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The Gold Standard under a Free Banking System: The Uruguayan Experience

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ABSTRACT

One of the main findings of the Gold Standard literature of the last decades has been to dispel the myth that central banks abided by the so-called "rules of the game". These rules required that they act to change the money supply in the same direction as gold flows, thus ensuring paper currency was always backed by a gold and guaranteeing fixed exchange rates. This, however, would have forced these countries to expose the domestic economy to the vicissitudes of balance of trade shocks. What economic historians in fact have found is that central banks in many countries shielded their economies from external shocks by sterilizing gold inflows and by expanding domestic credit when facing gold drains (Bloomfield, 1959: 27). Central banks were able to do this due to their monopoly on paper currency emission, which allowed them to, among other actions, manipulate the discount rate and affect the volume of credit. In countries without central banks, however, adjustments were processed through commercial banks, which "had less discretion than central banks and, indeed, were more wholehearted followers of the rules of the game, as popularly interpreted (Ford, 1989: 209)." This paper sheds doubt on this last assertion, through the study of Uruguay, a small, peripheral Gold Standard country with no central bank before 1907.

Uruguay was particularly open to external shocks due to its trade openness and dependence on capital inflows. However, the country managed to link its currency to gold at a fixed rate from 1876 until 1913, with only a brief departure during the 1890 crisis, after which it returned to gold backed currency at its previous par value. In fact,

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it was the only Latin American country to maintain the Gold Standard for more than a short period of time, a surprising fact considering it did not have anything resembling a central bank until 1907. Adhering to the "rules of the game" under the pre-1907 free banking system should have implied great sacrifice in terms of internal stability, since it faced mostly fixed prices for primary product exports and imports of capital and manufactured goods, external shocks would have been processed through largely through changes in employment, incomes and non-traded goods prices.

This paper explores how Uruguay was able to maintain a fixed exchange rate for so long, looking primarily at the banking sector, and the behavior of specific banks in terms of reserve management with respect to credit and bank created money. The main finding is that two of the most important private banks, —the Banco Comercial and the Uruguayan Branch of the London and River Plate Bank—, consistently broke the rules of the game, changing their volume of credit in the opposite direction as gold reserves. In doing so, they likely smoothed domestic volatility for their client base, the businessmen involved in international commerce. In this sense, they appear to have, in some ways, acted similar to the central banks in other Gold Standard countries.