

## BOOK REVIEWS

### **American Default: The Untold Story of FDR, the Supreme Court, and the Battle over Gold**

Sebastian Edwards

Princeton, N.J.: Princeton University Press, 2018, 252 pp.

Sebastian Edwards has written a very important book on a monumental episode in U.S. history, the great debt default of 1933–35, which was a true turning point in American political and economic history. The episode belies myths that Americans construct about their history: America has strong protection of private property rights, is bound by the rule of law, and pays its debts.

Between 1933 and 1935, a series of events and actions culminated in default on U.S. sovereign debt and corresponding forced defaults on private debts. In recounting that story, Edwards proceeds at a fast pace, as the events themselves did. He writes well, and, at times, the book reads like a novel.

Edwards reprises the period 1929–32 and then moves into the presidential campaign in full swing by March 1932. It's mostly about FDR and campaign staff and advisers because, incredibly, President Hoover did not campaign until very late. At the core of FDR's advisers were professors constituting the "Brain Trust," mainly Raymond Moley, Rexford Guy Tugwell, and Adolfe Berle. FDR leaned on them heavily. As Edwards makes clear, however, they knew little about the issues they would be facing (such as gold and foreign exchange).

It was not at all clear in early 1932 that the gold standard was a problem for America. Jacob Viner had pointed out that the United

States had the largest stock of gold in the world. The percentage of monetary liabilities backed by gold holdings at the Federal Reserve exceeded the statutory requirements of 40 percent. Between then and Election Day (November 8, 1932), all that would change.

What changed everything, of course, was that the Federal Reserve never acted to stem the crushing price deflation and tumbling economic activity. Nor did the Fed do anything effective to address the banking crisis. The crumbling banking system would force political action. And the political forces of the day, conservative, populist, and just plain self-serving, would shape the course those actions took.

The “do nothing” tag on Herbert Hoover is incorrect. He conceived and even had a blueprint drawn up for a bank holiday to stop bank closures. However, he let his attorney general and the Fed board of governors dissuade him from the plan. FDR adopted the idea and even used Hoover’s blueprint.

When a new wave of bank failures hit in October 1932, neither the outgoing nor the incoming administration had a plan to save the banks. Compounding this, the interregnum between Election Day and the presidential inauguration was much longer than now. Inauguration Day was March 4, 1933. Hoover was paralyzed by events, and FDR was not ready to act. Edwards effectively describes the situation on the eve of Inauguration Day: “the largest democracy in the world had no banking system to speak of. It appeared that both New York state and Illinois would have to declare banking holidays to stem the outflow of metal.”

Roosevelt used Hoover’s Treasury team (along with his own) to come up with a plan over the weekend of March 4–5. By presidential proclamation, all banks were temporarily closed. As the plan evolved during the following week, banks were classified into three categories: A (opened immediately after the bank holiday); B (in need of recapitalization); and C (to be closed permanently). By March 29, banks with an estimated 90 percent of deposits had reopened. Critically, the Federal Reserve acted as lender of last resort in this period, while the Reconstruction Finance Corporation supplied capital in the form of preferred stock purchases. The banking crisis ended.

In the meantime, Congress quickly passed the Emergency Banking Act to give legislative backing to FDR’s proclamation, which was made under the Trading with the Enemy Act of 1917. The Banking Act contained a provision giving the government the

authority to decree a gold embargo. It was intended to spur depositors to return gold to the banking system. It did not work.

A series of domestic political and international monetary events began forcing FDR's hand and set in motion a move off the gold standard. A call to remonetize silver galvanized the administration into action. Even those calling for "moderate inflation" were horrified by the prospect of remonetizing silver. Support for inflation was growing in Congress, however, so the administration sought a way to end the deflation, allow for moderate inflation, but avoid unleashing uncontrolled inflation. Debtor relief was the motivation.

The reader may wonder where the Fed fit into this story. The startling answer is almost nowhere. With all the calls for inflation, almost no one thought the central bank might play a role. As I noted earlier, the "Brain Trust" had no background in such matters. People like Irving Fisher were kept on the fringe of the debates. The stalking horse for the inflationists was the agriculture bill. In truth, most of the political forces asking for inflation were seeking a rise in commodity prices, especially agricultural prices. That was certainly true of FDR. In general, monetary policy debates of the time were dominated by monetary cranks and the otherwise uninformed. Politics ruled over economics.

Executive Order 6111 banned gold exports and called into question gold clauses in debt contracts. Gold clauses went back to the Civil War period when the dollar's link to specie was broken. Gold clauses began to be inserted into debt contracts to ensure that creditors would be paid in undepreciated currency. The clauses did not require that creditors actually be paid in gold but in dollar equivalents of a stated amount of gold. No one expected that most debt would in fact be paid in gold. The purpose of the clauses was to curb government's propensity to inflate. And, indeed, the clauses worked. All of this would be important in the *Gold Clause Cases* the Supreme Court heard in 1935.

I'll skip over an extended discussion of the chapter on the London Monetary and Economic Conference of 1933—a critically important conference that might have restored the international monetary order. In what some may see as an anticipation of current events, FDR was not inclined to multilateralism at the time. He preferred bilateral negotiations. FDR would pull the rug out from under his trusted adviser and delegate to the conference, Raymond Moley, who later resigned.

The cases challenging the invalidation of the gold clause were making their way through the court system and would eventually be combined in the *Gold Clause Cases*. They involved different legal issues and presented different fact patterns, including different questions of legal standing and computation of damages. There were American holders of U.S. Treasury debt; foreign holders of U.S. Treasury debt; American holders of domestic, private debt; and foreign holders of U.S. private debt. All had gold clauses.

Creditors and debtors alike were in limbo. There was growing uncertainty in debt markets. Everyone had a reason for the legal issues to be resolved. The resulting Supreme Court cases occupy the heart of the book. I commend Edwards for his command of the legal issues and his ability to render them intelligible to the reader.

There is no question that the U.S. government defaulted on its sovereign debt and that it compelled private issuers to default by voiding the gold clauses. The violation of a material covenant in a debt instrument constitutes a default. Creditors can take legal action, including forcing bankruptcy, after default in private debt cases. The gold clauses were certainly material to the debt instruments that contained them. So there was only one central legal issue in these cases: Did Congress have the legal authority to annul contracts?

The government's case rested on Article I, Section 8 of the U.S. Constitution, which gives Congress the power to "coin money [and] regulate the value thereof." However, invoking that clause begged the question of what to do about existing contracts. Even the dissenting justices acknowledged that the government could change the gold content of the dollar. Again, the issue was whether Congress could alter existing contracts.

The Supreme Court found, by a 5–4 vote, that abrogation of the gold clauses in private debt contracts was constitutional. By a vote of 8 to 1, however, the Court found that the congressional joint resolution abrogating the gold clause in public debt was unconstitutional, meaning the government lost the public debt cases on its primary argument. Then, in a 5–4 vote, the Court ruled in favor of the government's secondary argument: holders of U.S. debt had suffered no losses because they were paid in dollars whose value had increased by 1933. Deflation saved the government's day.

In my view, the Supreme Court decided on pragmatic grounds. As Edwards indicates, it did so to avoid a head-on clash between two

branches of government. That was only delayed, not avoided. The Court left no clear legal precedent on the primary constitutional question.

Edwards deals ably with the economic consequences. He makes a case that monetary easing in 1934 occurred because of the gold clause decision. But easing had always been in the Fed's power, even with the gold standard. There is no question that the United States had joined the long list of defaulting governments. Near-term recovery, which was not permanent, came at a long-run cost.

Edwards's interest in this important U.S. episode stemmed from his experience with the Argentine debt default of 2002. The facts differ, but the legal and economic issues are similar. The U.S. government of 1933 had borrowed in gold dollars and wanted to pay back in paper dollars (to simplify). The Argentine government had borrowed in dollars and wanted to pay back in pesos. Both governments argued economic necessity. The United States litigated in its own court system and won as a practical matter. Argentina litigated in international arbitration panels and lost. One could easily conclude that there are different rules for large and small countries.

Referencing Reinhart and Rogoff's *This Time Is Different*, Edwards observes that "sovereign debt restructurings constitute a never-ending story, which repeats itself with an astonishing degree of circularity." I highly recommend *American Default*. It is more than compelling history; it is a tract for our times.

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### **The Virtue of Nationalism**

Yoram Hazony

New York: Basic Books, 2018, 304 pp.

In his eloquent and ambitious defense of the virtues of nationalism, Yoram Hazony has a clear political target: the "emerging liberal construction" that opposes the idea that nations should have their "unique laws, traditions, and policies." Hazony wants to make nationalism great again, so to speak, and he considers the global elite unduly biased against it. By his account, the self-absorbed cosmopolitan advocates of effacing national diversities and specificities are