"gold export point," the level at which it became profitable to convert dollars into gold and to ship the gold to the United Kingdom. Since gold was directly related to the supply of money and credit the export of gold would cause prices in the United States to halt their rise and those in the United Kingdom to increase. When price levels in the two countries came into line with each other the exchange rate was close to parity and there was a state of international equilibrium.

Usually, before the gold export point was reached, the decline in foreign exchange would attract short-term capital, thereby tending to bring international payments back into balance. The system worked well largely because the British Government and the Bank of England pursued liberal trade and monetary policies and served as world banker.

Before considering international balance under conditions of currency inconvertibility it might be helpful to trace the steps in the process of adjustment under the exchange rate mechanism of the free gold standard.

Illustration of adjustment to increased commodity imports under a system of free exchange rates and the free gold standard

1. An excess of U.S. commodity imports over commodity exports causes dollars to become more plentiful in terms of British pounds sterling, so that dollar exchange drops from $4.866 equals £1 (parity) to, let us say, $4.87 equals £1.

2. In consequence, £1 will now purchase more dollar exchange than previously and it becomes profitable to convert pounds into dollars for short-term investment in the United States.

3. The ensuing flow of short-term capital into the United States will increase the supply of short-term capital relative to the demand for it and cause the short-term interest rate to fall, thus tending to neutralize the effect of the decline in the exchange rate.

4. Meanwhile, since the dollar is now cheaper in terms of pounds sterling it becomes more profitable than before for foreigners to buy merchandise in the United States. Hence, U.S. exports will increase relative to imports, thereby tending to correct the assumed excess of imports over exports. The effect will be to raise the value of the dollar in terms of pounds and tend to bring it back to parity.

Observe that these correctives (capital movements and merchandise trade) have been brought about by fluctuations in foreign exchange rates without any manipulation of interest rates and without any shipment of gold.

5. If the adjustment mechanism just described fails to work promptly the value of the dollar in terms of pounds sterling will continue to fall until it reaches $4.886 equals £1. This is the "gold export point." Since it costs—or used to cost—about 2 cents to ship 1 pound sterling in gold from New York to London it will be more profitable to ship gold than to pay more than $4.886 for £1 in foreign exchange.

6. The movement of gold from New York to London decreases U.S. monetary reserves and increases those of the United Kingdom, thus serving to contract credit in the United States while expanding it in the United Kingdom.

7. In consequence, commodity prices in the United States will tend to fall relative to prices in the United Kingdom, thereby making