CHAPTER V

CAUSES AND CONDITIONS OF THE MONETARY SLUMP

Booms during the course of great wars can never break down into slumps, because, on the one hand, a warring government's demand for money to use is insatiable, irrespective of the cost, and, on the other, inconvertible paper currency can be issued without limit, so that the banks are enabled to create any desired amount of credit without running the risk of being left without means to meet valid cheques drawn upon them. Peace-time booms, however, may and do come to an end, either through a check to the expectations that have hitherto led business men to seek and use money, or through a check to the readiness of bankers to supply it, or through a combination of both these things.

The suggestion has sometimes been made that the post-war Boom was stopped by deflation, in the sense of an absolute reduction in the quantity of bank money in existence. But in truth bank deposits, as represented by the deposits of the London clearing banks, did not contract. On the contrary, till August 1922, in all except three separated months, they were higher than they were in April 1920 at the peak of the Boom. It is true, of course, that *the rate at which they were increasing* became much less rapid than it had been; and this is an important fact. But the view that the Boom was broken and the Slump started by an absolute contraction in the supply of bank money is demonstrably incorrect.

It follows that the down-turn, and the subsequent rapid decline, which characterised the post-war Slump must have

been the result of happenings on the demand side, or, more precisely, of movements in the attitude of business men towards the prospect of returns from using money in industry. In their minds, and not anywhere else, the immediate cause of the Slump, like the immediate cause of the preceding Boom, resided.

This attitude of mind operated through decisions to turn over balances less rapidly, or, if we prefer it, to transfer money from active deposit to savings deposits, decisions which imply reducing the income velocity of money. For, while, with a certain amount of wobbling, the volume of deposits trended gently upwards till the middle of 1922, non-financial clearings took a definite down-turn in April 1920 and, thereafter, fell continuously for more than a year. According to the statistics prepared by Messrs. Phelps-Brown and Shackle, the velocity of the total cheque-paid non-financial circulation, *i.e.* roughly, non-financial clearings divided by current accounts, after a wobble round March, definitely turned down in July 1920, and thereafter fell steadily with scarcely a break till July 1921. It stood at 13·60 in April 1920 and at 10·49 (23 per cent less) a year later; at 13·61 in July 1920 and at 8·98 (34 per cent less) a year later. This velocity is, of course, a transaction, not an income, velocity; but, as was explained in Chapter II, during the period covered by the Slump the two sorts are likely to have changed in much the same proportion. However that may be, with the stock of deposits sensibly constant, it is clearly only through shifts in their income velocity that movements in the minds of business men could, and in the post-war Slump did, act upon money income, money expenditure and effective demand — three names, all of which for our present purpose mean substantially the same thing.

What then was it that swung the attitude of business men downward? It is sometimes suggested that the

dominant factor was a contraction in the sale of British goods abroad. This, however, was certainly not so in the early stages of the Slump. When normal seasonal changes are removed, the value of British exports did, indeed, reach its maximum in July 1920 and subsequently decline. But the decline was not extensive for some months; and in November we were still exporting a bigger value, and *a fortiori* a bigger quantity of goods, than in April. The *Economist* writes:[1] "Although trade depression developed seriously long before the end of the year, most branches of British industry engaged in the export trade were well occupied for almost the whole of 1920 in working off old orders. Thus the figures of overseas trade for the full year make a brave showing, and the effects of the depression, and of the long-continued fall in prices, were not very clearly reflected in the Board of Trade returns until January 1921. A summary of the value figures of imports, exports and re-exports in 1920, compared with 1919, reads as follows:

Class of Trade	Calendar Year		Increase or Decrease in 1920	
	1919	1920		
	£	£	£	%
Imports	1,626,156,212	1,936,742,120	+310,585,908	+19·1
British exports	798,638,362	1,335,569,027	+536,930,665	+67·1
Re-exports	164,746,315	222,405,957	+ 57,659,642	+34·9
Total exports	963,384,677	1,557,974,984	+594,590,307	+61·8

These figures refer to merchandise only."

At a later stage no doubt, as the whole world became more and more impoverished, the failure of foreign markets played its part in accentuating our own depression. Thus we also read in the *Economist*: "Our old customers are not producing that surplus of commodities which they

[1] *Economist*, 1921, p. 346.

used to produce and to exchange for British goods. Apart altogether from difficulties of exchange, the sugar and wheat and flax and timber and oil, which we used to receive from Eastern and Central Europe in payment for our exported goods, are not being produced in the old pre-war quantities. We cannot sell, because our customers cannot buy. In the Far Eastern markets, to which for twelve months in 1919 and 1920 we sold great quantities of textile goods at almost any price, the fall in silver and other causes have restricted purchasing power. China and India can no longer pay the prices which they paid up to six months ago. In the markets of South America and the Dominions our customers have satisfied their immediate necessities and now will not buy from us if they can obtain what they want at lower prices elsewhere. Competition, which for six years had been suspended, is returning to the overseas markets, and British goods cannot command war prices any longer. They have to be sold on their merits, in competition with American goods, and with goods which are being turned out by the reviving European countries, Belgium and Germany. We have within the last few months suddenly discovered that our cost of production is too high for our customers' willingness or capacity to pay. We have fewer customers than we had, and those who remain are poorer than they were. In the United States the same discovery has been made, and in the same way. Costs have gone up, production per man employed has gone down, and the consumer — at home and overseas — has struck. The immediate result is widespread unemployment. Existing stocks are being sacrificed, there is a great apparent fall in prices, but new goods are not being made. They cannot be made, under present conditions of cost, at prices which the world is now disposed to pay." [1]

But it was not misfortune abroad that first caused the

[1] *Ibid.* 1921, p. 159.

bright outlook upon which our business men had been gazing to darken, thus breaking the post-war Boom and ushering in the Slump.[1]

It was, I suggest, something much simpler. As we have seen, after the war there was an enormous mass of what we may call once-for-all work to be done. Huge losses of shipping awaited replacement. The capital equipment of railways and many industrial establishments had been allowed to deteriorate, and an immense amount of delayed work of maintenance and repair was called for. The stocks of many things in the hands of dealers and shopkeepers had perforce fallen very low and needed to be built up again. When these various tasks had been carried so far as it was found practicable to carry them, there was nothing obvious to take their place. It was as though the public had in a short once-for-all rush stocked itself with some new kind of durable commodity, such as motor cars or radio sets, and, thereafter, only called for the much smaller rate of output needed for replacements and for the small annual increment of new customers. In conditions such as these, at all events with industry organised as it was at that time, with no large scheme of public works to intervene and take up the slack, entrepreneurs would find their opportunity for using money to advantage cut down. Openings of which they had been availing themselves were no longer there to be exploited. This was the primary force at work.

But there was also something else. It has been urged strongly by Mr. Hawtrey that the down-turn in business expectations which took place in the spring of 1920 was directly due to monetary policy. As a prelude to a discussion of this thesis a brief reminder is needed of what that policy was. Throughout the summer and autumn of 1919 the Bank rate was maintained at 5 per cent, as it had been

[1] Cf. *ante*, Part III, Chapter I, section II.

since 15th April 1917. On 7th November 1919 it was raised to 6 per cent, while concurrently the Treasury bill rate on three and six months bills was raised to 5½ per cent. This was the first overt step towards arresting in peace-time that general expansionist tendency which during the war itself the authorities had, from time to time, checked, but had failed to bring to an end. A second step soon followed. In accordance with a recommendation made by the Cunliffe Committee on Currency and Finance in their Second Report on 3rd December, the Treasury, twelve days later, fixed for 1920 a maximum of £320 millions for the fiduciary issue of currency notes, and announced that this maximum would be reduced to £248 millions by 1924.[1] It also accepted the Committee's recommendation that henceforward the actual maximum fiduciary circulation of these notes in any one year should become the legal maximum of the following year. These rules, of course, did not fix a limit for the total note issue, since the Bank of England was still free to purchase gold and to issue notes based upon it: but the total issue had never been limited. In spite of these measures, the expansionist movement, as manifested in the various indices whose movements were described in Chapters II and III, continued. In the early part of 1920 bankers endeavoured to exercise a restraining influence by rationing credit to some extent among their customers. According to the *Economist* of 17th April some dealers in credit " had hoped that efforts lately made by the banks to check the demand for advances and to discriminate between them might have sufficed ".[2] But, in the view of the Treasury and the Bank of England, it did not suffice. They were stimulated to action by the fact that so many Treasury bills had been allowed to mature that a gap of £63 millions had to be

[1] Dearle, *An Economic Chronicle of the Great War*, p. 298.
[2] *Loc. cit.* p. 809.

filled.[1] On 15th April the Treasury bill rate was raised from $5\frac{1}{2}$ to $6\frac{1}{2}$ per cent and on the following day the Bank rate from 6 to 7 per cent, the highest rate, except for July and August 1914, since the American crisis in the autumn of 1907.[2] It was this step, in Mr. Hawtrey's view, that changed the attitude of the business world, and so broke the Boom.

It will be understood from what has already been said that Mr. Hawtrey is not arguing — an argument which, as we have seen, is inconsistent with the facts — that high Bank rate did this by causing a contraction in bank loans and deposits. He is arguing that it did it by affecting, not, so to speak, the supply of money, but business men's psychology and, through that, the demand for it. Thus he writes: "The effect of a movement of the Bank rate is largely psychological. It is required to offset, not the profits that traders have been making, but the profits that they expect to make in the future. If they can be brought to moderate their expectations, a comparatively low rate will be deterrent. Conditions in the spring of 1920 were obviously unsound, and the Government and the Bank of England were so evidently determined to stop the inflation that 7 per cent turned out to be enough."[3] Moreover, in order that this sort of shock may be effectively administered it is not necessary, in a period of expanding prices, for business men to be made to think that the monetary authorities are about to force prices down. Their action has been geared to an expectation that prices will *continue to rise*. If they do not, money that has been expended in the expectation that they will is likely to yield, not a

[1] *Economist*, January 1920, p. 11.

[2] Dearle, p. 312.

[3] *Currency and Credit*, p. 414. Evidence of this determination had been provided by the fixing of a limit to the fiduciary issue of currency notes in December 1919. On 16th April banks were released from their undertaking not to sell holdings of 5% War Loan, 1929–47, or 5% Exchequer Bonds, 1921, below their issue prices. This was a necessary sequel to the rise in Treasury Bill rate and Bank rate to their new higher level.

profit, but a loss. It is as bad, when a manufacturer has adjusted himself to rising prices, to be faced with prices that have become steady, as it is, when he is adjusted to steady prices, to be faced with the prospect of a fall. This point was well made by the late Lord Stamp in a discussion before the Royal Statistical Society in 1922: "It has always appeared to me — but I may be wrong — that what actually happened was that it was not so much an actual deflation as the refusal to mature of an anticipated inflation which the business world had been allowed by inference and experience to expect was forthcoming. It is just the same feeling you have when you go upstairs in the dark and tread on a top step which is not there. That is what the business world did; they were led to expect that the steps went on indefinitely, and they suddenly stopped, and, although the steps were not drawn away or made any lower, it had exactly the same shock on the system."[1] This is part of the reason why so slight a thing as a small rise in Bank rate can sometimes produce momentous effects. In general, as Mr. Hawtrey writes elsewhere: "It is not the *past* rise in prices, but the *future* rise, that has to be counteracted. The problem is a psychological one. As soon as the rate is high enough to offset the traders' hopes of future profits it becomes deterrent. And a very relevant factor in the psychological problem is the traders' expectations as to the intentions of the authority which fixes rates. If that authority means business, and can be relied on to push up rates relentlessly till they become deterrent, the *mere expectation* that this will happen may make quite a moderate rate adequate. For the prospect of rising prices is dispelled and normal standards of profit and interest are re-established in the traders' minds."[2]

That this would be the sort of process by which the

[1] *Journal of the Royal Statistical Society*, 1922, p. 212 (discussion).

[2] *Ibid.* p. 236: Hawtrey, "The Federal Reserve System of the United States".

imposition of a high discount rate breaks down a boom, when it does break it down, and that in fact such a process was operating in 1920, we may readily agree. But to agree to this is by no means to agree with what seems to be Mr. Hawtrey's thesis, that the 7 per cent Bank rate bore the whole, or even the main, responsibility for the monetary transformation scene in the middle of 1920. Mr. Hawtrey, in the summary of his thesis quoted above, himself observes that " conditions in the spring of 1920 were obviously unsound ". If so, it is surely strange that this unsoundness should have had nothing to do with the breaking of the Boom. The suggestion that raising the Bank rate to 7 per cent broke the Boom and initiated the Slump, if it means, as presumably it does, that, had the rate been kept at 6 per cent, the Boom would not have broken and the Slump would not have occurred, is surely over-strained !

While, however, in my opinion, Bank rate manipulations did not play the dominant rôle which Mr. Hawtrey assigns to them in generating the 1919–20 Slump, I have no wish to deny that in the development of that, as of other slumps, when it had once got under way, monetary factors were very important. Once the ascent of a boom is stopped, it very seldom happens that finance and industry thereafter go forward on an even keel. It seems to be the fate of economic man, when he has made a steep climb, to find himself, not on a plateau, but on the summit of a peak, which has to be descended on the other side. This happened in 1920. The explanation, or at all events a great part of it, lies in what Mr. Hawtrey and others have called the " vicious circle " or " vicious spiral " of deflation. A check to rising prices, by frightening dealers, causes them to restrict their orders from manufacturers, and this in turn causes manufacturers to check their hiring of labour. Money income available for spending is thus reduced, but the flow of output of finished commodities is

not yet appreciably checked. Hence, in some degree, stocks are piled up and, in some degree, prices are pulled down. In both these ways dealers are further discouraged from placing orders. Manufacturers themselves, moreover, finding the prices of materials falling, hesitate to make for stock, in the thought that perhaps soon not only will these materials fall further, but also money wage rates will begin to follow them down ; in which case competitors who held back for a time would be in a more favourable position than themselves. More generally, to quote Mr. Hawtrey again : " Prices once on the down grade, the holding of commodities in stock means an actual loss. The prospect of this loss has itself a deterrent effect upon traders, who make a practice of holding commodities with borrowed money, and reinforces the deterrent effect of the rate of discount. In the first instance the rise in discounts discourages dealers from buying and impels them to sell. But the result is so to depress markets that their efforts to sell are ineffectual. The unwillingness of the dealers to buy means fewer orders to producers ; profits are smaller, less wages are earned, and thus the consumers' demand shrinks. The rush to sell in an unfavourable market forces down prices, and the fall of prices reinforces the original process. Therefore, once a high discount rate has become deterrent at all, it tends to grow more and more deterrent." [1]

There remain to be considered three secondary ways in which the Slump of 1920–22 fed upon itself, accentuating still further the pessimistic attitude of business men, out of which it had been born. First, and probably most important, was the wage situation. During the earlier stages of the Slump, money wage rates not merely failed to fall in consonance with non-financial clearings and wholesale prices. They continued to rise for some six

[1] *Journal of the Royal Statistical Society*, 1922, p. 238 : Hawtrey, "The Federal Reserve System of the United States".

months after these had turned down; for some three months after the Cost of Living and the retail price of food had turned down. As we have seen, in January 1921 money wage rates were 18 per cent higher than in April 1920, while the *Statist* Wholesale index number was 26 per cent lower,[1] — the movement of this later index being substantially the same as the raw material index for England prepared by the Federal Reserve Board. These relative movements imply a great increase of costs as compared with selling prices. Hence the behaviour of money wage rates must have greatly aggravated the check to industry, which the monetary Slump entailed, even had it left the state of mind of business men unchanged. But it did not do that. With prices falling rapidly and money wage rates still obstinately rising, business men were bound to reflect that money wage rates must come down soon. This expectation would make them restrict their activity more than they would have done had they thought that the high wage rates would last for ever.

A second reaction to be borne in mind is this. At the height of the 1920 Boom a number of people bought income-yielding instruments for enormous sums, apparently with the idea that the current prices of the goods these instruments helped to make would last for ever. Many cotton mills, for example, and many ships changed hands at astonishing figures. Moreover, many tenant farmers bought their holdings at inflated boom prices; landlords being the more willing that they should do so in that to raise rents in corresponding measure would have been difficult and unpopular. "Changes of the war and immediate post-war period probably raised the proportion of occupying owners from about 11 to about 35 per cent of the total."[2] When the Slump came, all these

[1] Cf. *ante*, p. 164.

[2] *Agriculture in the Nineteenth Century*, Essays in Honour of Sir Daniel Hall, p. 58.

people naturally found themselves in financial difficulties, particularly those of them who had raised their purchase money by loan or mortgage. These difficulties affected their ability to provide working capital or improved equipment for their business, generated among them and among their creditors gloom and despondency, and so pushed the Slump still further downhill. Moreover, the collapse of prices led, as it was bound to do, to an attack, among other wages, upon those of coal miners, and so was ultimately responsible for the disastrous coal strike of April–June 1921, which, of course, in turn inflicted heavy damage on industry.

A third reaction has to do with the cancelling of orders. As a downward movement of prices develops there is apt to appear, as part effect of what has happened already, and as part cause of what is to happen presently, a tendency on the part of purchasers to cancel orders. On 20th November the *Economist* wrote : " Traders throughout the country are feeling very severely the requests which are now being received on a large scale for the cancellation of contracts ".[1] The *Economist* mentions specially cancellations from America and Spain. In Professor Kirkaldy's book, too, stress is laid on the cancelling of orders and the chief responsibility for this is laid on foreigners, who — for monetary contraction was taking place over a large part of the world — were themselves confronted with falling prices in their own countries. " One of the main causes that accelerated the fall in prices since April 1920 was the cancellation by foreign buyers of orders already placed with the United Kingdom for high-priced goods — in particular textiles. Cancellations were also received from the Colonies. Many of these cancellations related to goods already shipped, but not taken up by the consignees. . . . Cancellations within the home market have been largely

[1] *Loc. cit.* p. 902.

the result of cancellations received from abroad. Merchants and traders have begged manufacturers to cancel orders previously placed with them, in some cases offering part compensation, on account of cancellations received from abroad. Manufacturers in their turn have attempted to cancel orders they had previously placed for raw material. And so the chain of cancellations has tended to grow." [1] This naturally reacted seriously on the psychological attitude of business men.

In the light of the history here sketched out, an important thesis, upon which Mr. Hawtrey, along with others, has laid great stress, is likely to win general assent. With the Boom obviously broken and prices falling rapidly, the maintenance of a 7 per cent Bank rate for nearly a year undoubtedly aggravated and intensified the Slump. If what was aimed at was simply to stop inflation, there was no need to keep discount high once the down-turn had been definitely brought about. Writing of the United States, in which for some time a similar policy prevailed, Mr. Hawtrey asks: "How did such a mistake ever come to be made? The explanation is, I think, simply that the working of the 'vicious circle' of deflation was not understood. It was not realised that a deterrent re-discount rate, once it has taken effect, can safely be reduced, and that the falling prices and shrinking purchasing power will then do their work without extraneous aid." [2]

For the United States this comment and explanation are just. For this country, however, we need not infer from the action which the monetary authorities took that they did not understand the working of the vicious circle. Their purpose was not simply to arrest an inflation. They were also deeply concerned to prevent the New York exchange from running away, as it must have done if

[1] *British Finance, 1914–21*, pp. 260-61.
[2] *Journal of the Royal Statistical Society*, 1922, p. 249: Hawtrey, "The Federal Reserve System of the United States".

prices here had only fallen gently while American prices were rushing downward. Even as things were, English prices fell less steeply than American prices, and the exchange sagged. The mistake of the British authorities, if it was a mistake, was not one of technical analysis but one of broad policy, namely the decision described in Chapter I to restore our currency to pre-war gold parity in the near future. Once that decision was taken, with American prices moving as they did, to allow the monetary Slump here to become profound, in spite of the damage thereby done to industry and employment, was a necessary means to an accepted end.