

THE ROAD TO

HELL IS

PAVED WITH

GOLD

INTENTIONS

“SUCCESS IS STUMBLING FROM FAILURE TO FAILURE WITH NO LOSS OF ENTHUSIASM.” Whether or not Churchill actually said this, his ability to “keep bugging on” through six years of blood, toil, tears and sweat undeniably helped the Allies to victory in the Second World War. But was one of Churchill’s earlier failures – the ill-fated return of Britain to the gold standard in 1925 – a major cause of the conflict? And what lessons, if any, does this episode hold for today?



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THE SCENE: A DINNER PARTY, 100 YEARS AGO. THE MEN ARE ALL IN DINNER JACKETS, THE WOMEN IN DRESSES AND PEARLS. AFTER MUCH MERRIMENT, THE CONVERSATION TURNS TO MORE SERIOUS MATTERS.

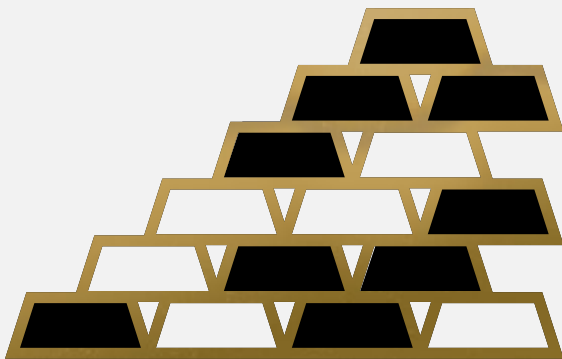
“I wonder if the government should return to the gold standard?” asks one man.

“I think it should,” replies another.

“Good. We’re all agreed.”

Then one of the women pipes up: “The government should stay off the gold standard, so that the pound can reach a level that would keep our exports competitive.”

Her husband, deeply embarrassed that his wife has ventured an opinion, hurries her away from the party.



This comic sketch from Harry Enfield deftly skewers patronising male attitudes. But it also displays remarkable expertise on monetary policy. If only they had listened to her, the most destructive conflict of all time might have been avoided.

Winston Churchill's 1925 decision to put Britain back on the gold standard led within four years to the Great Depression in the US. Ultimately, it caused a European economic and banking crisis so severe that the German population gave the Nazi Party the largest share of seats in the Reichstag by mid-1932.

*Post hoc ergo propter hoc*¹ – Latin for “It’s correlation, not causation, mate!” Quite possibly. But let’s look into the past and see what lessons we might learn for today.

GOOD AS GOLD

It is not true that all empires have needed a gold coin; but all gold coins have needed an empire. The pure, standardised gold coin was invented around 550BC by King Croesus of Lydia. The Croeseid and all successful coins since have been associated with economic and military hegemony.

There are two main reasons for this. Firstly, the commercial value of a gold coin is due not just to its composition, but to

the authority of the minter, who provides public assurance of its purity. Secondly, only empires on the rise or at peak strength can cope with the economic discipline imposed by a hard currency – as we will soon see.

RAISING THE STANDARD

For practical purposes, ‘the gold standard was originated in England’² in 1663, when Charles II issued the new gold guinea. But our story really begins in 1752, with the peerless David Hume. Hume’s price-specie flow mechanism showed that an effective gold standard would act as an automatic stabiliser to prevent any country on the standard from running a large trade deficit or surplus. Deficit countries would see gold drain from their borders as it was spent on imports. This fall in the supply of money would necessitate higher interest rates (an aspect which will shortly be relevant to us) or lower domestic prices, eventually rendering the country more competitive and so restoring its trade balance to neutrality.

Countries often abandoned the gold standard in times of conflict. In 1797, Prime Minister William Pitt the Younger took Britain off the gold standard because of the high cost of the Napoleonic wars. But Hume’s work was held in such regard that Robert Peel’s Bullion Committee decided in 1819 to take Britain back onto the gold standard by 1823. They managed it two years early, despite widespread riots as deflation of 30% was imposed on wages and prices.³ The measure succeeded: the price index in 1914 was at the same level as 1822. To put that in context, it’s as if a stamp today cost the same as it did in 1932: 2d, or about 0.7p, rather than 2024’s £1.65.

¹ As Barry Eichengreen more forcefully put it in 1992: ‘Monocausal explanations are certain to be partial and misleading.’

² Hawtrey, RG (1927), *The Gold Standard In Theory and In Practice*

³ Bank of England’s RPI dataset 1800-2024

“The extraordinary growth of the British economy and empire during the 19th century was at least partly attributed to this decision to go back onto gold.”

The extraordinary growth of the British economy and empire during the 19th century was at least partly attributed to this decision to go back onto gold, the ‘single most important defining decision in Britain’s financial history.’⁴ Thus was imprinted on British minds the absolute primacy of retaining a stable, gold-backed currency.

CAN I PAY BY CARD?

Whilst the gold standard was effective in the co-operative world of 1873-1914, the First World War changed everything. Governments financed their war efforts through a mixture of borrowing, money-printing and tax rises. Real note printers like Germany, Austria-Hungary and Russia – where taxation failed to cover interest costs, let alone war costs – suffered hyperinflation after the war.⁵ In the UK, which ran a 28% budget deficit, taxes shot up (the income tax rate quintupled), yet taxation revenue only paid for around 25% of the cost of the war.⁶ The remainder was met by borrowing and money-printing, and UK inflation exceeded 20% per year by the end of the conflict.

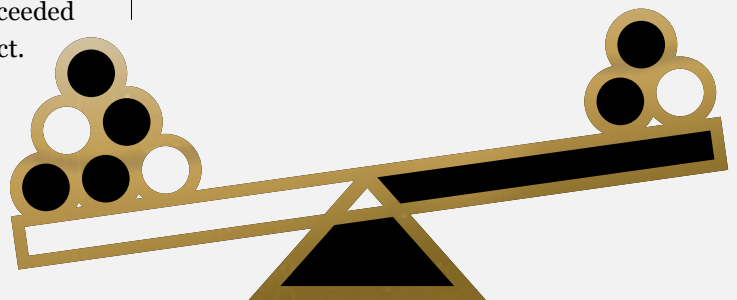
To permit these levels of spending, borrowing and inflation, all belligerents broke with the gold standard.

FOOL’S GOLD

After the war, the British approach was predictable: in November 1918, a committee chaired by the Governor of the Bank of England, Walter Cunliffe (presumably in a dinner jacket), reported it was ‘imperative... the gold standard should be restored without delay.’⁷

But the Cunliffe Report made two major errors. First, it failed to recognise that, even before the outbreak of war, the foundations of the gold standard were under threat from the growth of the US economy and of the financial sector more generally. This wasn’t a new phenomenon: the Bank had defended the pre-war value of sterling with only a ‘thin film of gold’.⁸ To top it all, during the war, gold had flowed unceasingly from Europe across the Atlantic, and the US economy had boomed as Europe had foundered.

The report’s second and much larger error was that it did not recognise the shift in the balance of economic power from companies



4 Ahamed, L (2009), *Lords of Finance*

5 Strachan, H (2004), *Financing the First World War*

6 Ibid

7 Kynaston, D (2017), *A History of the Bank of England 1694-2013*

8 Sayers, RS (1957), *Central Banking After Bagehot*

to workers. Usually, the most obvious sign that workers believe they have the upper hand in negotiations (but an unfairly low share of profit) is a rise in the number of strikes. In 1912, even before the war, the coal miners launched Britain's third-largest strike of the 20th century. After the war, with millions dead and communism on the rise, organised labour's hand was strengthened further. Universal suffrage, the welfare state and mass trade unionism were the legacies of total war in Europe: 'the quid pro quo for the carnage inflicted on populations by their government'.⁹ The gold standard, and its requirements for deflation, had not yet been tested under the conditions of (nearly) full franchise democracy. So by 1924, as JM Keynes (no dinner jacket, but a terrific moustache) put it, the Bank of England was 'attacking the problems of the post-war world with unmodified pre-war views and ideas.'¹⁰

A THEORETICAL INTERLUDE

At its core, monetary policy is a choice between flexible prices and flexible exchange rates. The gold standard was a regime of fixed exchange rates. That meant prices had to be flexible downwards (deflation) as well as upwards (inflation). Modern fiat currency systems are a regime of flexible exchange rates, where currencies can fall in value so prices don't have to, reflecting resistance on the part of voters in the full franchise era to seeing their nominal wages fall.

A gold standard requires the central bank to use interest rates to target a value of the currency; a fiat system requires the central bank to use interest rates to target the value of money (normally in the form of a price level or an inflation rate).

WINSTON'S CHOICE

As a result, on becoming Chancellor of the Exchequer in November 1924, Churchill (certainly in a dinner jacket) faced a dreadful dilemma –

OPTION 1

Follow Keynes' advice, stay off gold and devalue the pound. But abandoning a century of sound money would be a brave move. The Cunliffe Report, the 'Project Fear' of its time, claimed that not returning to the gold standard 'will handicap our industry, our position as an international financial centre will suffer and our general commercial status in the eyes of the world will be lowered.'

OPTION 2

Follow the example of 1821, rejoin the gold standard at the pre-war rate and impose terrible deflation on workers and prices. But the 1914 price level was 60% lower than that of 1920. The modern equivalent would be reducing the median UK wage from today's £37,000 per year to just over £14,000, with almost no change in the cost of buying an iPhone or going on holiday abroad. By 1924, prices had already fallen a good distance thanks to high interest rates, but at a heavy cost: nearly 1.5 million unemployed, nearly 10% of the working population. Further reductions in prices and wages would be extremely difficult, if not impossible, to achieve.

Germany and France chose inflation and devaluation; the US chose deflation and gold. What would Churchill do?

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AN ANGEL ON EACH SHOULDER

America made it clear what it thought Churchill should do.

During the war, the US had attracted huge gold inflows. By 1923, it held 75% of Western gold reserves. Under a traditional gold standard, this would have resulted in a massive expansion of domestic credit, as interest rates collapsed.

Enter the first ever chairman of the newly established Federal Reserve (Fed), Benjamin Strong (dinner jacket status unclear, probable bow tie). Strong decided to de-link credit creation from gold reserves and instead give the Fed control of the supply of credit. In theory, the Fed would provide credit if the economy weakened and remove it if the economy strengthened. This is of course now seen as the fundament of

modern central banking. At the time, ‘it was a radical departure from more than two hundred years of central banking history.’¹¹

This left the US with two things: much more gold than it had use for; and discretionary control over interest rates. Not only did it want Britain back on the gold standard, so that gold would remain a useful national asset for the US, but it also had the ability to help Britain make that transition by cutting rates further than was appropriate for the US economy.

Sure enough, through 1924 and 1925 the Fed eased credit conditions and cut rates, whilst encouraging bank lending to Britain. This made it look (however briefly) like Britain might be able to rejoin the gold standard.

In March 1925, after much deliberation, Churchill made his decision: to rejoin. “There is no escape,” warned a former chancellor. “You will have to go back; but it will be hell.”¹² So sterling limped back on to the gold standard, at the pre-war rate of US\$4.86 – with the pound estimated at the time to be overvalued by at least 10%. To stay on the standard, interest rates would have to be raised further, and wages would have to keep falling.

Keynes saw the danger clearly: ‘The proper object of dear money is to check an incipient boom. Woe to those whose faith leads them to use it to aggravate a depression!’¹³

11 Ahamed, L (2009), *Lords of Finance*

12 Ibid

13 Keynes, JM (1931), *The Economic Consequences of Mr. Churchill*

THE ECONOMIC CONSEQUENCES OF THE DECISION

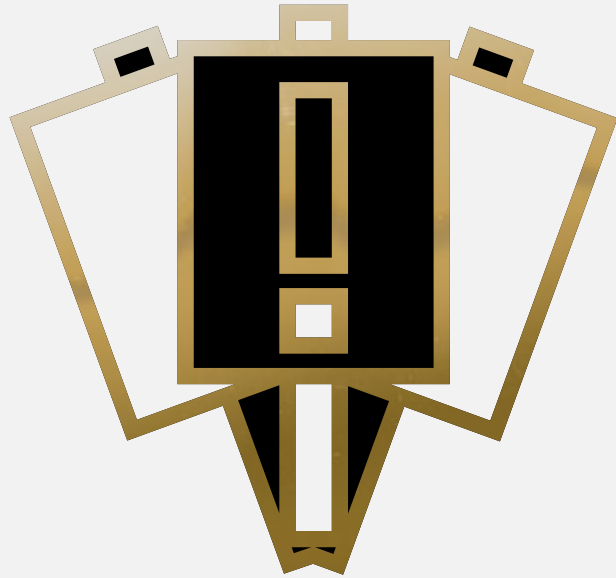
Higher interest rates and a more expensive currency was a catastrophic combination, particularly for Britain's export industries such as shipbuilding and coal mining. Further attempts to reduce wages proved deeply unpopular. In May 1926, 1.7 million workers downed tools in the General Strike, the largest in British history (measured by workdays lost, some five times larger than the worst year of the 1970s). As markets realised sterling was overvalued, gold began to pour out of Britain – exacerbated by an unhelpful request from the Bank of France for its sterling holdings to be converted directly into gold and removed from the Bank of England's reserves at a critical moment.

In July 1927, the major central bankers – including Bank of England Governor Montagu Norman (in a velvet-collared cape) – held a secretive team offsite to discuss the weakness of the pound. The solution that followed the Long Island getaway involved little adjustment from France, Britain or Germany. The US, on the other hand, contributed 'a major shift in monetary policy',¹⁴ with the Fed forcefully pushing down interest rates.

SPIKING THE PUNCHBOWL

Strong saw the potential for adverse consequences – he admitted to his French counterpart that lower rates would administer *un petit coup de whisky* to the stock market. But there were some signs of weakness in the US economy, and he was not alone in wanting easier monetary policy for domestic reasons.

It was a fateful mistake. The stock market, which had been broadly flat since late 1925, exploded into the stratosphere, doubling



over the next year and a half. Recognising its mistake, the Fed started hiking discount rates through 1928. But not only was it too late to prevent the momentum in risk appetite, it also continued to issue cheap credit to banks – a proto-QE – which 'alone contributed the inflationary stimulus in the fatal last half of 1928'.¹⁵ By mid-1929, the stock market was up 130% since Strong's rate cuts – equivalent to the entire increase in the S&P 500 Index since 2017, but in half the time. It was too late to shut the stable door; the bourse would soon be halted.

APRÈS MOI, LE LENGTHY DECLINE IN STOCK MARKET PRICES

The fall from this peak was precipitous and prolonged. Within three years, the market was down 88% in dollar terms. Viewed through the lens of gold prices (Figure 1), the Dow

¹⁴ Eichengreen, B (1992), *Golden Fetters*

¹⁵ Rothbard, MN (1963), *America's Great Depression*

Jones stock market index was not to recover its 1929 peak sustainably until 2013 (having exceeded it for a time in the 1960s and 2000s).

Yet the fall in US stock markets was the ignition switch of global economic turmoil, not the engine.

In Germany, a promising economic recovery from the hyperinflation of the early 1920s was brought to a shuddering stop. In 1930, unemployment exceeded 20% and, in the election that September, the Nazi Party became the second-largest bloc in the Reichstag, with Hitler promising to ‘rebuild Germany’s prosperity and to restore its position in the world.’¹⁶

As Hitler’s Brownshirts entered parliament, Germany lost half of its gold reserves overnight, leaving the country in a

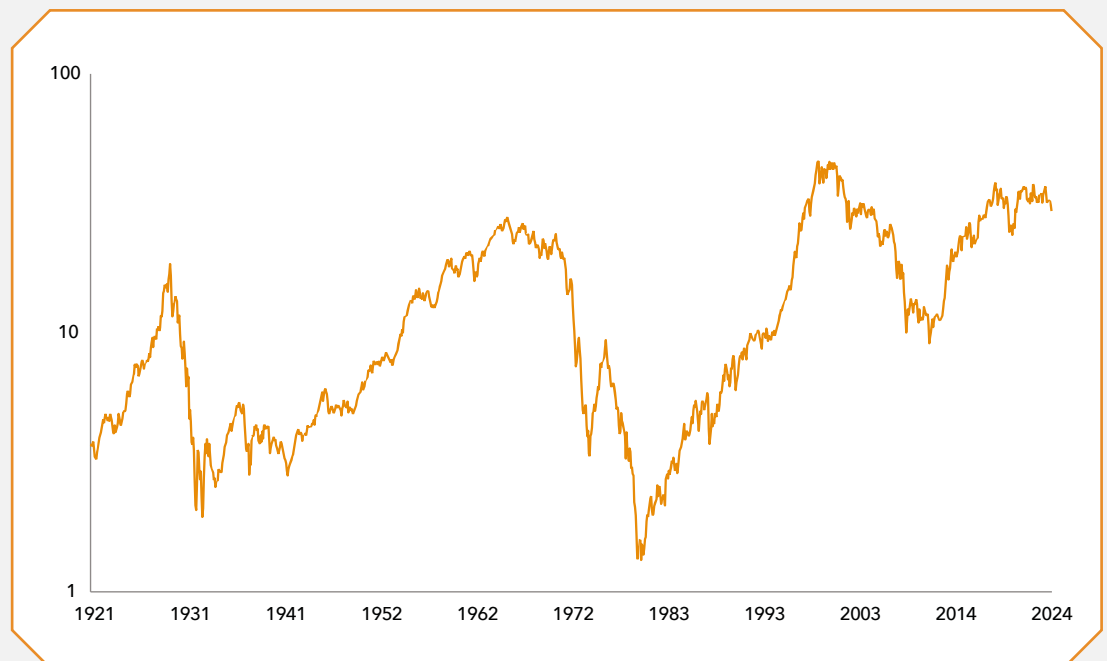
fragile position. Then, in May 1931, the failure of Austria’s Credit-Anstalt bank – so colossal that its balance sheet was as large as total Austrian government spending – sparked a ‘full-fledged banking panic’ in Germany.¹⁷

The Germans were forced to choose between the stability of the domestic banking system and maintaining the gold standard. After a brief hesitation, they opted for domestic financial stability. In July 1931, they froze foreign deposits and replaced gold convertibility with exchange controls. Eight weeks later, Britain unwound the mistake of 1925 and left the gold standard, shortly followed by another 25 countries.

What ensued was a global credit crunch as nervous savers converted bank deposits into gold bullion. By the end of 1931, one in

Figure 1

US DOW JONES INDUSTRIAL AVERAGE (TOTAL RETURN), EXPRESSED IN GOLD TERMS (LOG SCALE)



Source: Bloomberg, data to 31 October 2024

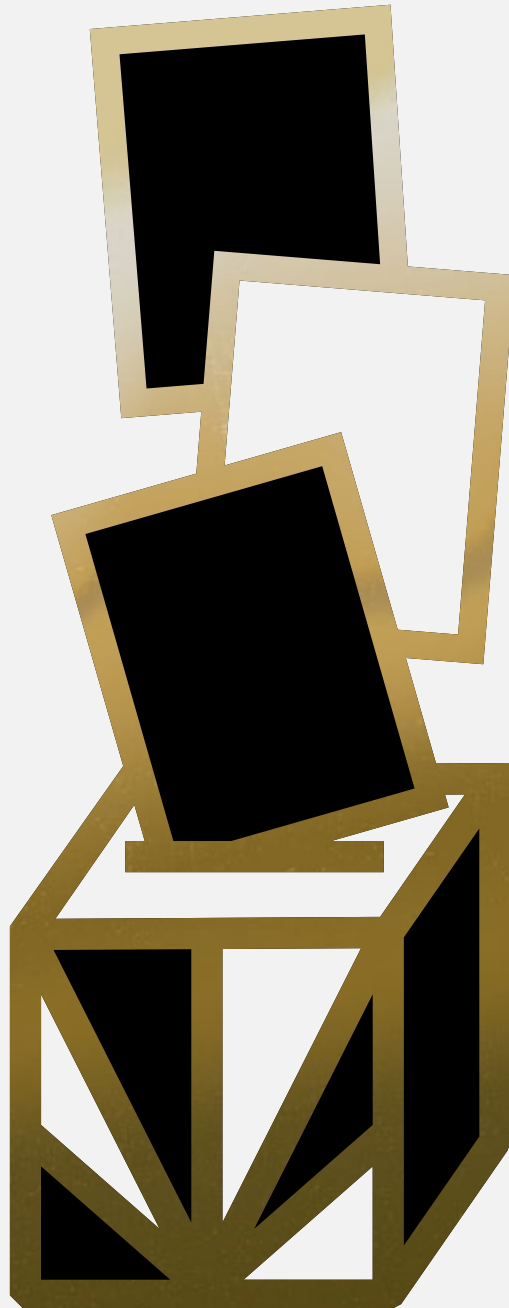
ten American banks had closed their doors. The true Great Depression year was 1932, as deflation of -10% and interest rates of +2.5% imposed on the US a real interest rate of +12.5% (compared with around 2% today, itself an elevated level relative to the period after the global financial crisis). The German economy collapsed, with unemployment peaking at over 30%. In mid-1932, the Nazis became the largest party in the Reichstag, and six months later Hitler was chancellor. Owing in part to a mere monetary policy decision, the world would never be the same again.

PRESENT PARALLELS

In broad terms, interfering with the natural mechanics of interest rates can lead to the creation of large global imbalances, imbalances whose unwinding may be hugely destructive.

The creation of the Federal Reserve (and its immediately political approach to interest rate setting) led within two decades to America's largest ever boom and bust. To compensate for the imbalances resulting from the First World War, it decided to run monetary policy for the benefit of another country, in an attempt to prop up a failing system, and blundered badly.

It is tempting to draw some close parallels to today's situation, most obviously with China. Since 1994, China has run an avowedly mercantilist economy, protected by implicit tariffs and subsidies. In the process, it has accumulated gold bullion and a huge trade surplus, transmitting deflationary pressure to the rest of the world, as the US did in the early 20th century. Just like the



“ In 1925, the problem was prices and wages that were assumed to be flexible downwards becoming sticky. Today, it’s the opposite: prices and wages assumed to be sticky becoming flexible upwards.”

early Fed, China sought to avoid its currency appreciating or those inflows generating inflation domestically, so it accumulated trillions of dollars of US Treasuries, pushing down US interest rates.

Enormous imbalances have built up as a result: piles of debt mixed with layers of leverage, all because interest rates were pushed too low. In a disinflationary world, that might be acceptable. But, as in 1918, a seismic event has changed the world. Covid-19 may have been an invisible enemy, but the money printing and government spending was all too visible.

Ultimately, the full franchise democracy in place since the 1920s is incompatible with the gold standard’s requirement for deflation, because voters don’t like to see their wages fall.

Churchill’s mistake, therefore, was failing to recognise that the change in the underlying fabric of the economy needed to be accompanied by a change in the monetary policy regime. In 1925, the problem was prices and wages that were assumed to be flexible downwards becoming sticky. Today, it’s the opposite: prices and wages assumed to be sticky becoming flexible upwards.

In the 1920s, gold left Britain because investors knew high interest rates could not be sustained in the face of a changed world: inflation was irresistible. Today, the gold price – up 80% since covid – is rising as investors realise that high interest rates cannot be sustained, and that policymakers prefer consumer price inflation to asset price deflation. Watch out for the volatility as global imbalances are revealed and then corrected. ●

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