In this reexamination of Canada's balance-of-payments experience under the gold standard, the authors develop and empirically test a new portfolio approach to the mechanism of balance-of-payments adjustment. This adjustment mechanism responded to massive inflows of foreign capital during a critical period of Canada's economic growth in the early years of the twentieth century. The authors show that the existence of international mobility of capital requires a fundamental revision of the price-specie-flow theory that has traditionally been used to explain adjustment when the balance of payments was more nearly dominated by the balance of trade. The approach taken by professors Dick and Floyd not only answers the critics of Jacob Viner, who first explored the Canadian case after 1900, but also offers a new perspective on how the gold standard in general actually worked.

This new interpretation of the Canadian experience is an extension of the monetary approach to balance-of-payments adjustment that realizes the full implications of international capital mobility. Interest-rate differentials do not drive capital flows, but instead reflect risk premiums set by the exchange of imperfectly substitutable securities of different countries in world-asset markets. Changes in domestic relative to foreign price levels equilibrate markets for goods, but do not satisfy purchasing-power parity. This innovative theory may apply to any fixed exchange-rate system when capital is internationally mobile.

The authors apply standard elementary economic principles to this working of the balance of payments under the gold standard, making this book useful reading for those studying intermediate- and upper-level economics, especially in the field of international finance.

Canada and the gold standard

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Canada and the gold standard

Balance-of-payments adjustment, 1871–1913

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Preface

The experience of exchange rate instability since 1971 has renewed interest in the workings of the classical gold standard before 1914, when fixed exchange-rate regimes were dominant and smooth balance-of-payments adjustments widespread. How and why did the gold standard work so well, and are there reasons to hope for a return to this regime? Such a hope lingered in the interwar period, but the abandonment of gold as a medium for settling international obligations in the early 1970s does not augur well for return to a gold standard. The intellectual appeal of fixed exchange rates, however, has never evaporated, nor has the curiosity about how the gold standard actually worked. The present study transcends the debate over fixed versus flexible rates to present a new perspective on the classical gold standard that highlights the role of international capital mobility in the adjustment process.

Although the ideas presented in this book have potentially wider applicability to other monetary regimes and historical contexts, the immediate testing ground is the Canadian pre–World War I experience – long considered a prime example of smooth balance-of-payments adjustment under the gold standard. We view these ideas as a natural and belated evolution of economic thought prompted by the increasing importance historically of capital movements in the balance of payments, a phenomenon that draws attention to distinctive and hitherto little recognized implications of the recently developed monetary approach to balance-of-payments adjustment. Our ongoing work is continuing to uncover evidence in other countries and regimes in support of the theory offered here when capital mobility is an important element in the story.

This study is the fruit of nearly a decade of collaboration between the authors, who have interacted to refine the theory and explore hidden depths of the empirical evidence. The result, we believe, is a theoretically consistent framework of analysis that is particularly revealing about the mechanism of adjustment that was at work in the Canadian balance of payments between 1871 and 1914.

In the course of our collaboration, we have accumulated many debts to past and present authors, to the organizers of numerous seminars and conferences, to funding agencies, and to many others who have both enlightened and lightened our task by helping us to find and understand the appropriate data and by assisting us in the necessary tasks of producing a tidy and readable manuscript.

We acknowledge, in particular, lively and provocative discussion with Gordon Anderson, Michael Bordo, Charles Calorimis, Forrest Capie, Jack Carr, Michael Devereux, Gerry Dwyer, Stephen Easton, Barry Eichengreen, Al Hynes, Greg Jump, Mervyn Lewis, Don McCloskey, Ronald McKinnon, Angelo Melino, Anna Schwartz, Ronald Shearer, and Rick Simes. We have also benefited from correspondence with Arthur Bloomfield, Alec Cairncross, Jacob Frankel, Charles Kindleberger, Georg Rich, Larry Neal, and Brinley Thomas, and from the comments of two anonymous referees.

Our ideas matured as various parts and versions of the argument were subjected to the critical scrutiny of seminar participants at the Australian National University, Northwestern University, La Trobe University, the University of Melbourne, the University of Tasmania, Stanford University, the University of Toronto, the 1981 Seminar on the Application of Quantitative Methods to Canadian Economic History, the 1988 Annual Cliometrics Conference, the Ninth World Congress of the International Economic Association at Athens, Greece, 1989, and the Tenth International Economic History Congress at Louvain, Belgium, 1990.

The work has been supported financially by the Social Sciences and Humanities Research Council of Canada and the universities of Lethbridge and Toronto. Some of the work was completed while Dick was a visiting scholar at Harvard University and a research associate at the University of California at Berkeley, and while Floyd was a visiting fellow at the Research School of Social Sciences at the Australian National University. We acknowledge the support of our home universities that made it possible to devote undisturbed time to the project and the host universities for providing stimulating environments in which to work. The computing staffs of all these institutions helped to keep us in contact by electronic mail without which collaboration would have been much slower and more difficult.

We also acknowledge the comments and suggestions of two anonymous referees who read earlier versions of the manuscript, and the painstaking

attention to detail by the staff of Cambridge University Press, helping us at numerous points to better articulate and clarify our meaning.

The interest and enthusiasm of others to debate with us on controversial topics and to contribute to our thought as the work progressed in no way relieves the authors of full responsibility for the final product. While we have learned much in the process, our main thesis has changed little from its original conception, and the evidence in its favor has progressively mounted.

Finally, we acknowledge the forbearance of our families, who have borne with many of the sacrifices made along the way to turn ideas and evidence into a publishable manuscript.

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