

PART V
THE MONETARY FACTOR

CHAPTER I
THE MONEY LINK WITH AMERICA

WHEN once the war was over, it was obviously impracticable to continue for long pegging the American exchange by means of dollars borrowed from the United States Government. On 20th March 1919, therefore, it was announced that the exchange would no longer be officially supported — that the peg at 4.76 dollars to the pound would be removed. During the war the export of gold by private persons had been stopped by the fear of enemy action at sea and the refusal of the Government to insure gold cargoes. After the Armistice, for the first few months export was still “practically prohibited by the power of the Bank of England working through the patriotism of those through whom the export would be carried out”¹. With the prospect of very high profits from exporting gold, which would appear should the exchange, once unpegged, fall seriously, it would not have been feasible by indirect methods to prevent a large gold outflow. But, if such an outflow took place then, in spite of the fact that as yet no limit was imposed on the issue of fiduciary notes,² the Bank could hardly have refrained from protecting its gold reserve by imposing a high discount rate, and so bringing about a severe restriction of credit. To allow such a state of things to develop in the dawn of peace, with

¹ *Economist*, 5th April 1919, p. 553.

² On 15th December 1919 a limit was fixed by Treasury Minute; cf. Chapter V.

a substantial part of the army still being demobilised, would have been very dangerous. On 31st March, therefore, an Order in Council (valid till the ratification of the Peace Treaty, but thereafter needing renewal by Parliamentary action) was promulgated, prohibiting the export of gold coin and bullion. The Gold Standard was thus formally abandoned, and the sharp rein which its maintenance might, indeed must, have imposed on a liberal credit policy was cut. Nobody has questioned that, in the circumstances, the Government was bound to take this step. Mr. Hawtrey has put the case conclusively: "If notes remained convertible into gold and all obstacles to the export of gold were removed, the exchange would be supported by a limited gold reserve instead of by an unlimited supply of dollars. It looked as if, in that case, only a very severe restriction of credit would save the gold reserve from early exhaustion. To start peace with a trade depression seemed an appalling prospect."¹ Though, however, the Government decision was, on the facts, undoubtedly a wise one, it was responsible for some unfortunate consequences, the nature of which and the way of their happening we shall have presently to describe. The dilemma in which the Government was placed is not, as will be realised, one that could recur. Since Great Britain had been off the Gold Standard since 1931 and the Bank of England was no longer under obligation to give gold in exchange for notes, the Government could not at the end of the second war be confronted with the situation which obtained in March 1919. Should, however, a strong opinion have grown up that the rate of 4.03 dollars to the pound, which was maintained throughout the course of this war, had somehow become sacrosanct, a new very similar dilemma might have to be faced.

At about the time when the hesitancy of the Breathing

¹ *Currency and Credit*, p. 407.

Space ended in this country, it ended also in the United States. There prices turned gently upwards in February 1919. In England, according to the *Statist* index number, the turn came a little later, but was more marked. In general terms, in both countries prices turned upward in the spring. In June the United States embargo on the export of gold was removed, so that the Dollar Standard and the Gold Standard were henceforward the same thing. During the Boom that followed, English prices ran considerably ahead of American prices and, in general, the monetary Boom was more intense here. Thus between April 1919 and April 1920, while the American Bureau of Labour index number rose by 34 per cent, the *Statist* number rose by 44 per cent. If we use the Federal Reserve Board indices, which are specially designed to facilitate international comparisons, we find the American aggregate index rising 33 per cent, against 56 per cent for the English aggregate index. This relative price movement was accompanied by a fall in the New York exchange between the two Apriks from 4.65 dollars to the pound to 3.91, *i.e.* in the ratio of 100 to 84.¹ Plainly, if the Gold Standard had not been abandoned, this lapse in the exchange would have had to be resisted by a more stringent credit policy, which would have prevented the monetary expansion, and so the price rise, from being carried in this country so far as they were in fact carried. Thus the prohibition of gold export, which had been imposed to safeguard us against the risk of enforced monetary contraction, turned out, in consequence of the American Boom, to have been unnecessary for that purpose. It removed a restraining influence, which would not in fact have enforced contraction but would have limited expansion — would have

¹ The normally excellent series of statistics printed in the London and Cambridge Economic Service contains large errors for the New York exchange in respect of a number of months in 1919 and 1920.

prevented it from outstripping, as actually it did, the contemporaneous expansion in the United States. Thus the abandonment of the Gold Standard here, in March 1919, was responsible for the post-war monetary expansion being extended further, and the price level rising higher — perhaps some 15 per cent higher — than would have happened had the Gold Standard been retained. The breaking of the monetary link with America had that immediate consequence.

But this is not the end of the story. Though in March 1919 the British Government deliberately broke that link, it only did so with the firm intention of forging it again in the near future. Its avowed policy was to re-establish our country on a gold basis at the pre-war parity as soon as that should prove practicable. This policy, which at the time was endorsed by nearly all persons of authority, dominated the outlook of the Treasury and the Bank of England over the whole of our period, until in April 1925 it was finally carried into effect. This meant that the state of the American exchange, rather than the industrial situation at home, was their principal preoccupation. A necessary preliminary to the restoration of the Gold Standard was to bring the exchange back to the neighbourhood of par. When it began to run away, measures had to be taken to arrest it; when it tended to stand still, further measures to improve it. These measures took the form of operations on the discount rate and Bank dealings in securities aimed at reducing the English, relatively to the American, price level. When that price level was itself falling, this entailed reducing our own price level in an absolute sense and in a greater degree. Any restrictive action which the Americans took we must take also; and, even when they did not take any, we, to make up our leeway, had, nevertheless, to take some.

Already in November 1919, when the exchange rate

was down nearly to 4 dollars, the British authorities had raised the Bank rate to 6 per cent. In January 1920 the New York Federal Reserve Board put up its re-discount rate to the same figure. Neither rise proved effective in stopping monetary expansion. The Bank of England discount rate was raised to 7 per cent on 15th April, and the New York Federal Reserve Bank's re-discount rate again followed on 1st June. These rises were the immediate prelude to a down-turn in prices. As Mr. Hawtrey has put it: "America and England alike were involved in the inflation of 1919-20, and resorted, almost simultaneously, to a ruthless credit restriction in 1920-21".¹ Prices in both countries fell rapidly. But nevertheless, in spite of a mounting volume of unemployment, the high rates were not relaxed in either country for a year. At last, on 28th April 1921, the Bank of England reduced its rate to 6½ per cent, and the New York Federal Reserve Bank re-discount rate followed in May. From now onwards both the English and the American rates were reduced by steps. But England presently began to lag behind. In November the Federal Reserve Board's re-discount rate was down to 4½ per cent, but the Bank of England did not follow in full measure. On 3rd November our rate fell to 5 per cent, and finished the year at that figure.

The lag in the fall of our Bank rate, coupled with the fact that during the Boom the up-swing of prices had been substantially larger in England than in the United States, naturally suggests that the subsequent down-swing in reaction from it would be more than proportionately larger. But things did not work out so. According to the index numbers prepared for international comparisons by the United States Federal Board, English wholesale prices turned down in May or June, United States wholesale prices in June. The down-swing of American prices had

¹ *Trade Depression and the Way Out*, p. 21.

carried them, by April 1921, to 27 per cent below their level in April 1919, while as yet English prices had only passed below their then level to the extent of 4 per cent. However, between April 1921 and the end of the year, English prices fell more rapidly than American, so that in December 1921 they were 20 per cent below their April 1919 level, American prices being now down to 29 per cent below theirs. The relative fall in English prices which this movement implies was accompanied by a substantial improvement in the exchange during the latter half of the year.

During the first half of 1922 American prices recovered, while English prices remained substantially steady, with the result that, by July 1922, both price indices stood at about 80 per cent of their level in April 1919. With American prices thus rising and the exchange improving, the Bank of England discount rate, as we have seen, was reduced to 5 per cent in November 1921, fell further to $4\frac{1}{2}$ per cent in February 1922, and then by steps to 3 per cent in July; at which level it remained for a year. Between July 1922 and the end of the year, English prices fell to 77 per cent of their April 1919 level, while American prices remained steady. In December 1922, the last month of what I have called the Slump, the New York exchange stood at 4.61 dollars to the pound. Thereafter for two and a half years the two sets of prices did not alter much, either relatively to one another or absolutely.

At the end of 1922, when this country entered the Doldrums, credit in the United States was expanding, with a good employment situation. Memories of the post-war Boom bred anxiety, and the Federal Reserve Board of New York in February 1923 raised its re-discount rate to $4\frac{1}{2}$ per cent. From March 1923 the exchange, which in that month had reached the high level of 4.70, began to fall; in June it had reached 4.61. Thereupon in July the Bank

rate was put up to 4 per cent. " In the following months, however, Bank rate was not made effective. The market rate of discount dropped almost to 3 per cent. . . . On the whole, despite the rise of Bank rate in 1923, the exchange had been sacrificed to the trade revival."¹ This policy justified itself when, by successive stages in May, June and August, the New York re-discount rate was brought down again to 3 per cent. For, to have followed the rate up and then immediately afterwards down would have created an unnecessary disturbance. Now, however, the goal of a restored Gold Standard was in sight. In July 1924 pressure was applied by the Bank of England, which drove the market rate up to $3\frac{5}{8}$ or $3\frac{3}{4}$ per cent. Very little effect seems to have been produced on our price indices. But this was the month in which partial recovery in employment gave way, as was shown in Part II, Chapter III, to renewed depression. The exchange at the same time rose, helped up by speculative anticipations of a return to par. At the end of February 1925 the New York re-discount rate was raised again to $3\frac{1}{2}$ per cent. Thereupon the Bank rate here was put up to 5 per cent to prepare the way for the — as it was thought — final return to the Gold Standard in April. On the 27th of that month the Chancellor of the Exchequer announced that the Bank of England would sell gold for export without restriction at the coinage price of £3 : 17s. 10½d. a standard ounce. Early in May the Gold Standard Act was passed. With subsequent happenings we have not here to do.

¹ Hawtrey, *Currency and Credit*, p. 437.