INTRODUCTION

This is the story of a forgotten episode in U.S. history, the story of the great debt default of 1933–1935, of the time when the White House, Congress, and the Supreme Court agreed to wipe out more than 40 percent of public and private debts. This is also the story of the nation’s efforts to get out of the Great Depression, bring deflation to an end, and get people back to work. It is the story of how the three major powers of the time—the United States, the United Kingdom, and France—failed to agree on policies that would have sped up the recovery and reduced the suffering of millions of their citizens. It is the tale of how perplexed economists changed their views about the world, and discarded decades-old tenets and dogmas. Finally, it is an account of the early stages of the struggle between President Franklin Delano Roosevelt and Supreme Court Chief Justice Charles Evans Hughes, a confrontation that led to the president’s attempt to pack the Supreme Court in February 1937.

There are many ways of telling this story. For instance, we could begin in October 1929, when the stock market crashed and the Great Depression was unleashed. Or we could begin on November 8, 1932, when American voters decided to turn their backs on Herbert Hoover and elected Franklin D. Roosevelt by a landslide. But possibly, the best starting point is April 5, 1933, when President Roosevelt, who had been in office for exactly one month, issued an Executive Order requiring people and businesses to sell, within three weeks, all their gold holdings to the government at the official price of $20.67 per ounce. The Order was published in every newspaper and transmitted over thousands of radio stations. Large signs were placed in post offices around the country. The posters were printed in large block letters and informed the public that everyone had “to deliver on or before May 1, 1933, all gold coin, gold bullion and gold certificates now owned by them to a Federal Reserve Bank, branch or agency.”

The notice stated that there were only four exceptions to the president’s directive: each person could keep gold coin or certificate not exceeding $100 in value; industry and the arts could maintain enough metal as “may
be required for legitimate and customary use”; financial institutions were allowed to hold gold in trust for a foreign central bank; and gold involved in “proper transactions” approved by the Treasury could be held temporarily by financial institutions. Those who didn’t comply with the Executive Order faced “criminal penalties . . . [a] $10,000 fine or ten years of imprisonment, or both.”

The public was shocked. Throughout the history of the nation, gold had been used as a store of value, and many families owned gold coins as part of their savings. Gold was given as wedding presents and at bar mitzvahs, and newborns often received a gift of one or two coins from their godparents. The fact that all metal had to be turned in to a relatively new institution—the Federal Reserve had been created less than twenty years earlier—made things even worse.

As the May 1 deadline approached, radio announcers reminded families of what they had to do. People could still not believe what was happening. It was true that during the previous months there had been an extraordinarily high demand for the metal and that hoarding had increased sharply, but that was exactly how the system was supposed to work: from time immemorial people resorted to gold when they faced economic uncertainty, including fears of banks’ collapses.

In the early hours of March 6, when he had been barely one day in office, President Roosevelt declared a national banking holiday. Its purpose was to stop massive withdrawals of currency and gold, and to put in place an emergency plan to strengthen the nation’s financial system. A week later, on March 13, banks began to reopen their doors, and people redeposited their cash and gold in massive amounts. Confidence was on the upswing after President Roosevelt delivered his first Fireside Chat on Sunday March 12. FDR assured the public that those banks that were reopened were solid and in excellent health. As the president had predicted, people were again “glad to have their money where it will be safely taken care of.”

So, if things were improving, why was the government forcing the public to part with their gold? Coercing people to sell their hard-earned metal was not an American thing to do. This had never happened before, not even during the Civil War, when the gold standard was suspended and the Treasury issued “greenbacks.”

The secretary of the treasury, Will Woodin, a small and affable man and lifelong Republican who loved music and had composed a number of popular tunes, including “Raggedy Ann’s Sunny Songs,” tried to explain the
policy by saying that “gold in private hoards serves no useful purpose under current circumstances. When added to the stock of the Federal Reserve Banks it serves as a basis for currency and credit. This further strengthening of the banking structure adds to its power of service toward recovery.”

The weeks that followed changed America forever. On March 5, after President Roosevelt convened Congress into an Extraordinary Session, the legendary “Hundred Days” began. Between March and June, 1933, Congress passed legislation that would fundamentally alter the way the economy functioned, and set the bases for the welfare state. Some of this legislation was later challenged in the courts system, and some was eventually declared unconstitutional by the Supreme Court. There is little doubt, however, that these feverish weeks of continuous debate and lawmaking planted the seeds of a new America, a country where the federal government would take an active role in economic and social affairs, a nation that would create an intricate safety net for the poor, the unemployed, and the disadvantaged.

While the foundations of the American economy were being profoundly changed by one act of Congress after another, the gold saga initiated with the April 5 Executive Order continued to unfold. On April 19, during the thirteenth press conference of his young presidency, President Roosevelt stated unequivocally that the country was now off the gold standard. He explained that the fundamental goal of abandoning the monetary system that had prevailed since Independence was to help the agricultural sector, which had been struggling for over a decade. He declared: “The whole problem before us is to raise commodity prices.”

The next step in this drama came on May 12 when Congress passed the Agricultural Adjustment Act (AAA). Title III of this legislation included the “Thomas Amendment,” which authorized the president to increase the official price of gold to up to $41.34 an ounce. A devaluation of the dollar, many thought, would rapidly result in “controlled inflation” and would help farmers by raising commodity prices and by lightening their debts when expressed in relation to their incomes. A number of experts noted that Great Britain had devalued the pound in September 1931, and had slowly begun to recover.

Things, however, were not as easy as they seemed. In the United States, most debt contracts—both private and public—including a “gold clause,” stating that the debtor committed himself to paying back in “gold coin.”
These clauses were introduced into contracts during the Civil War, a time when two currencies circulated side by side—a currency backed by bullion and one unbacked, the so-called greenbacks issued by the Union’s Treasury. Debts that included the gold clause were considered to be more secure, since the amount to be received in payment at some future date was anchored to the price of gold and, thus, not affected by possible changes in the purchasing power of paper money. After the end of the Civil War there had been no need to invoke them, but with time gold clauses came to be considered a “normal” component of debt contracts; it became customary to include them in corporate and utilities bonds, and in many mortgage contracts. In 1933, however, it became evident that these clauses were a problem. If the currency was devalued with respect to gold, the dollar value of debts subject to the clauses would automatically...
increase by the amount of the devaluation. This would result in massive bankruptcies and in a huge increase in the public debt. For all practical purposes, then, when FDR was inaugurated as president the “gold clauses” stood in the way of a devaluation of the dollar.

Three months after Roosevelt had become president, on June 5, Congress passed Joint Resolution No. 10, annulling all gold clauses from future and past contracts. This opened the door for a possible devaluation. Republicans were dismayed and argued that the nation’s reputation was at risk. The government, on the other hand, claimed that the Joint Resolution didn’t imply “a repudiation of contracts.” The secretary of the treasury stated that since gold payments had been suspended in April, all Congress had done was clarify that “the holder of an obligation cannot specify in what type of currency [gold or paper money] the contract is payable.” He was quick to state that the annulment of the gold clause “from all contracts and obligations, public and private, should have no depreciating effect on their value.”

On January 31, 1934, the other shoe dropped when President Roosevelt officially devalued the dollar by fixing the new price of gold at $35 an ounce, an increase of 69 percent relative to its century-old price of $20.67 an ounce. Conservatives deplored the decision, and argued that it would inevitably lead to a steep decline in America’s power. Others, including the farm lobby, were disappointed by what they considered an insufficient adjustment in the value of the dollar. In explaining the decision, FDR said that the devaluation was necessary, since the nation had been “adversely affected by virtue of the depreciation in the value of currencies to other Governments in relation to the present standard of value.” Many considered this to be a direct reference to the devaluation of Sterling.

Not surprisingly, those who had purchased securities protected by the gold clause claimed that the Joint Resolution of June 1933 was unconstitutional. Various lawsuits were filed and made their way through the courts system. Four of them got to the Supreme Court, and were heard between January 8 and January 10, 1935. Two had to do with private debts, and two with public obligations. The most salient case involved a government bond in the series of the Fourth Liberty Loan issued on October 15, 1918. The obligation for this “4¼% Gold Bond” expressly stipulated that “the principal and interest hereof are payable in United States gold coin of the present standard of value” (Perry v. United States). The question before the Court was whether Congress had the constitutional power to
alter contracts retroactively. Could Congress annul private and public debt promises and, in the process, affect the wealth of debtors and creditors? And if, in the opinion of the Court, Congress had exceeded its power, what were the damages?

On February 18, 1935, the Supreme Court announced its decision. In all cases the Court voted 5 to 4 in favor of the government position. The majority’s opinions were written by Chief Justice Charles Evans Hughes, a distinguished jurist who had been governor of New York, secretary of state, and presidential candidate for the Republican Party in 1916.

There was a single dissent signed by the four conservative members of the Court, known as the “Four Horsemen.” When the time came to deliver the minority opinion, Justice James Clark McReynolds, a southern lawyer who favored bow ties and had served as attorney general during Woodrow Wilson’s first administration, decided to depart from protocol: instead of reading the prepared text he gave a short speech. He opened his remarks in a low tone. Slowly, he raised his voice and his southern tones quivered with anger. A minute into the speech he paused; it was a classical pregnant silence. He then said: “The Constitution as many of us understood it, the instrument that has meant so much to us, is gone.” He then talked about the sanctity of contracts, government obligations, and repudiation under the guise of law. It was clear, he stated, that Congress had the power “to adopt a monetary system. But because Congress may adopt a system, it doesn’t follow that this may be enforced in violation of existing contracts.” He ended his speech with strong words: “Shame and humiliation are upon us now. Moral and financial chaos may be confidently expected.”

COLLECTIVE AMNESIA

I became interested in the abrogation of the gold clauses some fifteen years ago when I received a phone call from a partner of a well-known New York law firm. He wanted to discuss Argentina’s devaluation and debt default of 2002. He had read some of my work on balance of payments crises, and he thought that I could help him with a case he was working on. During the years that followed, I wrote a number of expert reports on the Argentine crisis, and I collaborated with teams from several law firms in their efforts to get compensation for clients impacted by the Argentine devaluation and debt restructuring. The vast majority of these lawsuits...
involved the breaching of long-term contracts; Argentina unilaterally annulled contracts in dollars and rewrote them, retroactively, in pesos. We prevailed in every one of these cases; arbitration tribunals ruled, repeatedly, that Argentina had some responsibility in the unleashing of the crisis and, thus, had to compensate claimants—mostly large international companies—for damages.

In 1991, and as a way of ending a bout of hyperinflation, the Argentine government adopted a fixed exchange rate regime that pegged the value of the peso to the dollar at parity: one peso was equal to one dollar. In addition, it prohibited the central bank from issuing pesos without foreign exchange backing. This system was supposed to work in a way similar to the traditional gold standard, and its main purpose was to eliminate currency uncertainty and risk. As a way to add credibility to the new regime, a law forbade contracts from including clauses that indexed prices, wages, and other payments to past domestic inflation. Instead, most long-term contracts—and in particular contracts involving massive investments in infrastructure—were denominated in U.S. dollars. These measures were part of an ambitious program to stabilize the Argentine economy, attract foreign investors, and reignite growth after more than a decade of stagnation, high inflation, and instability. However, the plan—known as the “Convertibility Plan”—ran into serious problems, and barely lasted a decade. In late 2001, Argentina defaulted on its debt—it ended up paying twenty-three cents on the dollar—and in early 2002 the fixed exchange rate regime ended.

In a matter of weeks, the exchange rate jumped from one peso per dollar to over three pesos per dollar. After the devaluation, the government decided to alter contracts retroactively, and to “pesify” them: instead of dollars, contracts were unilaterally rewritten in pesos at the original one-to-one parity. This resulted in huge losses to investors and savers. International public utilities, construction companies, and financial institutions that had made large long-term investments in Argentina were seriously affected.

From early on, a particular aspect of Argentina’s legal argument attracted my attention. According to Argentine lawyers, the annulment of contracts that followed the devaluation of the peso in 2002 had a historical precedent in the United States in the 1930s. Argentina’s legal team noted that in June 1933, and in preparation for the devaluation of the dollar that eventually took place in January 1934, the Roosevelt
administration unilaterally and retroactively changed the currency of
denomination of public and private debt contracts. The Argentine
lawyers noted that in 1935 the U.S. Supreme Court had sided with the
government.12

Argentina’s legal point was simple: if the United States’ abrogation of
the “gold clauses” in 1933 was legal, so was Argentina’s own rescinding
of the “dollar clauses” in 2002.

I was vaguely aware of Congress’s 1933 Joint Resolution that changed
the currency of denomination of contracts, but I did not know the details
surrounding the episode, nor did I know the reasons given by the Supreme
Court when it supported the government’s position. I decided to ask some
colleagues whose field was macroeconomics about what had actually hap-
pened. To my surprise, almost no one knew details; in fact, some promi-
inent scholars were not even aware that this had occurred. I then turned
to Milton Friedman and Anna Schwartz’s encyclopedic A Monetary History
of the United States, 1867–1960 and discovered that in spite of their detailed
analysis of the Great Depression they mentioned the nullification of gold
contracts only in passing. Consultation of Allan Meltzer’s magnificent
A History of the Federal Reserve yielded a similar result. This 800-page
ouevre covered the episode only briefly.

I found this situation fascinating: only seventy years before Argentina
devalued its currency and rewrote contracts retroactively—an action
denounced by U.S. politicians and editorialists as openly populist and
illegal—the United States had gone through a similar process. Yet, almost
no one remembered this important chapter in U.S. financial history. It
seemed to me that the nation had gone through a process of collective
amnesia, and had decided to forget an episode that did not live up to
the vision that Americans have of their country: in the United States we
respect the law, contracts are sacred, and we have never defaulted or re-
structured the federal debt.13

As I dug more deeply, I discovered two things: The Supreme Court rul-
ing was extremely controversial during its time. In 1935, some analysts
even asserted that it meant the end of the rule of law. In many ways, the
ruling presaged the clash between the Court and President Roosevelt that
was to take place during the next two years, and that led FDR to attempt
stacking the Court in February 1937. I also discovered that although
there was no in-depth study of the episode, a small number of economic
historians were well aware of it, and had strong views about its significance and consequences. Many of them—the vast majority, I would say—thought that annulling gold-denominated contracts retroactively had contributed to the end of the Great Depression. According to these experts, this action had facilitated the abandonment of the gold standard and the devaluation of the dollar, and in this way had helped generate large inflows of gold between 1934 and early 1937. According to the dominant view on the Great Depression—a view supported by scholars such as Milton Friedman, Ben Bernanke, and Christina Romer, among others—this inflow of gold allowed the Fed to increase the supply of money and credit, and thus contributed to the increase in output and the decline in unemployment after 1933. It appeared to me that most of these scholars would have sided with Argentina during the legal proceedings that followed the 2002 default and devaluation.

In the years that followed, and as I worked my way through the literature and several archives, I became convinced that the abrogation could not be addressed in isolation. It was necessary to tell the complete and complex story on how the United States decided to abandon the gold standard and devalue the dollar. With the passage of time, the popular version of the episode has been simplified and sanitized, and many people—including many academic economists—believe that the decision was clean and straightforward.

Nothing was further from the truth.

The path to devaluation was tortuous and long—full of impediments, intellectual battles, uncertainties, and unknowns. In 1933, economists did not quite understand what was going on, and many of their theories were unable to explain some of the basic developments of the period. The politics of the devaluation were extremely complex, and the personalities of some of the main players made the episode perilous and at times explosive.

In trying to reconstruct the intricate paths that led to the abrogation of the gold clauses, I found myself, again and again, delving into the historical details of that era; some of these details are related to politics and international relations, and others to economic reform, including changes in monetary policy. Hopefully, the reader will find out that what may appear to be only side discussions are actually necessary to provide adequate background on what really happened during that intense year of 1933.
Here are some of the many questions that sprung into my mind as I plowed into the archives and analyzed the historical data:

- Was the abrogation a partial default on the government debt, or could it be described in any other way?
- Did it create a serious confidence crisis, as Supreme Court Justice James Clark McReynolds wrote in his minority opinion?
- How did investors, both domestic and international, react to this event?
- Was this a necessary step prior to abandoning the gold standard?
- What were the roles of academic economists, politicians, and the president himself during this episode?
- Was it true that, as argued by Friedman and Schwartz, “the nationalization of gold, [and] the abrogation of the gold clauses . . . had the opposite effects [from the devaluation of the dollar] by discouraging business investment”? Could it happen again in the United States or in other nations?

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During this book’s long gestation, I had the good fortune to discuss the gold standard and the issues surrounding the abrogation of the gold clauses with a number of extraordinary individuals. Slowly, they educated me and opened my eyes to the fascinating world of the Great Depression. During 2004 and 2005, I had several conversations with Milton Friedman on monetary policy during the 1930s, one of the subjects that made him famous and that was cited by the committee that awarded him the Prize in Economic Science in Memory of Alfred Nobel. At the time, we were both members of California governor Arnold Schwarzenegger’s Council of Economic Advisers. The Council met regularly in Sacramento, and during coffee breaks I would ask Milton questions, listen to his answers, and take detailed notes. We talked about the Fed, silver, the velocity of money, and open market operations. He told me some anecdotes about the discussions that surrounded the gold-clause debates in the 1930s, and directed me to what to read. Throughout those conversations Milton stood by what he had written forty years earlier: in his view the retroactive nullification of private and public contracts had introduced uncertainty, and had
been detrimental for the nation. I also had the fortune of talking about these issues with Anna Schwartz. We would meet at the National Bureau of Economic Research Summer Institute, and Anna would illuminate me by telling me what she thought about the subject. She was generous enough as to send me copies of some of her own notes on the abrogation, including a memorandum she had prepared for a law firm in the 1980s. Allan Meltzer helped me clarify my thinking on the role of the Federal Reserve during long conversations in different places. The instance I remember most vividly was a long hike in Jackson Hole. Otmar Issing was with us, and he provided many deep thoughts from a German and European perspective. When we came back to the lodge, I rushed to put down in my notebook everything I had heard.

The economic history fraternity has been generous, and has been willing to accept an outsider into their ranks. In particular, I have benefitted from long discussions with Michael Bordo. As always, my conversations with Ed Leamer—often while driving to UCLA football games at the Rose Bowl—have been illuminating; he asked difficult questions, ventured explanations to some of the puzzles that kept me awake, and raised important methodological issues. Doug Irwin read an almost complete draft of the manuscript, and made extremely useful suggestions. Daniel Artana made helpful comments to an earlier draft. Conversations with George Tavlas helped me clarify the role of the Chicago School during the policy debates of 1933–1935. The late Craufurd Goodwin forced me to think deeply about the role played by the members of the advisory group known as the “Brains Trust” during the events discussed in this book. Throughout the years I benefitted from conversations and exchanges with a number of colleagues. Although many of them may not have been aware of it at the time, they provided invaluable insights into my understanding of the topic of this book. In particular, I enjoyed talking to Randy Kroszner, Tom Davis, Jerry Jordan, Adam Posen, José de Gregorio, Barry Eichengreen, Charles Calomiris, Andy Atkeson, Guillermo Calvo, Gene White, Alan Taylor, Al Harberger, Harald Beyer, Angel Soto, Pablo Guidotti, Dora Costa, Alejandra Cox, David Romer, Jerry Nickelsburg, Liaquat Ahmed, Eric Rauchway, Carmen Reinhart, Scott Sumner, and Chris Meissner. I thank my co-authors Francis Longstaff and Alvaro García Marín. I thank Jill Harris and Jay Boggis for their help during the editing process. The book is much better because of them. I am grateful to the Center for Global Management, at UCLA’s Anderson Graduate School
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