States increased, relative to their prices in the United Kingdom, there was a tendency for Americans to increase their imports of those commodities. Unless offset by other price changes in the opposite direction, the increase in U.S. imports, relative to U.S. exports, caused an increase in the demand for sterling in terms of dollars, thereby causing the dollar to weaken relative to the pound sterling. The decline would not go beyond the "gold export point" (4.886-plus per £1), however, for at that point it would be more economical to convert dollars into gold for shipment to the United Kingdom than to pay a higher price for sterling in the foreign exchange market. Since gold was directly related to the supply of money and credit, the exportation of gold would cause price levels in the United States to halt their rise, relative to those in the United Kingdom. When prices 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, long before the gold shipping point was reached the decline in the foreign exchange value of the dollar would itself attract short-term capital (since a given number of pounds would purchase more dollars than before) thereby tending to bring international payments and receipts into balance with each other. The system worked well largely because the British Government pursued liberal trade and investment policies.

ILLUSTRATION OF ECONOMIC ADJUSTMENT UNDER A FREE GOLD STANDARD

1. An increase of U.S. commodity imports, relative to U.S. commodity exports, causes dollars to become more plentiful in the foreign exchange market, relative to other currencies, so that the value of the dollar drops from \$4.866=£1 (parity) to, say, \$4.87=£1.

2. Because pounds will now purchase more dollars than before, it becomes more profitable than before 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 increases the supply of short-term capital, relative to the demand for it, and causes the short-term interest rate in the United States to fall, thereby tending to neutralize the effect of the decline in the foreign exchange rate.

4. Also, while the dollar is cheapening, relative to sterling, it becomes more profitable than before for foreigners to buy certain kinds of merchandise in the United States. Hence, U.S. exports will increase, relative to imports, tending to correct the previous excess of imports over exports. The effect will be to raise the value of the dollar back toward parity.

It is important to observe that these correctives—capital movements and merchandise trade—are brought about by changes in foreign exchange rates, without the international transfer of gold.

5. If, however, this adjustment mechanism fails to work effectively the foreign exchange value of the dollar will continue to decline until it reaches \$4.886 to £1. This is the "gold export point." Since it costs (or used to cost) 2 cents to ship a pound sterling's worth of gold between New York and London it is more profitable to ship it than to pay any more than \$4.886 (a 2-cent differential) for a pound sterling in foreign exchange.