the world with a multilateral trading system which worked so well that by the close of the 19th century it was looked upon as natural and permanent. International trade was relatively free, not in the sense that there were no trade barriers, but in that tariffs were applicable to all foreigners alike. There was no intended discrimination against customers or suppliers.

This near-automatic system came to prevail largely because of the United Kingdom's position in the world economy. She was the first country to experience the Industrial Revolution and was the hub of the trading world. The ready convertibility of the pound sterling into other currencies and into gold and her strong international creditor position made it convenient for traders everywhere to carry on international trade in terms of pounds sterling.

Convertibility meant that the British pound could be converted into gold at a fixed ratio at the will of the holder, whether a Britisher or a foreigner. The fact that the United Kingdom maintained convertibility made it easier for other countries to do so also. The United States remained on a free gold standard until 1933.

Under the free gold standard, currencies are legally defined in terms of their gold weights. The dollar was 23.22 grains of pure gold and the British pound sterling 113.0016 grains. The ratio of the weights of the two currencies ($4.866\frac{1}{2}$ to 1) was known as the "par of exchange."

Individuals anywhere could convert gold into currency, or currency into gold, at the legal ratio, or convert either currency into the other at the current exchange rate. Gold was not only the standard of value, domestically and internationally, but also provided a mechanism for keeping currencies in line with each other at roughly their parities. As a consequence, gold was distributed throughout the world according to need as determined by changing prices and foreign exchange rates.

For example, if commodity prices in the United States increased relative to prices in the United Kingdom there would be a tendency for commodity imports from the United Kingdom to increase. The increase in commodity imports, relative to commodity exports, would cause the dollar to weaken, relative to the pound sterling, on the foreign exchange market. The decline would not go beyond the