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The Director of Financial Enquiries

A Study of the Treasury Career
of R. G. Hawtrey, 1919-1939.

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The Director of Financial Enquiries. A Study of the Treasury Career of R. G. Hawtrey, 1919-39.

In 1904 Ralph George Hawtrey, a Cambridge Mathematics graduate, entered the Treasury as Second Class Clerk. Apart from one year of secondment he was to remain employed by the Treasury until 1947. His career progress was modest. He never achieved a position of high administrative responsibility. Only in 1919, at the age of forty, did he achieve the grade of Assistant Secretary. In this position, as Director of Financial Enquiries within the Finance Division of the Treasury, he had no administrative responsibility, but was required to prepare reports on matters of his own choosing or as directed by his Treasury superiors. In his remaining 28 years at the Treasury he made no further career progress. As such, his was an unremarkable career.

His career was only remarkable because, after entering the Treasury, he took up an interest in the subject of Economics – he became a self-taught economist. Having developed his economic understanding through his experiences within the Treasury, it owed little to any previously existing 'school'. Thus, in 1913, in his first book *Good and Bad Trade*, he was able to produce the first complete monetary explanation of the trade cycle. His standing as an economist rose even as his civil service career halted. In 1919 he produced a book *Currency and Credit* which became a standard university text on monetary economics for over a decade. He was appointed visiting Professor of Economics at Harvard for 1928-9, was elected to a fellowship of the British Academy in 1935, appointed Professor of International Economics at the Royal Institute of International Affairs in 1947, knighted (for 'services to Economics') in 1956, and elected to an Honorary Fellowship of Trinity College, Cambridge in 1959. As an economist of standing he used his position in the Treasury to criticise the policy-making authorities.

The Financial Enquiries Branch, for which Hawtrey was responsible, has commonly been described as a 'backwater' – removed from centre of economic decision-making. Likewise, within studies of the Treasury, there has been a tendency to deprecate Hawtrey as a figure of fun; partly on account of personal inefficiencies and eccentricities, and partly on account of a certain 'unworldliness', with his views being tied too closely to his economic theory and divorced from the traditional culture within which the Treasury and the Bank of England had been accustomed to operate.

This thesis will examine the way in which, as an economist, Hawtrey used his position within the Treasury to criticise, and attempt to change, policy. It will concentrate on his *differences* with the advice of other economists and his *differences* with the policies of the Treasury and the Bank of England.

The findings of this study are that while much of the criticism of Hawtrey's career may be true, there were times when Hawtrey was both persuasive and influential. Much of his influence stemmed from his relationship with senior members of the Treasury administration, and whilst there were times when senior staff respected his judgement, there were times when his views ran contrary to the ethos of the Treasury and were ignored. However, even when he was ignored, as he often was, Hawtrey's criticisms drew attention to the wider implications of policy in such a way that he can be seen as acting as the Treasury's 'conscience'. As such, his influence was often not directly on policy but, more subtly, upon the way in which the Treasury's perception of its responsibilities changed.

Preface and Acknowledgments

Prefaces are where writers make excuses for their words. This one cannot claim to be an exception. Thus it begins with a description of the unusually circuitous route by which this thesis came to be undertaken.

A student presenting a Ph.D. thesis in Economic History might be expected to possess certain essential building blocks; the minimum foundation might be regarded as A-levels in History and Economics with a first degree in one or other of these subjects. This work is presented with no such underpinning.

A degree in Physics, taken in the early 1960s, served as passport to a career, teaching physics and mathematics, in laboratories and classrooms in secondary schools and sixth-form colleges in the West Midlands, Cheshire and West Yorkshire. The intellectual giants bestriding this former life of mine were not Smith, Ricardo, Mill or Keynes, but Archimedes, Galileo, Newton and Einstein.

Retirement offered the possibility of widening academic horizons. Initial steps in this venture were towards the Open University and a degree in English Literature. Attempting to follow this up I sought, in vain, for a specialist in colonial and post-colonial literatures at my local university, the University of Huddersfield, to supervise a research project on the work of the St. Lucian poet, Derek Walcott. Unable to find anybody there, or anywhere else, with time to share my enthusiasm for Walcott's work, I re-directed my academic efforts by enrolling for the degree of M.A. in History at Huddersfield.

The context for the awakening of a new interest was a study, with Professor David Taylor, of poverty in Victorian London. In Henry Mayhew's writings on poverty amongst nineteenth century silk-weavers in the London area of Spittlefields, he observed that the silk-workers who managed to survive, being underpaid, were being forced into excessively long hours of work in order to subsist, in the course of which they were driving other weavers out of work. Interviewing the silk-workers, he found that they blamed their condition on the repressive effects of 'the free market in goods', in particular the competition from goods made in France where, the workers believed, the tax regime was more lenient. Mayhew took up the cause of the silk-workers, increasingly directing his anger at the Political Economists whom he held responsible for the dominant free-market ideology, which he accepted as the cause of the poverty he was witnessing. He regarded the message of the Political Economists as grossly immoral:

Do your neighbour as your neighbour would do you.¹

[The underlining, but not the italics, are mine]

Moreover, he believed their ideas were not founded upon observations of things happening in the real world.

¹ H. Mayhew, 'Answers to Correspondents' [No. 20, 26 April 1851] in B.O.Taithe, *The Essential Mayhew* (London, Rivers Oram, 1996), p.136.

Economists from Adam Smith down . . . have shown the same aversion to collect facts as mad dogs have to touch water. It is so much easier to ensconce themselves in some smug corner and there remain all day, like big-bottomed spiders, spinning cobweb theories amid heaps of *rubbish*.²

As a physicist with a fascination for models and theories, it was inevitable that 'cobweb theories' would entice me into their trap, and there I have remained, entrapped, ever since.

Early stages of this confinement were spent reading about the nineteenth century economists from Smith to Marshall. The smooth progress of self-tuition came to an end with the advent of Keynes, much as my understanding of physics had stumbled as the certainties of Newtonian processes gave way to the relativistic mechanics of Einstein. Both *The General Theory of Employment Interest and Money*, and *The General Theory of Relativity*, for me, had eel-like qualities; no sooner did I feel that I had intuitively grasped their ideas than some doubt would cause that tenuous grasp to fail - my sense of understanding would slither away, and the process of retrieval would have to begin all over again.

Keynes's ideas were produced out of the experiences of the unemployment of the inter-war period. To improve my understanding of Keynes I approached Keith Laybourn, Professor of History at the University of Huddersfield, with a view to completing my M.A. course by writing a dissertation on Keynes's political

² H. Mayhew, 'Answers to Correspondents' [No. 34, 2 August 1851] in B.O.Taithe, *The Essential Mayhew* (London, Rivers Oram, 1996), p.179.

activities during the early inter-war period. The dissertation covered Keynes's involvement with the Lloyd-George wing of the Liberal Party, their Summer Schools which produced the Liberal Yellow Book 'Britain's Industrial Future', his collaboration with Hubert Henderson in supporting Lloyd-George's claim that the Liberals could 'conquer unemployment', his alliance with Ernest Bevin within the confines of the Macmillan Committee, and his cautious, guarded support for Oswald Mosley's 'Manifesto'. Whilst researching for this dissertation a shadowy figure kept appearing and disappearing; a figure, apparently, kept in captivity, deep in the bowels of the Treasury.³ The name of the shadowy figure was Ralph Hawtrey.

My recollection of the first encounter with the name is very clear. It took place whilst reading Alan Booth's book *British Economic Policy 1931-49*.⁴ Booth, in discussing the generally accepted historiography of inter-war depression, suggested that it usually rested on two dubious propositions: first, that inter-war unemployment arose from the application of obsolete economic theories, and secondly, that whilst Keynes understood the appropriate remedies to counter unemployment, Treasury officials did not.

³ A reference to Churchill's request to Treasury officials that he [Churchill] be allowed time to discuss economics with Hawtrey. The quotation is repeated in several books and is drawn from P.J.Grigg, *Prejudice and Judgement* (London, Jonathan Cape, 1948) p.82 – [Churchill requested that] 'the learned man should be released from the dungeon . . . have his chains struck off and the straw brushed from his hair and clothes and be admitted to the light and warmth of an argument in the Treasury board room with the greatest living master of argument'.

⁴ A.Booth, *British Economic Policy 1931-49: Was there a Keynesian Revolution?* (Hemel Hempstead, Harvester Wheatsheaf, 1989).

Typically, Ralph Hawtrey is identified as the main source of outdated, orthodox economics within the Treasury He regarded the trade cycle as a purely monetary phenomenon, to be regulated by monetary measures rather than by public expenditure. . . . By the mid-1930s, however, Treasury officials, by direct exposure to Keynes's arguments, had been re-educated away from 'outmoded economics'.⁵

Booth is here, of course, echoing conventional historiography. The reason why that first encounter with the name of 'Hawtrey' remains clear in my memory is because it was so strongly reinforced by my second encounter – an encounter which, at the time, startled me by its apparent incongruity. Reading through Keynes's great work, my concentration level started to flag. I turned idly to the preface of the book where Keynes acknowledged his debts. Only four academics were deemed worthy of acknowledgement.

. . . I have depended on the constant advice and constructive criticism of Mr. R. F. Khan. . . . I have also had much help from Mrs. Joan Robinson, Mr. R. G. Hawtrey and Mr. R. F. Harrod, who have read the whole of the proof-sheets.⁶

⁵ *Ibid.*, pp.23-4.

⁶ J.M.Keynes, *The General Theory of Employment Interest and Money* (London, Macmillan, 1957), p.viii.

It seemed less than credible that the man who, however mistakenly, had been 'identified as the main source of outdated, orthodox economics within the Treasury' could be the same man who had given 'much help' and 'read the whole of the proof sheets' in the process of the production of Keynes's revolutionary text.

Similar dichotomies regarding Hawtrey were to arise throughout Peter Clarke's book *The Keynesian Revolution in the Making 1924-1936*.⁷ Referring to suggestions that the Keynesian multiplier had originated from Hawtrey's work, yet Hawtrey had been 'if not the architect, at least the structural engineer of the Treasury View', Clarke posed the question as to how it could be possible for one man to be 'at once anti-Keynesian and proto-Keynesian'.⁸

References to Hawtrey continued to intrigue. As the Second World War approached, and senior Treasury officials were still suggesting that government works, without reflationary finance, would merely replace private works without any beneficial effect on employment, Clarke made the pertinent point that 'perhaps Hawtrey's long years in the dungeon . . . had, in the end given him a more subtly insidious influence in the 1930s than has usually been supposed'.⁹ By contrast, Roger Middleton in his study of the relationship between economic theory and policy, *Charlatans or Saviours? Economists and the British Economy*

⁷ P. Clarke, *The Keynesian Revolution in the Making 1924-36* (Oxford, O.U.P., 1988)

⁸ *Ibid.*, p.143.

⁹ *Ibid.*, p.319.

from Marshall to Meade, has suggested that under the influence of Sir Richard Hopkins the Treasury was 'quietly' professionalised during the 1930s in such a way as to marginalise Hawtrey.

Hawtrey[']s . . . major influence was if anything to convince his generalist colleagues that economic theory posed no great intellectual challenge nor had any real relevance to the administrative tasks facing the department it is not difficult to see that he would not be a key player in the education and professionalisation of the Treasury . . .¹⁰

Looking at the literature relating economics and economists to policy, Middleton noted that there was a relative paucity of material on the role of economists in government departments prior to the Second World War. A small number of career civil servants had published autobiographies, and there was, he noted, 'a study of Hawtrey, the one economist in the Treasury before the Second World War, but [it] had little to say about his official career.'¹¹ This observation can be taken as cue for the present study, which was undertaken in the hope of, in some small measure, filling the intimated void.

The beginning of any project involves a certain amount of dithering and uncertainty of direction before aims become clearer and fruitful ways of working

¹⁰ R. Middleton, *Charlatans or Saviours? Economists and the British Economy from Marshall to Meade* (Cheltenham, Edward Elgar, 1998), p.199.

¹¹ *Ibid.*, p.385. The study referred to was Deutscher, P., *R.G.Hawtrey and the Development of Macroeconomics* (London, Macmillan, 1990).

established. Again, this project was no exception. Part of the problem was Hawtrey's immense output. Black's obituary of Hawtrey appended a bibliography of 99 published pieces of work: either books or articles in learned journals.¹² They ranged from an article on the speed of warships, written whilst he was still a schoolboy and published in *Fortnightly Review*, to an article on stopping inflation, published in *Bankers' Magazine* in his 92nd year. Many of these publications were invaluable in clarifying Hawtrey's thinking and the economic model which he brought to bear upon his work.

Vast though Hawtrey's output was, it gave only small guidance as to the nature of his work in his Treasury post (although some of his published articles and sections of his books are quite clearly revisions and re-workings of his Treasury memoranda). Churchill College in Cambridge houses a large, well-ordered collection of Hawtrey's papers. Several visits to Churchill unearthed much fascinating material, but little which gave any real feeling for Hawtrey's role in the dynamics of the Treasury. A 'Treasury' section of the Churchill collection has 67 files and includes lengthy memoranda on economic conditions in America, Germany and India. Again, these memoranda gave little indication of the contexts within which they were produced, and no sense of Treasury dynamics. A further discouragement was that Hawtrey could never be concise. His typed memoranda seem interminable; his hand-written notes, in a large, heavily-stylised, looping hand manage (especially as he grew older) no more

¹² Black, R.D.C., 'R.G.Hawtrey', *Proc. Brit. Acad.*, 63(1977), 363-407.

than two or three words per line and, although decipherable, are virtually unreadable for the purpose of extracting meaning. Much of the material in the Churchill collection relates to work he produced after 1939 – his Treasury History of the Second World War, his time as Henry Price Professor International Economics at the Royal Institute of International Affairs, and papers relating to the Radcliffe Committee on the working of the monetary system, of which he was very critical.

Early visits to the National Archives at Kew proved little more encouraging than the visits to Churchill College. T 208, the papers of the Financial Enquiries Branch (usually referred to as the 'Hawtrey Papers') seemed to replicate much of what I had already encountered within the 'Treasury' File at Churchill. Again, it is an extremely well-ordered collection of some 206 files containing memoranda, reports and figures; most of which were produced during Hawtrey's time as Director of the Financial Enquiries Branch.

Judging by the quality of the paper, most of the papers in T 208 ('Hawtrey Papers') are 'bottom copies'; probably the fourth or fifth carbon copy of memoranda. As such they were 'bare' copies, devoid of any comment, and retained only for record purposes by the Financial Enquiries Branch itself. I wanted to get some feel for what was going on inside the Treasury, and what role Hawtrey was playing. These files were not helping me. After many months during which I made several visits to the Hawtrey Archives in Cambridge, made a number of visits to the National Archives at Kew, read much of Hawtrey's

writings and even prepared a few preliminary chapters of the thesis, I felt to be getting no nearer to what I felt should be the real business of the project. I finally turned to the archive files of some of its senior figures. Here, at last, I began to find what I needed – Hawtrey’s work set in the context of a living, dynamic institution. At this point, after the best part of a year of frustration, the project finally ‘took off’.

The process of research and writing has served up joys and pleasures, as well as a few trials and tribulations. There have been many times when I have questioned the wisdom of attempting to produce a thesis from the kitchen table of a small cottage high in the Pennine hills when most of my primary evidence lay in the busy metropolis some 200 miles further south. Indeed, both time and expense have imposed a great limitation on the extent to which I have been able to interrogate Treasury files. Even so, the route south to the National Archives, via M1 (I now know the names of all its service stations off by heart), M25 and M4 has become all too familiar, if not tiresome. One attempt to spend successive days at the National Archives by sleeping overnight at a London Youth Hostel was a disastrous experiment which I have not sought to repeat.

Similarly, the jargon employed in financial discourse used to confuse; now it jars. Whilst the logic of the operation may be quite simple, I still find it impossible to glide easily over a phrase such as ‘the discounting of bills drawn on London’ without having to pause, re-enact the process in my own mind in terms

of seller, buyer, borrower, lender and dealer, and then think of Sir Ernest Gower's book *Plain Words*.

The joys have come in a number of ways. Understanding of my new science, Economics, has progressed hand-in-hand with the writing of the thesis. As with my old science, Physics, I will probably never rise above mediocrity, but the pleasure lies in the small steps of progress.

I have discovered a rich vein amongst the writers of economic history. Alan Booth, Alec Cairncross, Peter Clarke, Barry Eichengreen, Roy Harrod, Susan Howson, Roger Middleton, Donald Moggridge, George Peden, Robert Skidelsky, Jim Tomlinson and Donald Winch will all receive acknowledgements in footnotes, but at times when I have wearied of Hawtrey I have still continued to read, and enjoy, their writings even when that reading delivered no return to the thesis.

The style of the research has not always been to my taste, but even the process of ploughing through the memoranda of civil servants has yielded occasional moments of pleasure. Treasury memoranda are not the lightest of reading, but hand-written marginal comments (where legible) often provided relief and amusement, as well as insight. In fact, the possibility of unearthing some gem within the margin proved to be a necessary stimulus for maintaining interest when the spirit wearied of the task. My favourite aside remains a hand-written note by Frederick Leith-Ross, attached to one of Hawtrey's memoranda, as he passed it on to his superior, Sir Otto Niemeyer. The memorandum in question was one of Hawtrey's more notable ones in which, in late 1925, he

deplored the raising of Bank rate to 5 per cent some seven months after the restoration of the Gold Standard, a move which he described as 'nothing less than a national disaster'.¹³ Passing the memorandum to Niemeyer, Leith-Ross attached a short note - 'This is almost pure Havenstein and I kept a copy for you.'¹⁴ I was convinced that this note spoke volumes, but being ignorant of Havenstein I couldn't be sure of its meaning. A little delving revealed Rudolf Havenstein to have been the President of the Reichsbank, who, at the height of German hyperinflation brought in strike-breakers to prevent striking printers from halting the flow of currency notes. More than any formal note, this aside indicated the extent to which the Treasury was terrified of the prospect of inflation, and deeply mistrusted the advice of economists – even its own!

The greatest of the joys has been the involvement with the dedicated staff of the History Department and the Business Studies Department of the University of Huddersfield, and I hope that they will take this acknowledgement as words of sincere thanks for their efforts on my behalf. My interest stems from a lecture course on Victorian poverty delivered by Professor David Taylor, who readily agreed to be one of my supervisors despite, at the time, carrying out the onerous task of Faculty Dean. Dr. Vince Fitzsimons from Huddersfield University Business School agreed to oversee the thesis from the perspective of an

¹³ Treasury Papers T 176/13. 'The Niemeyer Papers'. 'The Credit Situation', by R.G.Hawtrey, 5 December 1925.

¹⁴ *Ibid.*, Note appended by F. Leith-Ross to 'The Credit Situation' by R.G.Hawtrey, 5 December 1925.

economist. He has been unfailing in his help whenever I needed to discuss aspects of economic theory. My greatest good fortune has been to have been under the wing of my principal supervisor, Professor Keith Laybourn. Keith's enthusiasm is infectious. His generosity lies in his willingness to share that enthusiasm with everybody. Having shared his enthusiasm for History, my greatest fear would have been to let him down by producing work which failed to meet his standards. His encouragement throughout the past few years has been unfailing and I hope that he is not too disappointed with my efforts.

My final, and greatest, thanks must go to a lady who will probably never read a word of this. Whilst generally disliking dedications in books, I have begun to understand the sense of guilt which prompts them. Writing, whether history or fiction, takes the writer away from the immediate present into different places and different times, and having to live with someone who is only present in body must be very trying. So, to Jill - much love and many thanks – perhaps next year I will live a little more in 2008, and rather less in 1928.

Postscript to the preface

Visitors to our cottage in Scholes have not usually been steeped in the history of economic thought. Consequently, when informed that the various papers untidily scattered around the kitchen were to assist me in writing about the career of a man called 'Hawtrey', it has been difficult to prevent the conversation converging to a discussion about 'Carry On' films. I would like to have been

more informative about any link. This suddenly seemed a possibility when reading, in E. G. Davis's brief account of Hawtrey's life, that '[Hawtrey's] father left teaching to follow a famous brother, Charles Hawtrey, to the stage. He then failed in this attempt to earn a living as an actor'.¹⁵ Here, I thought, must be a link. Noting ages, I deduced that the father of the economist and the grandfather of the comedy actor could well have been brothers. Establishing this, I decided, would be a most useful piece of research. Sadly, it was not to be. The actor, who camped his way through the interminable series of films was born 'Hatee' and changed his name to 'Hawtrey' for stage purposes.

¹⁵ E. G. Davies, 'R.G.Hawtrey, 1879-1975' in D.P.O'Brien and John R. Presley (ed.), *Pioneers of Modern Economics in Britain* (London, Macmillan, 1981), p.203.

Introduction

The warm and generous obituary to Sir Ralph George Hawtrey by R. D. Collison Black in the 1977 edition of the *Proceedings of the British Academy* outlined a man of great intelligence, breadth, humanity and generosity of spirit who lived a remarkably long, rich and (despite the length of his Treasury employment) varied life.¹⁶ Born in Slough in 1879, the son of a preparatory school assistant master, Hawtrey entered Eton as a King's Scholar in 1893. His early academic successes included winning, in 1896, the Tomline Prize, Eton's highest mathematical award. He continued to win mathematical prizes, and a First Class Honours Degree, after gaining a scholarship to read Mathematics at Trinity College, Cambridge. In 1903 he embarked upon a life-long career as a civil servant. Almost paradoxically, his life continued to be marked by the academic distinctions which flowed his way. He took up the position of Visiting Professor of Economics at Harvard University in 1928-29, was elected to a Fellowship of the British Academy in 1935, had conferred the honorary degree of D.Sc. (Econ.) by London University in 1939, and was elected President of the Royal Economic Society for the years 1946-48. From 1947 to 1952 Hawtrey served as Henry Price Professor of International Economics at the Royal Institute of International Affairs at

¹⁶ R. D. Collison Black, 'Ralph George Hawtrey' *Proceedings of the British Academy* 63 (1977), pp. 362-397. R.D.Collison Black was visiting Professor of Economics at Yale 1964-5, and appointed Professor of Economics at Queen's University, Belfast in 1962. He was made a Fellow of the British Academy in 1974.

Chatham House. He was knighted in 1956 and elected to an Honorary Fellowship of Trinity College Cambridge in 1959.

Hawtrey's social life seems to have been no less rich or varied, and even his private life had a touch of the exotic. Whilst at Cambridge he came to be influenced by the ethics and teachings of the philosopher G. E. Moore. Moore regarded 'goodness' as a matter for direct judgement rather than for reference to any external religious or social code of behaviour (a cloak – no doubt – for the unconventional lifestyles of future members of Bloomsbury). Cambridge undergraduates were eligible for election to an elite discussion group whose members regarded themselves as disciples of Moore – the 'Apostles'. Hawtrey's election as an Apostle enabled him to move in an exalted literary circle which included E. M. Forster, Lytton Strachey and Leonard Woolf. In 1903 he was instrumental in proposing and seeing the election to the Apostles of John Maynard Keynes. Keynes was to remain a life-long friend despite differences over economic theory and policy which involved them, at times, in bouts of quite severe mutual criticism. Another friendship which commenced during this period was that with Bertrand Russell who, in 1908, after they had left Cambridge, corresponded with Hawtrey concerning proofs of various theorems with which Russell was struggling with whilst writing, with Whitehead, his *Principia Mathematica*.¹⁷

¹⁷ *Ibid.*, p.365.

The Cambridge Apostles formed the basis of the Bloomsbury Group, London's self-selected literary elite, and Hawtrey continued his association with the members of this group whilst working in London. The letters of Virginia (Stephens) Woolf record Hawtrey as staying with the Stephens family at their cottage in Carbis Bay, Cornwall.¹⁸ Woolf records Hawtrey as a rather shy young man who irritated her by making frequent comments, in Latin, to the male company of the household. It was through his Bloomsbury connections that he met Emilia d'Aranyi, great-niece of the renowned Hungarian violinist Joseph Joachim; she herself enjoyed a reputation as a concert pianist, being one of three talented musical sisters. They were married in 1915.¹⁹ Shortly after their marriage Virginia Woolf wrote to Keynes's lover, Duncan Grant, that Emilia d'Aranyi was 'a practically barbaric Pole . . . with ungoverned passions and the brain of a yellow cockatoo'.²⁰ There appear to have been no children from the marriage but Hawtrey remained devoted to her until her death, following a long illness, in 1953.²¹

¹⁸ V. Woolf, *The Flight of the Mind. The Letters of Virginia Woolf. Vol. I: 1888-1912 (Virginia Stephen)*, ed. Nigel Nicholson, (London, Hogarth Press, 1975), p.207.

¹⁹ J. Macleod, *The Sisters D'Aranyi* (London, Allen & Unwin, 1969). This account of the lives of three exceptionally talented musical sisters is one of the few sources for insights into the private life of Hawtrey.

²⁰ V. Woolf, *The Question of Things Happening. The Letters of Virginia Woolf. Vol. II: 1912-1922*, ed. Nigel Nicholson, (London, Hogarth Press, 1976), p.145.

²¹ Black, 'Ralph Hawtrey', p. 366.

Despite being a career civil servant from 1903 to 1947 (interrupted only by his year's secondment at Harvard) Hawtrey was an academic economist of significance. Between 1920 and 1939 he was the fifth most frequently cited macroeconomist from articles included in the *Index of Economic Journals* – below Keynes, but above von Hayek, Marshall, and Joan Robinson.²² His 1919 publication, *Currency and Credit*, was used as a textbook during the 1930s at the Universities of Chicago, Harvard, Cambridge and Melbourne.²³

After his final retirement, in 1952 at the age of seventy-three, from the research chair at the Royal Institute of International Affairs he continued to publish books on economics and ethics, to write articles for learned journals and the press, and to encourage young researchers into economics and economic history. To the end of his life, in 1975 at the age of ninety-five, he retained a lively interest in world affairs. When the Bank of England's historian, Professor Richard Sayers, visited Hawtrey on the occasion of the latter's ninety-fifth birthday, he remarked how he found him 'still the same charming and interesting man' he had first met some forty-two years previously.²⁴

Despite this roll of prizes, honours, and acclaim, there are two dark clouds over Hawtrey's life which might lead to the assessment that his legacy is one of failure. First, for the last forty years of his life he was to see his economic model, with attendant policy prescriptions, discredited by the Keynesian

²² Deutscher, *R.G. Hawtrey and the Development of Macroeconomics*, p. 193.

²³ *Ibid.*, p. 5.

²⁴ Black, 'Ralph Hawtrey', p.369.

hegemony. Secondly, his career as a civil servant has often been judged as disappointing and even irrelevant.

Recent studies have led to a measure of rehabilitation. The breakdown of the post-war Butskillian policy consensus amidst both unemployment and inflation has shaken confidence in Keynesian prescriptions, and the advent of more avowedly monetarist policies has led to some revival of interest in Hawtrey's work - nearly all by economists. One work, *R.G. Hawtrey and the Development of Macroeconomics* by Patrick Deutscher (1990), at the University of Michigan, has been devoted entirely to an analysis of Hawtrey's theoretical output. Davis (1980) has written on the extensive correspondence between Hawtrey and Keynes during the preparation of Keynes's *Treatise on Money*.²⁵ Laidler (1993, 1998a, 1998b) has attempted to link Hawtrey's period as visiting Professor of Economics at Harvard with the origins of the Chicago School of monetarist economics which spawned Milton Friedman, economics guru to Margaret Thatcher and Ronald Reagan.²⁶ Davis (1981) has contributed a chapter on Hawtrey to an anthology of British economists.²⁷

²⁵ E.G. Davis, 'The Correspondence between R.G. Hawtrey and J.M.Keynes on the Treatise: The Genesis of Output Adjustment Models' *Canadian Journal of Economics*, 13 (1980), 716-724.

²⁶ D. Laidler, 'Hawtrey, Harvard and the origins of the Chicago Tradition' *Journal of Political Economy* 101 (Dec. 1993) 1068-1103; 'More on Hawtrey, Harvard and Chicago' *Journal of Economic Studies* 25, (1998a) 1: 4-16; 'Hawtrey, Harvard and Chicago: a final comment' *Journal of Economic Studies* 25, (1998b) 1: 22-24.

²⁷ E. G. Davis, 'Ralph Hawtrey' in O'Brien, D.P., and Presley, J.R., *Pioneers of Modern Economics in Britain* (London, Macmillan, 1981).

There is little which I would be capable of adding on the subject of Hawtreyan economics to the writings of these economists. However, as part of this thesis I have set myself the task of setting out, as clearly and simply as possible, the structure of Hawtreys model of the economy. I have done this not for the purpose of assessing its merit, but for the purpose of appraising the extent to which Hawtreys Treasury memoranda, which often contained criticisms of Government, Bank, and Treasury policy, flowed logically from his own theoretical model.

Just as Hawtreyan economics has come under reappraisal since the 1960s, so there has been a degree of reappraisal of the Treasurys stance between the wars. The aspect of inter-war economic policy most closely associated with Hawtreys is probably the 'Treasury View' (Hawtreys, in later life, claimed that Keynes attacked the 'Treasury View' because it was his view)²⁸. The nature of the 'Treasury View' changed over the years and it is still a matter of some dispute. Essentially, it was a view which justified the Treasurys reluctance to sponsor a general 'Public Works' programme as a means of relieving unemployment, since it claimed that the provision of such works was, in itself, incapable of providing *extra* employment. Hawtreys (see above) may have claimed ownership of the 'Treasury View', but his particular contribution to it is generally recognised as being an argument, logically derived from his own theory, that if conditions were created which were favourable for the extension

²⁸ Hawtreys interview with Sir Alec Cairncross, 1966. HTRY 13/5.

of credit, then the credit expansion, by itself, would create extra employment without recourse to 'Public Works'; the provision of 'Public Works' would be 'mere ritual' serving only to boost the egos of politicians desirous to be seen to be 'doing something'.²⁹ Treasury officials found this argument particularly useful up to 1931. After 1931 they may have continued to believe the argument, and there is some evidence to suggest that they did but Keynes's, and Denis Robertson's, assaults upon it caused them to proclaim it less confidently and so they shifted their stance towards 'administrative difficulties'. By the 1950s and 1960s the 'Treasury View', in whatever form, was thoroughly discredited, and Joan Robinson, one-time protégé of Keynes, but by then Professor of Economics at Cambridge, described Hawtrey's theoretical justification for the view as 'laughable'.³⁰ Recent studies have tended to take a more charitable view of the way in which the Treasury responded to the inter-war slump.

A recently unpublished thesis by M.M.M. Luthje of Cambridge University has argued that, between 1927 and 1933, Hawtrey was instrumental in moving the Treasury towards a monetary solution to the world-wide economic downturn.³¹ Whilst the evidence of the current thesis leads to the view that this somewhat

²⁹ R. G. Hawtrey, 'Public Expenditure and the Demand for Labour', *Economica*, V (1925), pp. 38-48.

³⁰ J. Robinson, *Economic Philosophy* (1962), p.73.

³¹ M.M.M. Luthje, 'The Politics of Monetary Policy in Britain from the First World War to the World Economic Conference of 1933'; unpublished Ph.D. thesis, University of Cambridge, 2002.

overstates Hawtrey's role, it does show that Hawtrey was, arguably, at his most influential in the years immediately following the retreat from the Gold Standard.

This study aims to shed light on the historical figure of Hawtrey, the Civil Servant. It will look at his economic philosophy, the economic model which guided him in his work, and the way in which his economic model directed his policy advice. It will attempt to assess his influence on colleagues and outside agencies. It will look at the quality of his relationships with colleagues and how these relationships affected his effectiveness. It will examine his responses to criticisms of the Treasury made in the press (more often than not by Keynes), and the extent to which the Treasury took cognisance of his opinions. It will also try to consider the way in which his role changed over the inter-war period in response to changing institutions and changing economic conditions.

A reading of the few studies to have been done on policy advice in the inter-war period could lead to the summary conclusion that Hawtrey's Treasury career was largely irrelevant. Collison Black would have yielded to no one in his admiration of the character of Hawtrey. Concluding his obituarial essay he likened Hawtrey to a certain 'Cambridge type':

It is a type unworldly without being saintly, unambitious without being inactive, warm-hearted without being sentimental. Through good report and ill such men work on, following the light of truth as they see it; able to be sceptical without being paralysed; content to know what is knowable and to reserve judgement on what is not. The world could never be driven by

such men, for the springs of action lie deep in ignorance and madness. But it is they who are the beacon in the tempest, and they are more, not less, needed now than ever before.³²

'Unworldly' Hawtrey might have been, but not so unworldly as to admit to Sir Alec Cairncross that he decided to enter the Civil Service at Eton on hearing that it was possible, as a civil servant, 'to earn one thousand pounds a year at the age of forty - *and* come out with a pension at the end!'³³ However, despite the warmth of Black's admiration for Hawtrey, he had, at an earlier point in the essay, this to say about Hawtrey's Treasury career.

. . . Hawtrey drew up many and varied reports and memoranda on economic and financial matters which are now to be found among the papers of senior Treasury officials of that period, but the impression prevails that they did not receive much attention, and that the Financial Enquiries Branch under Hawtrey was something of a backwater.³⁴

In reference to Hawtrey's work, the same term was used, in 1930, by Keynes whilst he was persuading Hubert Henderson to take up the position of Secretary to the newly-formed Economic Advisory Council rather than the professorship he

³² Black, 'Ralph George Hawtrey'. Black is using words which Lowes Dickinson applied to C.P.Stanger.

³³ Interview with Sir Alec Cairncross in 1966. Hawtrey Papers, HTRY 13/5.

³⁴ Black, 'Ralph George Hawtrey', p.379.

had been offered at the London School of Economics. Keynes promised Henderson that he 'really would be at the centre of things and not in a sort of Hawtrey backwater'.³⁵ By successfully persuading Henderson to take up the position with the Economic Advisory Council, Keynes effectively left the door open for one of his future censors, Friedrich August von Hayek, to enter the London School of Economics.

Regarding views that the Financial Enquiries Branch was a neglected 'backwater', much the same interpretation can be made from Churchill's remark to his senior officials that 'the learned man should be released from the dungeon . . . have his chains struck off and the straw brushed from his hair and clothes, and be admitted to the light and warmth of an argument in the Treasury Boardroom'.³⁶ Churchill was probably implying that the Treasury were culpably ignoring the expert advice which Hawtrey might provide.

Susan Howson has concluded that Hawtrey *had* been influential in the early 1920s *when other economists were not* [my italics], but lost in influence in the 1930s – predominantly as a result of the *content* of his economic analysis and policy recommendations. Howson is generally sympathetic to the idea that Keynes's ideas gradually took control of the Treasury during the thirties. This contrasts with Peter Clarke's suspicion that Hawtrey might have had a 'more insidious' influence on Treasury officials throughout the thirties by keeping alive

³⁵ S. Howson and D. Winch, *The Economic Advisory Council 1930-39: a Study in Economic Advice during Depression and Recovery* (Cambridge, C.U.P., 1977), p.25.

³⁶ P. J. Grigg, *Prejudice and Judgement* (1948), p.82.

the 'Treasury View' with its original 'crowding out' rationale.³⁷ Roger Middleton's is far more dismissive, regarding Hawtrey's influence being '*if anything*' [my italics] to persuade his Treasury colleagues of the 'irrelevance of economic theory to their task'.³⁸

As indicated in the Preface, apart from secondary sources and Hawtrey's own published writings, my main source of evidence in trying to come to an opinion on these and other matters has been the files of senior Treasury Officials to be found within the National Archives.

Within the archive files of senior Treasury staff can be found the places where Hawtrey's advice was subjected to scrutiny. They are the places where his memoranda were contested, and it is within these files that I have sought the evidence with which to build up some kind of a picture of the pattern of his career. Marginal comments on his memoranda often indicated where Hawtrey's views differed from those of senior Treasury colleagues. The position in the file usually gave some indication of whether alternative advice was sought, and pencilled comments could sometimes indicate the value attached to advice from different sources.

Booth and Glynn have questioned the usefulness of Public Record Office papers to the historian.³⁹ They give some endorsement to C. L. Mowat's view

³⁷ Clarke, *The Keynesian Revolution in the Making*, p. 319.

³⁸ Middleton, *Charlatan's or Saviours*, p. 199.

that 'there are few secrets in government' and that 'the Official Secret Act exists to conceal the fact that the cupboard is bare'.⁴⁰ They make the following observations regarding Cabinet papers. Firstly, that they are written, not primarily as a true and accurate record, but as a means of fulfilling two separate requirements: the need to give clear direction to administrators, and the need to find satisfactory words to accommodate conflicting viewpoints. Secondly, they point to lacunae, whether by error or design, by which it is impossible for official records to give an adequate account of the *motives* behind decisions.

Booth and Glynn also point out that the sheer volume of P.R.O. material deflects attention away from other material and results in a concentration on the *processes* of policy making to the neglect of the *reasons* for policy and the *outcomes* of policy. Such concentration of effort, they claim, leads to histories which exaggerate the importance of policy processes, and perpetuate the Establishment's own reading of problems.

The present study relies heavily on the papers in the Public Records Office. In that one of its principal aims is to uncover the extent to which one particular individual took part in the *processes* of the inter-war Treasury, it escapes the stricture of dwelling too heavily on the processes of policy. The "chat in the corridor" may have been where truly important business took place but, in the absence of diaries or witnesses, memoranda will have to suffice. In the case of

³⁹ A. E. Booth and S. Glynn, 'The public records and recent British historiography', in *Economic History Review*, 32(3), pp.303-15.

⁴⁰ *Ibid.*, p.303.

Hawtrey, who was to some extent an outsider to the very small and closely knit group of influential policy makers, the written memorandum was his method of attempting to break into, and influence, the powerful central group.

The plain memorandum may, indeed, reveal very little. This was my experience after many months of looking at the Hawtrey papers in Cambridge and the papers of the Financial Enquiries Branch in the Public Records Office. Much more is revealed when a memorandum has been circulated and is replete with underlinings, exclamation marks, question marks, and the occasional expletive. The proximity of a paper to those of others, its position in the time sequence or its promptness as a response all give indications of the dynamics within an organisation.

Throughout the years 1919-1939, the period of Hawtrey's effective tenure of the office of Director of Financial Enquiries (he nominally held the title until 1947, but after 1 January 1940 he had no responsibility other than compiling the Treasury's Second World War records) the Permanent Secretary to the Treasury was Sir Warren Fisher. Fisher regarded his position as that of 'Head of the Civil Service' and co-ordinator of all Civil Service departments. His role in offering financial advice was minimal, and consequently his archive file has largely been ignored. The civil servants with responsibility for advising the Chancellor of the Exchequer were the Treasury Controller of Finance and his Deputy. In 1919 these were Sir Basil Blackett and Sir Otto Niemeyer. Through the mid-twenties they were Sir Otto Niemeyer and Sir Frederick Leith-Ross. From the late

twenties until the outbreak of the Second World War they were Sir Richard Hopkins and Sir Frederick Phillips. The titles of the offices may have changed slightly over the years, and there was some overlap in the changes of pairings, but these were the 'Treasury Knights' in whose files I looked for evidence of the results of Hawtrey's work.

Many of Hawtrey's memoranda were unsolicited. He produced them because he was critical of some aspect of Government policy. In some of these memoranda there is a marked tone of anger. This was particularly apparent during the late 1920s when the United Kingdom had returned to the Gold Standard and Hawtrey believed that the Bank of England was pursuing a foolish and unnecessarily high interest rate policy. At this time, his memoranda, critical of Bank or even Treasury policy, could, for such a mild-mannered man, be quite savage in tone. Often, his memoranda were produced as a result of a specific request. On a very small number of occasions they were produced as a result of a direct request for guidance, or information, from the Chancellor of the Exchequer. At other times Hawtrey prepared a memorandum as a result of a Parliamentary Question. Often a senior colleague wanted support in preparing a memorandum and would seek to use Hawtrey's expertise, particularly with regard to currency and foreign exchange. Hawtrey would invariably write an unsolicited memorandum after press criticism of Treasury Policy.

The period chosen for the study, 1919-1939, does not precisely coincide with the period of Hawtrey's tenure of the post of Director of Financial Enquiries. He

was, for sure, appointed to the position in 1919. There is an element of mystery surrounding his appointment. In Hawtrey's Treasury Career File there are letters relating to his initial appointment to the Treasury in 1904, and to his transfer to the First (Finance) Division as acting First Class Clerk, and subsequently First Class Clerk, in 1910-11. There is a great deal of correspondence concerning the status of his year's secondment at Harvard for pension purposes, and about his retirement and subsequent re-employment for the purposes of recording Treasury activities during the Second World War. There is nothing in his career file, nor does there seem to be documentary evidence elsewhere, relating to his appointment as Director of the Financial Enquiries Branch.

It is possible to surmise that the post was created (or more accurately, re-created) for Hawtrey because of his limited capabilities as an administrator. The evidence for this is somewhat circumstantial and to some extent dependent on comments from secondary sources. First, regarding his incompetence, Hawtrey himself admitted, in his interview with Cairncross, that he was an indifferent Personal Private Secretary to Lloyd-George as Chancellor of the Exchequer since he [Hawtrey] 'constantly omitted things and forgot things'.⁴¹ Peden refers to Hawtrey regularly amusing and frustrating his colleagues by 'personal eccentricities including a tendency to mislay files'.⁴² Clarke has referred to

⁴¹ Interview with Sir Alec Cairncross in 1966. Hawtrey Papers, HTRY 13/5.

⁴² Peden, *Keynes and his Critics*, p.17. Peden's source for this information is a series of talks with Treasury officials in the 1970s (e-mails from Professor G.Peden).

Hawtrey being 'patronised' by his colleagues because of his lack of administrative ability.

There does seem to have been a degree of ineptitude on Hawtrey's part – sufficient to query why, in 1919, he was offered a responsible post within the Treasury. Again, there must be a degree of conjecture about this. In 1919 the Joint Permanent Secretary to the Treasury was Sir John Bradbury and the Controller of Finance was Sir Basil Blackett; these were the two most influential men in the Treasury. Hawtrey admired both these men; later referring to Blackett as 'a good friend' and to Bradbury as the most capable man he had ever met within the Civil Service.⁴³ In return, Bradbury and Blackett, whilst being aware of his shortcomings, probably recognised in Hawtrey the qualities of intelligence and high intellect together with an academic leaning and acute inquiring mind which fitted him for a post in the Treasury outside the conventional administrative ladder.

Such a post, Director of Financial Enquiries, had been created during the war, in 1915. It was a post designed to enhance the war effort by providing the Government with information on the state of enemy and allied finances – its terms of reference being 'to provide economic intelligence on matters such as foreign exchange, currency, banking, international movements of capital and the public expenditure and the borrowing and other financial operations of foreign governments; to prepare reports from time to time both on its own initiative and

⁴³ Interview with Sir Alec Cairncross in 1966. Hawtrey Papers, HTRY 13/5.

also upon any question which may be specifically referred to it by the Chancellor of the Exchequer'.⁴⁴ The appointee was Hartley Withers, a former economic journalist who resigned a year after his appointment in order to return to journalism, leaving the post vacant for the remainder of the war.

The appointments of Withers and Hawtrey were somewhat unusual, since they were specialists appointed to give advice of an economic nature to governments which still largely abided by the precepts of *Laissez-Faire*, but there was a precedent. Before the Great War Sir George Paish had been drafted into Government departments to give specialist advice. Paish had become the joint editor of the economic journal *The Statist* in 1900. As a result of expertise acquired in the statistics of the railway industry he was appointed adviser to the Board of Trade between 1906 and 1908. His knowledge of investments in foreign railway systems led to him being regarded as an authority on Britain's overseas investments. From 1909 Paish acted as unofficial advisor to David Lloyd George when the latter was Chancellor of the Exchequer. Paish's forecasts for the national economy became an essential component in Budget planning. He accompanied Sir Basil Blackett to America in November 1914 in an attempt to obtain financial support for Britain's war effort. In 1915, as his health declined, he withdrew from government work and returned to writing articles for *The Statist*.⁴⁵

⁴⁴ National Archives Catalogues. Covering details to the T208 (Financial Enquiries Branch) catalogue.

⁴⁵ Dictionary of National Biography. Biographical note by R. Middleton.

Hawtrey's appointment to the post of Director of Financial Enquiries was under quite different circumstances to those of Withers. Surprisingly, on his appointment in 1919, Hawtrey believed the post to have been newly created and was not aware, at the time, of any previous appointment, nor did he make any effort to contact Withers during the time he held the appointment.⁴⁶

The Financial Enquiries Branch was disbanded with Hawtrey's retirement in 1947, but it effectively ceased to be a department which the Treasury called on for reports and recommendations after the end of 1939. Hence the period 1919-39 has been chosen for the purpose of limiting the study.

As befits a History thesis, it has been written in a way which is largely chronological. Most chapters cover a specific time period, and the emphasis within each chapter is on the issue, or issues, with which Hawtrey was most closely involved. After the 'Prelude' dealing with Hawtrey's economic model, Chapter 1 covers the period 1919-1925 when much economic policy was directed towards the return to the Gold Standard. Within this period Hawtrey played a significant role with the British Delegation at the International Economics Conference at Genoa in April 1922.

In chapter 2, the return to the Gold Standard merits a section of its own since Hawtrey was more heavily involved than usual in the policy process, being one of the officials required to take part in 'Mr. Churchill's Exercise'. Chapter 3 covers credit policy over the years 1925-31, the years on the Gold Standard which led

⁴⁶ Interview with Sir Alec Cairncross, 1966. HTRY 13/5.

into the Great Depression. These were years which saw Hawtrey being angrily critical of the authorities' high Bank rate, even going to the extent of being critical of his own agency, the Treasury, for failing to exercise what he argued to be its statutory supervisory responsibilities over the Bank. They were also years when unemployment developed into a much bigger political issue.

The Lloyd-George wing of the Liberal Party took up the cause of the unemployed with proposals far more radical than those of the other parties. The Lloyd-George fund sponsored a series of Summer Schools in the 1920s in which politicians met with leading academics to develop new approaches to economic issues. Keynes was in regular attendance at these Summer Schools, and he was influential in steering the Liberal Party towards promising a programme of Government funded public works in its 1929 election manifesto, *We Can Conquer Unemployment*. Chapter 4 looks at the Treasury's response to this programme and, in some detail, at a memorandum of Hawtrey's in which he put forward his own scheme – his 'Bill Famine' plan – by which the necessary finance might be made available to support economic expansion.

Chapter 5 is devoted to the Treasury's involvement with the Macmillan Committee on Finance and Industry which sat between 1929 and 1931. The Macmillan Committee was a huge undertaking. It sat for two years, taking evidence from the Bank of England, the Treasury, commercial bankers, stockbrokers, industrialists, trade unionists and economists. The importance of the committee's findings seems to have been inversely related to the weight of

its deliberations. Its Majority Report, reflecting the predominant influence of Banks and the City, supported continuation of the principles of 'sound finance'; the Gold Standard, balanced budgets and use of Bank Rate to maintain the external value of sterling. The Minority Report calling for public works and import restrictions as means of helping employment was signed by, amongst others, Keynes and Bevin. Only Bevin, his views reinforced by Keynes's tutorials, seriously suggested leaving the Gold Standard. Leaving the Gold Standard in 1931 caused much of the committee's deliberations to lose their relevance. The Minutes of Evidence of the Macmillan Committee are of special value to economic historians because they contain a verbatim account of academics explaining their views, and the monetary authorities explaining their responsibilities, before a critical lay panel. The proceedings were dominated by Keynes who invariably produced the most perceptive questioning.

Both Hawtrey and Sir Richard Hopkins were summoned before the Committee in 1930, with each man being questioned for two days; Hawtrey as an economist, Hopkins as Head of the Treasury's Finance Division. Deutscher has dealt at length with the confrontation between Keynes and Hawtrey over each others technical terms.⁴⁷ I have dealt only very briefly with the theoretical dispute and focussed almost entirely on Keynes's questioning of Hawtrey's policy prescription. Keynes's interrogation of Sir Richard Hopkins afforded valuable insights into the way the 'Treasury View' on public works was metamorphosing

⁴⁷Deutscher, *R.G. Hawtrey and the Development of Macroeconomics* p. 193.

into something no longer dependent on Hawtrey's economics. At times, the proceedings of the Macmillan Committee offered compelling theatre. I have tried to convey that sense of theatre by including extended, but edited, excerpts of dialogue.

Chapter 6 deals with the deliberations about future exchange-rate policy after Britain had been forced off the Gold Standard in 1931. This, again, was a set of deliberations in which Hawtrey was more heavily involved than usual. Hawtrey's advice was strongly disparaged by Hubert Henderson, causing him to mount a spirited reply. Given the extent of disagreement, and subsequent debate between the participants, the debate on future exchange-rate policy after the Gold Standard has been given a separate chapter.

The 1931 discussions on exchange-rate policy saw Hawtrey's star in the ascendancy. He maintained a consistent view during the discussions, and that view eventually prevailed. The result was a period, between 1931 and 1933, when Hawtrey, working with Sir Frederick Phillips, was arguably at his most influential, as the Treasury sought to stabilise world currency exchanges. Chapter 7 takes the story up to the World Economic Conference in London in 1933. At this conference Hawtrey gave his support to the Kisch proposals for the redistribution of the world's gold supplies. This was yet one more occasion where Hawtrey found himself opposed to Keynes and Henderson, who had prepared their own joint plan for an international note issue. Hawtrey's influence

eventually dwindled as he repeatedly called for international inter-bank co-operation to co-ordinate interest rate policy.

Following chapter 7 there was to have been a Theoretical Interlude. Susan Howson has given one hint as to why the Financial Enquiries Branch might have gone unusually quiet during the mid-thirties: Hawtrey became embroiled in a series of disputes over economic theory with Keynes, Harrod, Kaldor, Robertson, von Hayek and Pigou.⁴⁸ It is difficult to discover the extent to which the correspondences by which these disputes were pursued were written during 'office hours', but it is quite possible to regard Hawtrey's engagement in these disputes as legitimate Treasury business, since one of his responsibilities was to interpret the work of other economists for the benefit of senior Treasury staff, and Sir Frederick Phillips was to later pay tribute to Hawtrey's value in this role. Being matters of general economic theory, these disputes do not properly belong to this study. However, intermissionary status was to have been given to just two lengthy Treasury memoranda which Hawtrey produced, in 1931 and 1936, after the publication of Keynes's two major works. They were written for the benefit of his Treasury colleagues and their purpose was to help the Treasury understand the implications which might be drawn from Keynes's two volumes, *A Treatise on Money* and *General Theory of Employment Interest and Money*. As usual, Hawtrey's inclination was to turn these memoranda into justifications of his own model at the expense of that of Keynes, and there is no evidence that

⁴⁸ Howson, 'Hawtrey and the Real World', p. 176.

anyone within the Treasury paid much attention to them. The plan to include this section after chapter 7 ran into problems when the section outgrew its status as an interlude, distorted the narrative, and extended the thesis beyond its acceptable length. I have, in consequence, abridged and appended it.

Chapters 8 and 9 complete the story up to the end of 1939. They cover the period of Hawtrey's advice on rearmament and war finance, and some of the details surrounding the circumstances of his retirement; a retirement which did not actually come into effect until 1947 despite him having no advisory role for the last seven years.

The result of focussing on those issues in which Hawtrey showed the greatest interest has been a rather lumpy, uneven treatment of Treasury policy during the wars. For example, the most significant event within the Treasury during the early thirties after the 1931 crisis was arguably the fiscal advantage it gained in 1932 by conversion of 5 per cent War Loan 1929/47 to 3.5 per cent War Loan 1952. This event seems to have passed without comment from Hawtrey. Similarly there is nothing within the thesis regarding the Treasury's implementation of the recommendations of the Geddes Committee or the May Committee since Hawtrey seems to have chosen not to make any significant comment on their findings.

Latterly, Sir Alec Cairncross, an economist with considerable experience of advising governments in the period after the Second World War, has written extensively on the relationship between economists and administrators of

economic policy. In 1985, as part of a study of the history of economic advice, Cairncross conducted three hour-long interviews with Hawtrey.⁴⁹ Generally, he tended to express surprise at the lack of feedback which Hawtrey received as a result of his many memoranda. Hawtrey's career will be considered against Cairncross's deliberations on the relationship between economic theory and economic policy, which will be revisited in the concluding chapter of this thesis.

⁴⁹ Hawtrey Archives, Churchill College, Cambridge. HTRY 13/5.

Prelude

Hawtrey's Monetary Model of the Trade Cycle

"The Trade Cycle is a Purely Monetary Phenomenon"

Hawtrey (1923)⁵⁰

I have adhered consistently to my fundamental ideas since 1913 and in so far as they have developed and grown, the process has been continuous since then. There has not been a departure followed by a relapse. I do not think this conservatism is a merit; indeed I should rather like to go in for something novel and extravagant if I could be convinced of it.

Letter from Hawtrey to Keynes, (9 May 1937).⁵¹

The work of Marshall . . . contribut[ed] to the understanding of certain characteristics of the upswing and downswing of the cycle, and the monetary elements at work in them . . . [but] . . . it was Ralph Hawtrey, educated at Cambridge to be sure but not really of the Cambridge School, who, in pre-World War I Britain, who produced a complete and purely monetary theory of the cycle. . . . a most original construction.

Laidler (1991)⁵²

⁵⁰ This is probably the best-known of the very few quotable remarks attributed to Hawtrey. It is to be first found in: R.G.Hawtrey, *Monetary Reconstruction*, (London, Longmans, 1923), p.141.

⁵¹ D. Moggridge (ed.), *The Collected Writings of John Maynard Keynes* vol. X1V (Cambridge, Macmillan, 1973) p.55.

In a 1963 letter to Claude Guillebaud . . . [Hawtrey] claimed that the source of much of his analysis was conventional wisdom circulating in the City . . .

Laidler (1991)⁵³

The memoranda in which Hawtrey offered *advice*, and which this thesis will focus upon, were often unsolicited. They were produced because he was critical of either the Bank of England or the Treasury and, as such, they made uncomfortable reading for these agencies, and gave rise to annoyance with Hawtrey. In general, they urged these bodies to look wider than their traditional narrow objectives and consider the wider issues of the state of trade, and of employment. They were always based upon a monetary model of the trade cycle which Hawtrey had developed before the First World War.

Early Influences

Hawtrey's model may have contained elements of those of other economists, but it seems to have been developed in isolation from them. He had not read economics as a student, and prior to the publishing of his first book he claimed not to have read the works of Marshall, Pigou or other prominent academic economists of the time. From time to time Hawtrey has been cast as a

⁵² D.Laidler, *The Golden Age of the Quantity Theory* (Hemel Hempstead, Philip Allan, 1991), p.101.

⁵³ *Ibid.*, p.116.

Marshallian economist.⁵⁴ He had never been a pupil of Marshall, and always adamantly denied any direct influence from Marshall. He admitted to having read John Stuart Mill's *Principles* whilst at Eton.⁵⁵ He had also read a book on banking and credit by an obscure nineteenth century economics writer, Henry Dunning Macleod, largely, it seems, because Macleod had dedicated the book to Hawtrey's great-great-grandfather who had been his mathematics teacher.⁵⁶ In addition, he acknowledged a debt to the financial writings of the mid-nineteenth century editor of the *Economist*, Walter Bagehot.⁵⁷

It has been suggested that not the least of the similarities between Hawtrey and another Cambridge economist, Malthus, was that they each came to the central idea of their economics through arguing with their respective fathers.⁵⁸

. . . George Hawtrey was apparently convinced by the arguments of the tariff reformers while his son Ralph was equally on the side of free trade. The latter was thus led to study . . . the speeches of the leading politicians of the time and was particularly struck by a point

⁵⁴ D. Winch, *Economics and Policy: a Historical Study* (London, Hodder and Stoughton, 1969), p.147. Winch wrongly classes Hawtrey, along with Robertson and Pigou, as pupils of Marshall.

⁵⁵ Deutscher, *R.G.Hawtrey and the Development of Macroeconomics*, p.8.

⁵⁶ S.Howson, 'Hawtrey and the Real World', in G.C.Harcourt (ed.) *Keynes and his Contemporaries* (London, Macmillan, 1985), p.181.

⁵⁷ Black, 'Ralph George Hawtrey', p. 371.

⁵⁸ *Ibid.*, p.370.

made by Joseph Chamberlain in 1903, to the effect that British exports had not increased over the preceding thirty years. On looking into this he realised that Chamberlain's figures related to the value of exports . . . and that the volume of those exports had actually increased substantially. Hence the significance of changes in the general price level came to Hawtrey . . .⁵⁹

In 1909 Hawtrey was promoted to the First (Finance) Division of the Treasury as acting First Class Clerk.⁶⁰ It was in the same year as his promotion to First Class Clerk that he began writing his first book. Again, the spur was his fascination with the problems associated with changes in the price level.

I began writing this book in March 1909 when the depression which followed the American crisis of 1907 was still unrelieved It struck me that the extinction of profit in a depression could be explained if the price level fell in the interval between the incurring of costs and the sale of the product. And if traders borrowed at interest to finance profit-making business, they could pay a higher rate of interest when prices were rising and a lower rate when prices were falling Here, I thought, was a discovery, but I was disillusioned . . . that the principle was one already recognised in Irving Fisher's work But I was not

⁵⁹ *Ibid.*

⁶⁰ *Ibid.*, pp. 366-367.

discouraged, for . . . its application to the explanation of the trade cycle would be new.⁶¹

Hawtrey's economic model of the trade cycle was quite idiosyncratic in its emphases. He claimed that it was derived from his observations of the workings of the city, but it probably also owed a great deal to his interest in nineteenth-century banking, finance and prices. David Laidler has described Hawtrey's first book, *Good and Bad Trade*, 'a most original construction' (see quote above), but perhaps even more remarkable than the original model is that over the course of the next 50 years, during which time Hawtrey entered into extensive correspondence with all the major economists of the period, he continued to remain faithful to his early model. Black notes that most of the key ideas in his first book, *Good and Bad Trade* (1913), can still be found, fifty-four years later, in his last book, *Incomes and Money* (1967).⁶²

Moreover, Hawtrey remained faithful not only to his original model, but to his own earliest terminologies and concepts - and, whilst continuing to use these concepts, he entered into dialogue with other economists using their, quite different, concepts and terminologies. Reviewing Hawtrey's *Capital and Employment* in 1938, Nicholas Kaldor wrote that:

⁶¹ R.G.Hawtrey, *Good and Bad Trade: An Enquiry into the Causes of Trade Fluctuations* (London, Constable, 1913), p.vii. The passage appears in the 'Foreword' to the Kelley reprint and is quoted in Howson, 'Hawtrey and the Real World', p.144.

⁶² Black 'Ralph George Hawtrey', p. 370.

[t]he second part [of *Capital and Employment*] consists of an extensive review of the theories of Mr. Keynes, Professor Hayek, Major Douglas, Professor Pigou and Mr. Harrod. This is in accordance with the tradition Mr. Hawtrey has made peculiarly his own, of attempting to bridge differences between economists through an extensive and sympathetic review of every important new contribution to his subject. As always, Mr. Hawtrey's criticisms of his contemporaries are a model of patience and fairness; and in his willingness to master other people's terminologies, while adhering consistently to his own, Mr. Hawtrey is surely unique.⁶³

Good and Bad Trade: an Enquiry into the Causes of Trade Fluctuations, was written in the period 1909-1913 whilst he was private secretary to the Chancellor of the Exchequer, David Lloyd George. He was also subordinate to Sir John (later Lord) Bradbury, who later became Joint Permanent Secretary to the Treasury in 1913. Hawtrey admired Bradbury's abilities and his knowledge and understanding of the City and its workings. Given that 'city wisdom' was the stated basis for Hawtrey's economic model (see Hawtrey's note to Guillebaud, quoted above), it seems very likely that Bradbury might have been the fount of much of that wisdom. Certainly, Hawtrey was always of the opinion that the theory of money had evolved from within banking practice, and not from the 'academic community'.⁶⁴ If Marshall did have any influence on Hawtrey then it

⁶³ N. Kaldor, 'Mr. Hawtrey on Short and Long Term Investment', *Economica*, New Series, Vol. 5, No. 20. (Nov., 1938), pp. 461-467.

was probably indirectly through the activities of Cambridge-educated economists working in the city. Absence of academic references within Hawtrey's first book led Pigou to dismiss it as an 'ordinary book' – as opposed to an academic treatise. Collison Black makes it clear that, in his view, the absence of references was because 'Hawtrey arrived at the basic ideas of his system in almost complete independence of other economists'.⁶⁵ Deutscher, too, begins his review of Hawtrey's work by suggesting that when Hawtrey made his initial forays into the economics of money and cycles 'he was not well acquainted with the existing literature'.⁶⁶

Nineteenth-Century Theories of the Trade Cycle

Until the second half of the nineteenth century the theory of the 'trade cycle' was of little interest. In a semi-agricultural society with cottage industries and small family businesses the fluctuation between good and bad harvests was regarded as of greater importance than business booms and slumps. Generally, every willing worker was found occupation – with varying degrees of profit.

Industrialisation drew attention to the trade cycle because of the sharp distinction between employment and unemployment. Marx, in the 1850s, had constructed a model of the trade cycle. In the Marxist model good times, and

⁶⁴ Hawtrey Papers, HTRY 13/5. Interview with Sir Alec Cairncross, 1985.

⁶⁵ Black, 'Ralph George Hawtrey', p.371.

⁶⁶ Deutscher, *R.G.Hawtrey and the Development of Macroeconomics*, p.8.

competition, forced firms to invest in capital equipment to become more efficient. Machinery enabled employers to lay off labour, and the unemployed pool of willing workers allowed the wages of retained workers to be forced lower. Reduced spending power entailed losses and the laying off of more workers in a self-reinforcing downward spiral. This tide finally turned when surviving firms were able to buy up the capital equipment of distressed firms at such bargain prices that operating them became, once more, profitable. Marx identified a source of instability within the capitalist industrial system, but the quantity of available money played no part in his analysis.

Discounting Jevons's theory of sun-spots (Jevons, a serious economist who did pioneering work on marginal utility, divined great meaning in the almost identical length of the trade cycle and the sun-spot cycle) most theories of the trade cycle in existence at the beginning of the twentieth century regarded it as the result of an imbalance, at any given time, between the demand for consumer goods and the demand for investment goods – the goods needed to manufacture the consumer goods. Although theories of trade fluctuation at the turn of the century recognised that the output of investment goods was considerably more volatile than that of consumer goods, it was not until 1917 (after the publication of Hawtrey's first book) that John Maurice Clark first gave it clarity through his 'accelerator mechanism'. Money entered into this 'imbalance' explanation of the trade cycle, especially at the turning-points of the cycle. During the period of expansion, the manufacture of investment goods was stimulated by the

availability of credit. The credit expansion forced the banks to raise their interest rates in order to stem the growth of lending and maintain their liquidity ratios. The high rates at the top of the boom led to cut-backs in investment, this reduced the incomes from the manufacture of investment goods and, eventually, caused descent into depression. Correspondingly, at the bottom of the cycle, low interest rates encouraged borrowing to enable cheap equipment from distressed firms to be purchased – and this played its part in the eventual upswing. Thus, monetary factors were regarded as amplifying industrial instability, but that instability was not regarded as being due to the instability of credit. To Hawtrey the roots of instability lay endogenously within the monetary system itself.

An early alternative model of the trade cycle was provided by Denis Robertson in his publication *A Study of Industrial Fluctuation* (1915). Robertson was raised in the Cambridge school of Marshall and Pigou, and during the preparation of his book Pigou urged him to uncover the 'real' forces contributing towards fluctuation rather than accept Hawtrey's monetary causes. Robertson placed stress upon the fluctuation of demand for investment goods. At the top of the cycle a 'glutability of wants' (later explained by Robertson as a saturation of the desire for consumer goods) caused a drop in the demand for additional investment goods, and the ensuing fall in incomes from the manufacture of investment goods marked the upward turning point of the cycle.

Robertson found the marking of the upturn at the bottom of the cycle more problematic. His study of the history of upturns led him to believe that they were marked by situations where it became profitable to acquire extra capital goods. Thus the purchase of new capital goods could be prompted by an abundant harvest (aligning him, to some extent, with Jevons's theory of sunspots) or the development of some new invention such as the railways or electrical power. Robertson was initially sceptical about the 'accelerator' principle, since he believed the initial spur to increased demand for capital goods lay outside any cyclical demand for consumer goods – the latter, in any case being responsive to changes in the demand for capital goods. However, in his later work he made increasing use of the accelerator principle.⁶⁷

Good and Bad Trade

In *Good and Bad Trade* (1913), Hawtrey's first book, he did not use the concepts of 'Consumers Income' or 'Consumers' Outlay' - concepts which became central to his later analyses. These concepts were more fully developed in his publications between the wars, and thus there is an element of immaturity about *Good and Bad Trade*. The book did, however, develop a complete theory of the trade cycle as caused by monetary instability. Hawtrey's method was to start with an abstract case of a country without a banking system, isolated, and using paper money - and then to consider the consequences of a 'sudden shock' in the

⁶⁷ D. P. O'Brien, *The Foundations of Business Cycle Theory* (Cheltenham, Edward Elgar, 1997).

size of the stock of money. Step-by-step, the exercise was repeated with the constraints gradually removed; a banking system was introduced, then an international dimension, and finally an international gold standard. His 'Introductory' outlined his purpose.

The general result up to which I hope to work is that the fluctuations are due to disturbances in the available stock of 'money' - the term 'money' being taken to cover every species of purchasing power available for immediate use, both legal tender money and credit money, whether in the form of coin, note or deposits at banks.⁶⁸

That he was conscious of the peculiarity of his own monetary approach to trade fluctuations can be seen in his Introductory's closing paragraph:

. . . at one time economists were so anxious to guard themselves from the fallacy of identifying money and wealth that they slipped into pedantic disregard of the influence of money in economic phenomena.⁶⁹

He warned against the prejudice 'which would condemn as superficial any theory claiming primary importance for purely monetary influences', stressing at the outset the importance of regarding money as more than simply a medium for

⁶⁸ Hawtrey, *Good and Bad Trade*, p.3.

⁶⁹ *Ibid.*, p.5.

facilitating exchange (a fault which he suggested classical economists were prone to make), but as an essential store of value.⁷⁰

. . . a man . . . will probably be paid at regular intervals . . . a sum which must last to the end of the interval . . . [therefore] he will find it prudent to always have a moderate sum in hand to provide against unforeseen contingencies Thus every man has to keep a greater or less reserve of money, or 'working balance'.⁷¹

Hawtrey then, in effect, posed two questions: 'What is the appropriate quantity of money required to maintain an economy?', and 'Does the quantity of money in the economy make any difference to the level of economic activity?' He answered these questions by considering the places, where, at any one moment of time, the country's stock of money might be.

The payment of a note is only a momentary transaction [it] spends the greater part of its life reposing in someone's pocket or purse, or in someone's till or cash-box or strong-room.⁷²

⁷⁰ *Ibid.*

⁷¹ *Ibid.*, pp.10-11.

⁷² *Ibid.*, p.10.

Whilst 'reposing' in these places the note would, of course, be part of the essential cash balance which each individual, or company, or bank, felt it prudent to retain as a balance. This largely answered Hawtrey's first question. The required stock of money would be that which satisfied the sum of the required cash-balances of millions of individuals and companies – the sum of millions of individual decisions, with each individual acting upon what he or she considered to be a prudent reserve of money.

Yet, would changing this quantity of money affect the nation's economy in any way? Hawtrey conducted a little 'thought experiment', imagining the face value of each note, overnight, to be doubled, thereby doubling the country's stock of money, and naturally concluded that if all adjustments could simultaneously be made then economic life would progress exactly as before with the nominal value of earnings, prices, expenditure and cash-balances doubled. Such instantaneous adjustments being impossible, Hawtrey then used cash-balance mechanics to illustrate how a disturbance to equilibrium by, first of all, a *reduction* of the money supply (in this instance, by an increase in taxation with no increased Government expenditure) might transmit itself into a reduction in aggregate money expenditure.

Before the withdrawal of money from circulation, every member of the community may be assumed to have adjusted his working balance of money in hand so as to fit the income he was accustomed to receive and the expenditure he was accustomed

to incur. After the withdrawal, therefore, some at any rate of the members of the community, having had to pay more taxes than usual, will find that they are in danger of a shortage. In the absence (as assumed) of a banking system, it will be necessary for them to restrict expenditure for a time in order to replenish their balances.

But though anyone may replenish his balance by economising, it is clear that no transfers of money from one individual to another can replenish all the balances A new equilibrium can only be found *by a change in incomes and expenditures which will make a reduced scale of balances sufficient.*⁷³

At this stage of his argument there was still nothing to suggest that reducing the supply of money could not have led to a new equilibrium with lower cash balances, lower wages and lower prices – life as before, but with the value of each unit of currency reduced by a proportion. He first suggested this as a possibility:

. . . there is . . . no remedy (to the loss of orders caused by a cut in the money supply) but the reduction of money wages to the point which will enable producers to resume their former activities and dispose of the output without incurring a loss. This reduction of money wages does not involve a proportional reduction in real wages, for it is accompanied by an all-round reduction in prices.⁷⁴

⁷³ *Ibid.*, p.38.

⁷⁴ *Ibid.*, p.42.

Then, however, he acknowledged the real problems which prevented the appropriate adjustments being made.

If customary wages and customary prices resist the change, the adjustment, which is bound to come sooner or later, will only be forced on the people by pressure of distress. . . . *The time taken in reaching the new position of equilibrium will probably depend on the willingness of employees to accept the reduced wages* [my italics].⁷⁵

'Wage stickiness', the reluctance of unionised workers to accept wage reductions in the event of a money-supply cut, was identified as the prime cause of the inability of employers to enact price cuts and restore the previous state of equilibrium at lower monetary values. The inability of producers to proportionately cut their wage bills prevented them from proportionately cutting their prices and maintaining their volumes of sales. Therefore, being forced to cut their volumes of sales they were forced into reducing their costs in other ways available to them. One other way available to them was the cutting of the quantity of labour which they employed. Equilibrium would then, however, eventually be restored at lower monetary levels.

⁷⁵ *Ibid.*, pp. 42-43.

In the remaining stages the pressure of distress due to lack of employment drives the working class to accept lower wages. As wages fall, prices fall, output increases, and employment improves, until at last all money values have completed a fall proportional to the original diminution of the stock of money and equilibrium is restored.⁷⁶

Hawtrey analysed the case of a monetary 'shock' which entailed an expansion of currency in precisely the same manner.

People find themselves one day with more money in hand than they expected. Each proceeds to spend his surplus. . . . retailers give increased orders to the producers, who in turn take what measures they can to increase their output.⁷⁷

These measures would have a bearing on employment –

If market conditions have hitherto been stable . . . there will be no large reserve of unemployed labour. . . there will be . . . temporary unemployed . . . inefficient men . . . veterans . . . youths who are hardly old enough to begin . . . overtime . . . but . . . the possible extension of the productive capacity of the community would not be very great. . . . Businesses . . . will

⁷⁶ *Ibid.*, p.94.

⁷⁷ *Ibid.*, p.49.

have to compete . . . to provide themselves with labour. Here is an influence tending to increase the rate of wages.⁷⁸

There would also be a tendency for prices to rise: `retailers being unable to obtain . . . their orders for new goods . . . would be prepared to pay increased wholesale prices to the producers.'⁷⁹

The outcome of this preliminary, unrealistic, part of the investigation was simply that - whether the initial `shock' to the system was a contraction or an expansion of currency - equilibrium would, in time, be restored with changed nominal values of costs, prices, profits and cash-balances. However, during the period of restoration of equilibrium, a contraction of currency would be associated with the characteristics of trade depression whilst an expansion of currency would be associated with the characteristics of a trade boom.

Up to this point in Hawtrey's analysis there was no tendency for business activity to move into a cyclical pattern; only for a monetary shock – of either kind – to lead to distortions in the pattern of wages and prices, with temporary conditions of depression or boom, before restoration of equilibrium. He then moved the analysis forward by adding a banking system.

With a banking system, when the stock of currency was reduced, individuals would look to the banks to restore their cash-balances.

⁷⁸ *Ibid.*, pp. 49-51.

⁷⁹ *Ibid.*, p.50.

The first effect of the contraction of the currency is that the working balance of cash in the hands of individual members of the community will be diminished. . . . those who have banking accounts will quickly draw out enough cash to restore their working balances.⁸⁰

In restoring their cash balances, people would lower the cash reserves of the banks. The banks, in their turn, would need to protect their reserve-ratios by raising their interest rates to attract money, and stem withdrawals. The high bank rate would then start to have an effect through its action on dealers' stocks. Dealers and wholesalers, Hawtrey suggested, were able to exercise far greater flexibility in adjusting their levels of stocks than producers and manufacturers were able to exercise in adjusting their levels of capital equipment. Consequently, the responses of dealers were far more sensitive to changes in interest rates. Rising rates would be an added expense to the dealers, who would attempt to mitigate their extra expenses by reducing their levels of stocks.

[The dealer] can reduce his indebtedness if he can reduce his stocks of goods, and he can reduce his stocks of goods by merely delaying replenishment when they are sold. . . . Consequently the manufacturers will find that they are receiving fewer and smaller orders [they] experience a slackening of

⁸⁰ *Ibid.*, p.58.

demand, and in order to relieve the resulting restriction of output
[they] lower prices . . .⁸¹

Other consequences followed. The extinguishing of the dealers' indebtedness to their bankers implied a reduction in the overall level of credit and, thus, a reduction in both the purchasing power in the hands of the public and the superstructure of incomes based upon that purchasing power (a central theme running through all Hawtrey's economics). The fall in incomes, hence demand, would reduce the dealers' sales - they would be forced to reduce even further their orders to producers and the decline would continue. Manufacturers, too, would reduce their demand for credit from the banks, a process which would further reduce the level of demand in the economy. Hawtrey regarded the effects at this stage to be only slightly different from those outlined in the first stage of the argument.

The process differs from that described in the last chapter chiefly in being more gradual. The diminution in the stock of money, instead of occurring suddenly, is caused progressively by the action of the trading world under the influence of the high interest rate.⁸²

⁸¹ *Ibid.*, pp. 62-3.

⁸² *Ibid.*, p.64.

High rates of interest would come to an end when the bankers had restored their reserve ratios – during which period those pressures of distress associated with depression would be observed. Hawtrey then seemed to suggest that it might be possible, even with a banking system, for equilibrium to be re-established with full employment at lower levels of prices and wages:

The bankers have restored their reserves and are satisfied. . . . [t]he aggregate of purchasing power is on the reduced scale corresponding to the reduced stock of money; the productive resources of the community will not be fully employed until the level of prices is reduced in the same proportion; prices cannot be reduced until the cost of production is sufficiently reduced; and the cost of production can only be reduced as wages are reduced.⁸³

Interest rate adjustments by bankers, however, gave rise to instability – and the trade cycle resulted. Equilibrium, Hawtrey suggested, was maintained when the interest rate of the banks (the market rate) was the same as the average rate of return on capital throughout business (the profit rate).⁸⁴ Under such conditions there would be no tendency for businesses to seek to increase or decrease the

⁸³ *Ibid.*, p.65.

⁸⁴ On pp. 65-7 of *Good and Bad Trade* Hawtrey introduced three different rates of interest: the 'natural rate', being the annual saving on labour per unit initial cost of investment goods; the 'profit rate', being the profit per unit initial cost of investment goods; and the 'market rate', being, in fact, the bankers' rate. The following analysis is somewhat simplified and uses only the last two rates of interest, but is adequate for demonstrating Hawtrey's thesis that the creation of credit is inherently unstable.

size of their loans. If businesses, through a sudden increase in the stock of money or for some other exogenous reason (possibly increased efficiency or technological innovation) were able to make themselves more profitable, then there would be an increased demand for credit at the prevailing rate of interest (if, say by innovation, a business is enabled to earn 10 per cent rather than 5 per cent on its capital investments whilst paying only 5 per cent to the banks for the loans by which it purchases extra equipment, then it will tend to expand its investment). Higher credit levels, leading to increased purchasing power would, in turn, lead to increased demand and make business still more profitable – increasing still further the divergence between the profit rate and the market rate. The point that Hawtrey sought to stress was, that any initial movement away from equality between the two rates of interest would, in the early stages, tend to be amplified. In the case of the profit rate moving higher than the market rate, the extension of credit would, eventually, cause concern over the banks' reserve ratios, leading them to increase the market rate until, eventually, they would stabilise borrowing at a point where the market rate was equal to the, now considerably enhanced, profit rate.

However, as the market rate rose, dealers and wholesalers (as argued above) would cut back on their orders to producers. This would initially act as a drag on the increase of the profit rate, but, as market rate was lifted to reach the level of the profit rate, cut-backs in orders by wholesalers would begin to reduce profits to the point where the profit rate would eventually turn down below that of the

market rate. Thus, it can be seen that Hawtrey saw two distinct movements, with a time-lag or phase-lag between them. As the market rate of interest rose, but remained below the profit rate, there would be tendency for manufacturers to take on more credit. The higher interest rates which ensued would cause dealers and wholesalers to reign back on credit. This situation can be modelled in the mechanics of moving bodies by a system subjected to two opposing, but fluctuating, impulses between which there is a time lag. The result is instability and an induced oscillatory motion (forced harmonic motion) – in this case, the oscillatory motion was the trade cycle induced by the instability of credit. Hawtrey was aware of the mechanical analogy.

A flag in a steady breeze could . . . remain in equilibrium if it were spread out flat in the exact direction of the breeze. But it can be shown mathematically that the position is unstable, that if the flag deviates from it to any extent, however small, it will, initially, tend to deviate further. Consequently the flag flaps.⁸⁵

Hawtrey then extended his analysis to take account of international trade – first with the simplifying assumption of no gold standard, but inconvertible paper currencies.⁸⁶ The initial international response – on the assumption that the initial ‘shock’ was a restriction of currency in Britain – would be for foreign investors to want to take advantage of the higher interest rates which the banks

⁸⁵ Hawtrey, *Good and Bad Trade*, pp. 76-77.

⁸⁶ *Ibid.*, pp. 89-101.

would impose as they attempted to restore their cash ratios (see above). The initial demand for sterling – for investment - would cause its value to appreciate on the exchanges. Hawtrey saw this appreciation of sterling as a means of enabling foreign manufacturers, exporting goods to Britain, to undercut British prices - forcing down the British price level and hastening the speed of the initial movement, in the cycle of wages and prices, down towards the equilibrium position.⁸⁷ Perhaps more importantly, the consequent appreciation of sterling acted as a means of isolating the rest of the world from the effects of the depression in Britain, since its effect was to negate the benefits of the greater interest rates for foreign investors – they may have been able to earn more interest, but each (inflated) pound would cost them more in their local currencies. Had this appreciation of sterling not occurred, then foreign banks would have had to increase their interest rates to stem the outflow of reserves, and the consequent fall in the level of worldwide credit would have diminished foreign incomes and demand, leading to worldwide trade depression. Overall, Hawtrey did not consider the international dimension, in the absence of a metallic standard, made any great difference to his analysis.

Indeed the only important consequence . . . of a contraction [of currency] in [one country] is the tendency of [other countries] to

⁸⁷ *Ibid.*, p.98.

lend money to the [first country] in order to get the higher rate of interest.⁸⁸

However, where two countries currencies were linked by the gold standard then, Hawtrey argued, the effect of a monetary 'shock' in one country could be more far-reaching.⁸⁹ Assuming a sudden contraction of currency in Britain then the consequences of such a 'shock' would, as we have seen, been a diminution of bankers' reserves, a lifting of interest rates, the attraction of deposits from abroad, a tendency for sterling to rise against foreign currencies – with the rise in sterling acting as a brake on further inward investment, and removing the need for foreign banks to have to safeguard their reserves by raising *their* interest rates. But, under the gold standard, were there any tendency for a foreign currency to fall below its lower specie point, investors from abroad had the option of directly transferring gold as a means of acquiring the sterling – in effect, there was no means by which currency adjustments might stem the flow of funds seeking higher interest rates. The outflow of currency or gold from

⁸⁸ *Ibid.*, p.99

⁸⁹ *Ibid.*, p.103. Hawtrey, despite much of his often dry and turgid prose, was not without a mischievous sense of humour. In introducing the topic of a monetary disturbance with a common metallic medium of exchange, he suggested that under such conditions the sudden effect of a currency contraction would be equivalent to the step of suddenly withdrawing from circulation a large quantity of gold, adding – '[i]t does not matter precisely what the step is. If the reader desires a concrete illustration he may suppose that the gold is melted down and made into a calf for the people to worship'.

countries abroad could only be stemmed by their bankers raising their interest rates.

The foreign bankers must in turn protect their reserves by putting up the rate of interest in their respective countries. Thus the contraction of the currency at once tends to spread itself over the whole of the gold-using world. The consequent depression is by this means alleviated in the area of stringency, but only at the cost of being extended in some degree to all the other countries.⁹⁰

The link between interest rates and incomes was, as ever for Hawtrey, the need for cheap credit to be available for companies to bridge the gap between taking on extra workers and the time when they were able to sell the finished products. Thus, Hawtrey argued, the international nature of the trade cycle which had been observed since the 1870's had been caused, in large part, by the operation of the international Gold Standard.

Hawtrey felt that the working classes lost out in both 'good' and 'bad' trade – the 'good' trade phase being that period of expansion when the profit rate of industry ran ahead of the market rate of the banks. The point being that 'bad' trade dealt them unemployment, whilst 'good' trade eroded their living standards through inflation. Both needed to be avoided.⁹¹

⁹⁰ *Ibid.*, p.105.

⁹¹ *Ibid.*, p.255.

As for remedies, Hawtrey held out little hope. The imposition (or removal) of tariffs was one means of *initiating* Hawtrey's disturbance in the stock of money, and these might, theoretically, be used to *counter* the effects of the instability of credit, but to be effective they would need to be continually changed – a situation with which 'traders would not acquiesce for a moment'.⁹² Irving Fisher's had proposed that paper currency be convertible into an amount of gold which was periodically to counter the effects of fluctuating credit. Such adjustments would have helped stabilise the prices of commodities, but Hawtrey regarded them as 'hardly . . . within the realm of practical politics'.⁹³

The Minority Report of the Poor Law Commission, issued in 1909 (and including Professor Pigou amongst its signatories), had recommended its preferred remedy. In recognition of the cyclical nature of trade, it suggested that a portion of the annual national expenditure on building (up to £4 million per annum) should be withheld, and only sanctioned when employment exceeded a specific level. This would have provided for up to £40 million per decade, obtainable through loans, with which to relieve unemployment during periods of depression. Hawtrey's response to such suggestions, in 1913, was hardly to change in the course of the next thirty years.

⁹² *Ibid.*, p.256.

⁹³ *Ibid.*, p.256.

. . . the writers of the Minority Report appear to have overlooked the fact that the Government by the very fact of borrowing for this expenditure is withdrawing from the investment market savings which would otherwise be applied to the creation of capital. . . . If savings . . . are diverted . . . the money to be spent by private individuals on the construction of fixed capital is correspondingly diminished . . .⁹⁴

Hawtrey made only one small concession; that a portion of the savings used to finance Government construction might be diverted from foreign investment. Yet he did not consider this to be wholly beneficial since much foreign investment took the form of exported capital goods. There would be a diminution of demand for these capital goods at a time when demand was already low.

Having dismissed tariffs and government spending as ineffective, and tampering with the gold standard as politically unacceptable, Hawtrey turned, albeit pessimistically, to one possible, realistic, hope for the mitigation of the cycle.

If the great central banks of the world . . . could agree together to draw the reins a little tighter at times when an expansion of trade is in progress, they might prevent the inflation of credit money reaching the dangerous point. To carry this policy through successfully, they would have to realise that, when the

⁹⁴ *Ibid.*, p.260.

supply of credit money is being increased, *future* demands for cash are being set in motion, and that a margin of reserve ought to be kept in hand to meet those demands when they materialise. And on the other hand, when the supply of credit money is being diminished the banks ought to be in a position to release a sufficient amount of cash to provide for the payment of wage bills on a scale more than proportionate to the aggregate of credit money, since the rate of wages will ultimately fall and they will then get back the extra cash into their vaults.⁹⁵

Essentially, Hawtrey was asking central banks to increase their rates more rapidly at the onset of a boom, thus maintaining a higher proportion of cash reserves as trade expanded, and to lower rates more rapidly at the onset of a slump, thereby reducing their proportion of cash reserves during periods of depression. Such actions would have acted as a damping mechanism on the oscillations of credit – shock absorbers reducing the motion of the springs after the car had hit the ramp. Hawtrey never lost his faith in the power of frequent adjustments of Bank rate. His pessimism in making these proposals lay in the absence of any central bank in the United States, whose 20,000 banks continued 'blindly building up vast inflations of credit money, only to land themselves every few years in a crisis accompanied by the suspension of cash payments and followed by a collapse of industry'.⁹⁶

⁹⁵ *Ibid.*, p.263.

⁹⁶ *Ibid.*, pp. 264-5.

In his review of *Good and Bad Trade*, in *The Economic Journal*, Professor Pigou criticized Hawtrey for his assumption that monetary fluctuations were the *cause* of trade fluctuations – '[s]uch a point of view is exceedingly superficial'.⁹⁷ His criticisms may be taken as representative of the general view of the economics profession at the time. Pigou regarded monetary fluctuation as being part of the symptoms of the trade cycle rather than its cause, with 'waves of confidence or depression in the outlook of the business community' playing as important a role in the cycle as monetary factors. He thought that Hawtrey had missed an opportunity of exploring the way in which monetary mechanisms augmented the causes of trade fluctuation which operated from *outside* the monetary system. In the face of all criticisms, Hawtrey defended his initial economic viewpoint for the rest of his life. Later work may have added refinement, but the basic structure of his economic model was laid out in *Good and Bad Trade*, and it was this model that was to form the basis of all his economic policy comment.

OTHER ASPECTS OF HAWTREY'S ECONOMICS

1. Dealers, Wholesalers and Middlemen

⁹⁷ A. C. Pigou, 'Review of *Good and Bad Trade: An Enquiry into the Causes of Trade Fluctuations*. By R.G.Hawtrey', *The Economic Journal*, Vol. 23, No. 92. (Dec., 1913), p. 582.

As Hawtrey moved from *Good and Bad Trade* (1913) to *Currency and Credit* (1919) the most significant development of his analysis of the trade cycle was the increasingly pivotal position accorded to the dealer – in particular, the wholesale dealer. The position of the dealer in determining the level of economic activity was accorded greater significance than either the producer or the consumer.

The wholesale merchants fill a very important place in the trading system. They judge demand and regulate supply. The outlook of the retailer is limited and local . . . and he cannot make a comprehensive survey of the prospects of demand. It devolves therefore on the wholesale merchant to set the machinery of production at work by giving orders to producers, and incidentally to start the machinery of credit.⁹⁸

In comparison to dealers the range of options to producers and consumers was limited. The flexibility of producers was limited by the fixed capital they had tied up in plant, and their need to operate that particular plant, as near as possible, to maximum capacity. Consumers were restricted to allocating income to those goods and services which retailers chose to supply. The wholesale dealers, however, had the greatest flexibility in responding to changing market conditions; they were in possession of the intelligence, through the dealer

⁹⁸ R.G.Hawtrey, *Currency and Credit* (London, Longman's Green, 2nd. edition, 1923) p. 8.

network, that equalised the prices of particular goods by informing potential traders of the conditions of supply and demand and thus effectively 'clearing' supply and demand.

Dealers were involved in two types of activity: first, holding stocks of goods; secondly transferring goods from places of excess supply to those of excess demand. Maintaining 'large' holdings of stocks enabled dealers to take advantage of economies of scale (in transport, for example) and maintain continuous supplies to retailers when production might be irregular (dependency on harvests, for example). Large stocks cushioned transitory surges of demand, which may, because of their transitory nature, not have been signals for the dealer to raise his prices, but if a dealer interpreted a change in demand as being sustainable then, to maintain his stocks, he would either have had to raise his prices to reduce demand or increase his orders to the producer – or possibly both. To take such steps when a demand surge was merely transitory would involve the dealer in loss of business or extra storage costs, therefore correct interpretation of market signals and forecasting of market conditions was important to him. A similar set of arguments was, of course, applicable to any loss of demand for a dealer's stocks.

The response of a producer to increased orders would be either to step up production using spare capacity, or, if that were not available, to lengthen delivery dates or quote higher prices. Long-term investments to increase output would require substantial planning and would only be made after a prolonged

period of consideration of future prospects, not on the basis of short-term data obtained from dealers. It was the dealer's antennae which were important in relating the demand of consumers to the supply of the producers.

The observation at the core of Hawtrey's analysis was that, since dealers did not wish to be holding large 'idle' balances of cash when holdings of stock fell temporarily below their maximum requirements, stocks tended to be financed by bank advances. The interest payable on these advances tended to be the largest element of the cost of holding stocks. Thus changes in short-term bank rates implied a substantial change in the cost of holding stocks. Moreover, since the cost of holding stocks was the most flexible of all the costs in the dealer's operations, his first action when faced with a need to reduce costs would be to reduce his indebtedness to the banks by running down his stocks.

It is the dealer in goods who is deterred by high interest. His capital is not composed, like that of a manufacturer, of a costly fixed plant; it is mainly working capital in the form of stocks of goods. The stock of goods appropriate to a given amount of sales is not a fixed quantity. . . if the cost of holding a stock of goods is increased. . . it is very easy for the trader to reduce the average quantity of goods held in stock, and so his indebtedness to the banker.⁹⁹

⁹⁹ *Ibid.*, pp. 69-70.

This contraction of stocks as a result of changes in short-term interest charges, Hawtrey argued, tended to be greater with manufactured products since, with agricultural products, farmers were more willing to reduce prices to induce dealers to transfer the cost of storage from themselves to the dealers, and with primary raw materials the variations in price in speculative markets outweighed the effects of interest changes.

A decision to run down stocks would lead to a decline in orders from producers which, since producers tend to be filling a backlog of orders extending into the future, only led to a decline in manufactured output after a time-lag. The eventual fall in production could be only partially mitigated by reducing prices because of the fixed costs of the manufacturer, and so this would lead to loss of employment and an overall reduction in consumers' incomes. The reduction in income would be only partially compensated for by consumers depleting their cash-balances, and so the consequent reduction in consumers' outlay would lead dealers' stocks being at higher levels than intended – a level originally designed to reduce their indebtedness to the banks. A further reduction in orders to producers would be prompted, and the economy would fall into a 'vicious circle of deflation' – or, in the event of a short-term interest reduction, a 'vicious circle of inflation'.

The reduction of rates would, of course, encourage dealers to hold higher stock levels. But there would be a limit to the quantity of stocks which it would be convenient for a dealer to hold – storage capacity being the simplest way of

illustrating this limit. Thus, below a certain level, the reduction of interest rates would not entice any greater holding of stocks. Hawtrey termed this a 'credit deadlock'. This represented a limitation of the extent to which reductions of interest rate might stimulate the economy. Hawtrey seems to have inserted this qualification as a way of explaining Keynes's concept of the 'liquidity trap' – his contention that in a recession low interest rates would not stimulate business investment since they would have the effect of 'pushing against a piece of string'.

Variation of Bank rate had traditionally been the Bank of England's method of maintaining an adequate level of gold reserve. By raising the rate it was intended to restrict the volume of lending, and thus the demand for both home-produced goods and the imported goods which were causing the drain of gold. If there was a rationale for the move, it was based upon a simple form of the quantity theory that there was a direct relationship between the volume of transactions and the quantity of money in circulation. Hawtrey's emphasis upon, and elaboration of, the role of the trader provided a more developed transmission mechanism by which changes in bank rate manifested themselves in changes of output and prices. Even in old age Hawtrey remained convinced that 'Keynes was always unsound on interest rates – he totally failed to understand its effect on dealers' stocks'.¹⁰⁰

¹⁰⁰ Hawtrey Papers. HTRY 13/5. Interview with Sir Alec Cairncross, 1985.

2. The 'Consumers' Income' and the 'Consumers' Outlay'

On 1 October 1931, Hawtrey received a personal letter from Keynes's Bloomsbury address.¹⁰¹

My Dear Ralph

. . . I have worked through your paper on the definitions of Consumers' Income and Outlay. . . .

As I understand your definitions, if a private person invites a builder to build a house in accordance with an estimate . . . and the value of the house is more than what it cost . . . the profit is a capital profit which has nothing to do with income. But if the builder [builds it], then sells it for an enhanced price to the private person, the profit would be part of the consumers' income. Is this right?

. . . suppose that prices fall below the cost of production . . . the entrepreneur makes a loss . . . he restores his cash . . . from some member of the public who has been saving. This represents on your definition . . . a reduction in consumers' income If, on the other hand . . . he makes no loss . . . but incurs a capital expense . . . made up by a loan from someone's savings . . . there would be no reduction in consumers' income.

I could further re-express my theory in your language by saying that when saving exceeds investment consumers' income is reduced below normal by an equal amount, and when investment exceeds saving then consumers' income is increased above normal by an equal amount. . . .

¹⁰¹ Hawtrey Papers. HTRY 10/80. Letter from J.M.Keynes to R.G.Hawtrey 1 October 1931.

Will you think this over?

Yours ever

JMK

Hawtrey's idiosyncratic definitions were the source of much confusion between himself and other economists.¹⁰² Deutscher has described the somewhat testy confrontation over definitions between Hawtrey and Keynes within the proceedings of the Macmillan Committee on 10 April 1930.¹⁰³

It might be tempting to attribute misunderstandings between Hawtrey and Keynes to them both being, to a certain extent, self-taught economists. It is true that neither Hawtrey nor Keynes sat a university examination in economics. But although Keynes, like Hawtrey, took a degree in mathematics, he *was* tutored by Marshall at Cambridge prior to being offered a position to teach economics within Marshall's department. He had been a teacher within the Cambridge faculty before entering the Treasury at the beginning of the Great War, and thus it can be claimed that he developed his understanding of economics within the great Marshallian tradition.

Hawtrey had no such background. Within Hawtrey's monetary model of the economy is a prescription for stabilising the wealth value of the economy –

¹⁰² Hawtrey was atypical in that he built a model of trade fluctuations, not from a study of previous contributions to the academic subject of 'Economics', but from observation of banking practices within the City of London. His 'idiosyncrasy' arises from the development of constructs within his model which did not correspond to those developed in Marshall's economics.

¹⁰³ Deutscher, *R.G.Hawtrey and the Development of Macroeconomics*, pp. 85-6.

something which he considered should be the highest objective of the banking system. It was Hawtrey's emphasis upon measures to stabilise sterling (which he did not regard as self-stabilising) which Sir John Hicks has suggested was the origin of Keynes's revolutionary thinking.¹⁰⁴

Much of the correspondence between Hawtrey and Denis Robertson arose from confusions over definitions. Hawtrey persisted, against all other recognized economists, in using the terms *Consumers' Income* and *Consumers' Outlay*.

Consumers' Income was defined as 'the total of incomes expressed in money'.¹⁰⁵ It included wages, salaries, interest, rent and dividends. To Hawtrey, this was a much more useful construct than 'national income' since, for the purpose of analysis 'it would apply . . . for *any* group, whether it be a nation or something larger or smaller or different'.¹⁰⁶ *Consumers' Outlay* was 'the total spending out of income'.¹⁰⁷ The *Consumers' Outlay* was divided into that part spent on goods and services, and that part used to purchase investment products such as shares and bonds. In terming this second part as 'investment', he used the word in a quite different way from Keynes, who used the word to mean the creation, by companies, of tangible assets such as buildings and machinery. The amount by which the *Consumers' Income* exceeded the

¹⁰⁴ J. Hicks, 'Automatists, Hawtreyans, and Keynesians', *Journal of Money, Credit and Banking*, Vol. 1, No. 3, Conference of University Professors. (Aug., 1969), p. 308.

¹⁰⁵ R.G.Hawtrey, *The Art of Central Banking* (London, Longmans, 1932), p.84.

¹⁰⁶ *Ibid.*

¹⁰⁷ *Ibid.*

Consumers' Outlay led to an 'unspent margin' (which could be negative) through which individuals maintained their essential cash-balances at an appropriate level. Any event which triggered a negative 'unspent margin' – releasing cash into the community – acted as the source of a process of cumulative expansion.

3. Banking

Hawtrey exhorted his readers to think of banks as 'dealers in debt' rather than receivers and lenders of 'the medium of exchange', since he believed that this was the only way to come to a proper understanding of the role of money in an advanced society.

If we turn to the actual institutions by which the money of a civilized country is governed, we shall find that the foundation is always a law prescribing by what means a *debt may legally be discharged* [Hawtrey's italics]. The law never says what may or must be used as a medium of exchange. The idea of money is derived from the idea of debt.¹⁰⁸

Two of the modern definitions of money are as 'a medium of exchange' and as a 'unit of account'. Hawtrey generally wished to emphasize its latter role, and to do this, in many of his writings, he encouraged his readers to visualize a society lacking any medium of exchange, where all purchases were settled by the

¹⁰⁸ Hawtrey, *The Gold Standard in Theory and Practice*, p.2.

transfer of debts between bank deposits. A bank deposit, which represented a debt of the bank to the depositor, could in part be transferred from the purchaser to the seller of any goods or services. A diligent and successful seller of goods or services might build up a sizeable deposit. On the other hand, a stroke of the pen upon a ledger might also create a new deposit - upon which a person would be entitled to draw for goods and services. This process could be profitable to the bank if were to charge a rate of interest to the person for whom the deposit had been created. In such a situation the only limitation upon the extent of the creation of new deposits would be the ability of new deposit holders to repay, with interest, their deposits in such a way as to maintain the profitability of the bank. A high rate of interest would, naturally, inhibit the formation of such deposits. In the real world, such creation of deposits would also be limited by depositors seeking to use their deposits to claim some medium other than the bank's own debt (i.e. cash). This restraint would constrain the bank to limit its deposits and maintain an adequate reserve of cash – and in such cases the interest rate would be the tool of limitation.

Hawtrey did not regard an increase in credit as leading to an increase in cash balances since any money borrowed would not be hoarded but *spent*. The spent money would enhance the incomes of its recipients. It was thus axiomatic for Hawtrey that credit creation fed directly into an enhanced consumers' income. Thus, given that Hawtrey regarded trade depression as entirely being due to a compression of the consumers' income, it followed that adjustment of the level

of credit by manipulation of short-term interest rates held the key the control of both unemployment and inflation. Reviewing the series of essays which Hawtrey compiled into his *Monetary Reconstruction* in 1923 – a time when unemployment was not the overriding concern that it was to later become, Denis Robertson wrote:

. . . a single dominant thought gives unity to the whole series: the pearls are strung on a single thread – the conviction that the general level of prices can and ought to be controlled by the manipulation of the rate of discount.¹⁰⁹

The same reviewer's comments, when reviewing Hawtrey's *A Century of Bank Rate* some sixteen years later, indicate how Hawtrey's faith in the power of Bank rate had been unshaken by two decades of economic depression.

. . . Mr. Hawtrey marshals his rich knowledge of financial history . . . in support of his well-known thesis that the manipulation of Bank rate, working through the decisions of merchants to alter the size of their stocks, can be an almost completely effective instrument for controlling the level of economic activity.¹¹⁰

¹⁰⁹ D. H. Robertson 'Review of *Monetary Reconstruction* by R.G.Hawtrey', *The Economic Journal*, Vol. 33, No. 130. (June 1923), 204.

¹¹⁰ D.H. Robertson 'Review of *A Century of Bank Rate* by R.G.Hawtrey', *The Economic Journal*, Vol. 49, No. 193. (March 1939), 94.

4. The Demand for Money

Individuals would tend to collect money at fairly widely-spaced intervals such as pay days, or periodic visits to the bank, or, at even more widely spaced intervals such as dividend payment days. Demands on the individual's cash would be virtually continuous. For this reason cash balances were needed. The greater a person's income the greater would be his overall level of expenditure, and therefore the greater his average cash balance would need to be. Unforeseen contingencies, and accumulation of funds to purchase investment vehicles were other motives for holding cash, but Hawtrey regarded the level of cash-balance to be directly related to anticipated outlay, and thus to income.

When consumers, as a result of increased incomes, anticipated an increased outlay, suggested Hawtrey, they would tend to increase their cash balances by drawing on their bank deposits – a process which would cause the banks' reserves to fall. Given the tendency, in an expanding economy, for wage rises to lag behind price rises, Hawtrey argued that the depletion of bank reserves was a lagging indicator – the last event in a series which ran through rising prices, rising wages, greater anticipated outlay, the demand for greater cash balances and finally bank withdrawals.¹¹¹ Consequently, using the state of the banks' reserves as the basis for adjustments in interest rates was to apply the stabilizing

¹¹¹ F.H.Capie and G.E.Wood, 'Money in the Economy, 1870-1939' in R.C.Flound and D.N.McCloskey (eds.), *The Economic History of Britain since 1700, (Vol. 2, 1860-1939)*, (Cambridge, C.U.P., 1994).

Capie and Wood showed that the period between 1870 and 1914 had been marked by stable demand for money, growing stability of the monetary system, little variation in long-term interest rates and stable inflationary expectations (pp. 219-20).

corrections too late in the cycle - with the result that the correction had to be applied more severely than would otherwise have been required. This, he suggested, exaggerated the cyclical swings. If central banks were prepared to look further than the state of their reserves – particularly into movements of price indices – and make prompt, frequent adjustments of their discount rates, then Hawtrey believed that worst effects of the trade cycle could be mitigated.

5. Investment and the Trade Cycle

In reviewing Hawtrey's theory of the cycle Laidler was of the opinion that open-economy, international considerations were not at the heart of Hawtrey's analysis since his 'treatment of these issues is markedly inferior to that of [John Stuart Mill]; for he does not consider the possibility that an external drain of (gold) might trigger the upper turning point of the cycle'.¹¹² Laidler also suggests that the phase difference between production for consumption goods and production for investment goods did not play a significant role in Hawtrey's analysis.¹¹³ However, towards the end of *Good and Bad Trade*, whilst discussing the reasons for financial crises, Hawtrey noted that 'industries engaged in the production of fixed capital are peculiarly sensitive to fluctuations in the general state of trade . . . and the consequences are to be seen both in the high unemployment rates in the industries during periods of depression and the high

¹¹² Laidler, *The Golden Age of the Quantity Theory*, p.111.

¹¹³ *Ibid.*

prices which rule in them during periods of activity'.¹¹⁴ Within such industries he included 'building and shipbuilding trades, the construction of roads and railways, and to a great extent the manufacture of machinery and vehicles . . . iron and steel trades, and brick-making and quarrying'.¹¹⁵ He used a numerical example to illustrate the effect on the capital goods industry of changes in demand for consumer goods –

For example, it may be taken that in a particular industry the output increases . . . at an average rate of 1% p.a. and that fixed capital requires renewal after 20 years use. Then 5% of the capital requires renewal each year and [with] the demand for [increased] plant the demand for new plant will be 6% of the total amount of plant. But if there is an expansion of trade which increases the output of this industry in a particular year by 4% . . . the new plant needed will be 9% of the existing plant . . . 50% more than the average.¹¹⁶

Here, in embryo form, was the accelerator principle which was to be worked out more fully by John Clark some four years later. Hawtrey did not seem to attempt to integrate this idea into his analysis as a means of explaining the trade cycle's self-generating nature. For him, it was a peculiarity of the trade cycle which

¹¹⁴ Hawtrey, *Good and Bad Trade*, p.206.

¹¹⁵ *Ibid.*, pp. 205-206.

¹¹⁶ *Ibid.*, p. 207.

required explanation, rather than a mechanism which drove the cycle. Prior to this short analysis he had asserted that '[the capital] industries really depend ultimately for the demand for their products upon the rate at which savings are accumulating'.¹¹⁷ Hawtrey is, here, equating investment with savings as the difference between income and consumption. Savings led to investment – without which the capital industries could not prosper. Given this belief in the importance of savings for the capital industries it is unsurprising that he continued to argue against the feasibility of public works expenditures as a means of stabilising the capital industries. This argument underpinned the 'Treasury View' which cautioned against financing public works on borrowed money as a means of reducing the unemployment count.

6. The Gold Standard

Susan Howson concluded that Hawtrey's role in the framing the Genoa Resolutions for the reintroduction of an international gold standard, in 1922, was the 'high point of his official career'.¹¹⁸ Nothing came of Hawtrey's Genoa Resolutions, but in terms of the level of his profile, this assessment is probably true. The Genoa Resolutions set out to establish an improved gold standard, since Hawtrey regarded the failure of the traditional gold standard to stabilise the value of money *as a means of account* – i.e. in terms of the generalised value of

¹¹⁷ *Ibid.*, p. 206.

¹¹⁸ Howson, 'Hawtrey and the Real World', p.176.

other commodities – as its major weakness. Fluctuations in the value of gold were the result of fluctuations in demand, and since the gold holdings of central banks formed the basis for expansion of credit – to Hawtrey, the necessary condition for the expansion of the consumers' income – he regarded it as vital that central banks took measures to stabilise the demand for gold.

With central banks acting independently of each other, one central bank restricting credit, stemming its imports and thus accumulating gold, would commit other banks to take similar measures to preserve their gold. Credit restriction and collapse of consumers' incomes would become a worldwide phenomenon. Such a process could be initiated by a general increase in the demand for gold. Hawtrey regarded a gold standard managed by international cooperation in response to world economic conditions as a necessity for preventing such fluctuations. World economic depression demanded an agreement for all central banks to expand credit in such a way that fear of loss of gold would be reduced. Similarly, any general deficiency in gold could be countered by a general agreement between central banks to adjust their gold reserve ratios – again, with co-operation reducing the fear of loss of gold - in such a way that the demand for gold remained steady and its value did not fluctuate. During the 1920s, as a means of both economising on gold and stabilizing its value, Hawtrey urged acceptance of a *Gold Exchange Standard*, whereby central banks' holdings of a limited quantity of gold-equivalent foreign reserve would be regarded as part of their essential reserve for creating credit.

In the 1930s, with Britain off the gold standard, Hawtrey recommended 'competitive devaluation' of currencies as a means of restoring world trade (see chapter 8). Generally, however, his preference was for a managed gold standard with fixed, rather than floating, exchange rates since stability encouraged international trade and benefited the City of London as a centre for financing world trade.

7. International Trade

Hawtrey's analysis of international trade relied upon two more of his idiosyncratic constructs – 'home trade products' and 'foreign trade products' - 'home trade products' were those incapable of being internationally tradeable, whereas 'foreign trade products' were those products, whether produced at home or abroad, which were capable of being traded internationally. The essential distinction between these two types of good being that whereas prices of 'home trade products' were largely responsive to domestic demand, the price of 'foreign trade products' was largely determined internationally – changes in demand in a single country having little effect on the international price. Conversely changes in the currency exchange-rate had little effect on the price of 'home trade products' whilst affecting the price paid for 'foreign trade products'. A depreciation of the pound would have raised the price of imported 'foreign trade products', and this would have given some scope for domestic producers of

'foreign trade products' to raise *their* prices – an important element in Hawtrey's arguments for overcoming trade depression during the nineteen-thirties.

International securities were regarded as roughly comparable with 'foreign trade products' in that they had an international price. Hawtrey viewed investment in foreign securities as evidence of insufficient outlets for investment at home; something likely to arise during depressions. He was, by 1938, prepared to concede that there would be one benefit of government-sponsored public works in that:

[t]he private enterprise displaced by Government borrowing may be the export of capital. A very substantial relief may be secured at a time of depression by a capital-exporting country in this way, in so far, at any rate, as the Government expenditure is directed at home and neither to the acquisition of imported products nor to the diversion of goods from export. . . . There is a favourable effect upon the balance of payments, which, with a given foreign exchange value of the currency unit, permits of an enlargement of the consumers' income.¹¹⁹

There was considerable reservation attached to Hawtrey's recognition of the validity of public works, since he viewed the measure as one which would intensify depression in those countries which had previously been importing capital. Public works were no answer to conditions of world depression.

¹¹⁹ Hawtrey, *A Century of Bank Rate* p.271.

8. The Schedule of interest Rates

Any review of Hawtrey's economic model must attend to the issue which arose with Keynes over the role of long-term and short-term interest rates, and the inter-relationship between these rates. This was an issue which came to divide Hawtrey and Keynes even more sharply than their differences over the efficacy of loan-financed public works as a means of alleviating unemployment.

In his earliest writings Hawtrey did not differentiate between loans taken out for different periods of time, or differences in rates for different-term loans. By 'interest rate' he usually implied the prevailing Bank of England discount rate, whose value influenced the short-term lending rates of the commercial banks (Hawtrey noted that Keynes often failed to specify the term of the interest rate; referring to 'the complex of the various rates of interest current')¹²⁰. The important transmission mechanism, for Hawtrey, was very simply that movements in the short-term interest rate influenced dealers to increase, or decrease, their stock levels, and the *changes* in the size of orders given by traders to manufacturers was responsible for fluctuating levels of industrial activity.

Hawtrey's views received little consideration from other economists of the time, and since he relished in responding to criticism, he expressed disappointment that, apart from Keynes, economists had not even troubled to

¹²⁰ *Ibid.*, p.196.

reject his theory.¹²¹ Keynes emphatically rejected the transmission mechanism of Hawtrey which related the trade cycle, via adjustments in dealers' stocks, to variations in the short-term rate of interest.

Sir John Hicks has expressed the view that large parts of Keynes's *Treatise* were a reply to the points in Hawtrey's *Currency and Credit* with which he differed.¹²² Hicks also drew attention to the large areas of agreement between Hawtrey and Keynes. Both agreed, largely against the received wisdom of the time, that the monetary system had no automatic stabilisers. (Hicks, incidentally, expressed the opinion that Hawtrey's model of a free-market system that was *not automatically* self-righting, as outlined in *Currency and Credit*, was the origin of the Keynesian Revolution).¹²³ Both agreed that the system needed to be stabilised by a *policy* devised by the monetary and fiscal authorities. Both agreed that interest rates, directly or indirectly set by a central bank, were an important element in the process of stabilisation. They strongly disagreed on the relative importance of long and short-term interest rates.

Hawtrey, as we have seen believed in the short-term interest rate, as set by the Bank of England's discount rate, as *the* means of controlling production through its effect on dealers' holdings of stocks. Keynes looked to fixed-capital investment for long-term production as the key to economic expansion and

¹²¹ Kaldor, 'Mr. Hawtrey on Short and Long Term Investment', 462.

¹²² J. Hicks, 'Automatists, Hawtreyans, and Keynesians', *Journal of Money, Credit and Banking*, Vol. 1, No. 3, Conference of University Professors. (Aug., 1969), 308.

¹²³ *Ibid.*, 308.

recovery; to the businessman's anticipated profit from an investment over the course of its life set against the long-term rate of interest used to finance that investment. Thus, to him, long-term interest rates were the important ones, and the only relevance of the short-term discount rate was the extent to which short-term rates influenced long-term rates – as he believed they did. Keynes believed that any additional costs imposed upon a dealer by an increase in short-term interest rates was as nothing compared to the prospect of his enhanced profit through rising prices in a period of expansion – the holding of liquid goods by dealers and middlemen were nowhere near as sensitive to changes in Bank rate as Hawtrey would have it.

Hawtrey's response to Keynes's criticisms in *The Treatise* and the *General Theory* came in his 1938 publication, *A Century of Bank Rate*. Hicks's opinion was that this was a 'demolition of the Keynesian mechanism'.¹²⁴ In asserting that changes in Bank rate (the cost of short-term loans) worked through into long-term rates, Keynes had used data from the 1920s only. Hawtrey used the data on short and long-term rates over the previous hundred years to show that Keynes's hypothesis was not supported by the evidence. Moreover, Hawtrey suggested there was little of substance in the weight which Keynes put on the value of the long-term rate of interest, since '[m]ost of the industrial projects offered for exploitation at any time promise yields ever so far above the rate of interest . . . [that] the rate of interest calculated on money raised will probably

¹²⁴ *Ibid.*, 310.

be no more than a very moderate deduction from profit'.¹²⁵ Two highly-rated economists supplying two powerful arguments against the effectiveness of either short or long-term rates; it was hardly surprising that Hicks, in his review of Hawtrey's work, should come to the provisional conclusion that 'Tweedledum and Tweedledee had both fallen flat, and the way was cleared for the Age of Fiscal Policy'.¹²⁶

Hawtrey, however, was not content to let the matter rest there, and took the matter up with Hicks; insisting that his work was not simply a demolition of Keynes's argument but a positive re-statement of his own position. He drew Hicks's attention to a section of his book which underlined the psychological importance attached to changes in the Bank of England's rediscount rate. In a section entitled 'Psychological Reactions' Hawtrey suggested that in (for example) raising its discount rate, the Bank of England was not merely making it more expensive for dealers to hold stock, but sending out a message of intent.

When Bank rate went up from 3 to 4 per cent., a trader would reason that this was intended to have a restrictive effect on markets, and that, if the effect was not brought about, the rate would simply go higher and higher until it was Those who took that view would restrict their purchases and demand would fall off, and so the 4 per cent. rate might be found potent

¹²⁵ Hawtrey, *A Century of Bank Rate*, pp.170-171.

¹²⁶ Hicks 'Automatists, Hawtreyans and Keynesians'. 311.

enough, even though, if unsupported by traders' anticipations, a 6 or 7 per cent. rate might have been necessary.¹²⁷

On having his attention drawn to this, Hicks re-assessed Hawtrey's position, and concluded that the 'psychological' element in Hawtrey's model was 'distinctly superior' to the 'psychological' element within Keynes's which depended upon a somewhat vague long-term expectation of profit.¹²⁸ In awarding pride of place, in this respect, to Hawtrey's model, Hicks drew upon a phrase of A.C. Pigou's – *announcement effect*. Hicks used the term *announcement effect* to indicate the way in which the announcement of a policy decision gives rise to people reconsidering their behaviour *before* the enacting of policy. Hawtrey's model relied upon the powerful *announcement effect* of changes in Bank rate. However, regarding its true effectiveness, Hicks (writing in 1969) had this to add:

. . . on Hawtrey's analysis . . . it should be possible . . . for the Central Bank to take *decisive* action. There is a world of difference . . . between action which is determinedly directed to imposing restraint . . . and identically the same action which does not engender the same expectations. Identically the same action may be *indecisive*, if it appears to be no more than an adjustment to existing market conditions; or if the impression is

¹²⁷ Hawtrey, *A Century of Bank Rate*, p.249.

¹²⁸ Hicks, 'Automatists, Hawtreyans, and Keynesians', 313.

given that it is the most that is politically possible. If conditions are such that gentle pressure can be exerted in a decisive manner, no more than gentle pressure will as a rule be required. But as soon as there is doubt about decisiveness, gentle pressure is useless From this point of view . . . the nationalisation of the Bank of England was a death-blow to the Hawtrey system. . . .for it made the Bank constitutionally incapable of arousing the expectations on which it had hitherto relied.¹²⁹

The Bank of England may, still, be nationalised, but in 1997 it was granted operational independence to set its rate to meet a set inflation target. In that its target was a pre-determined rate of inflation rather than a broad remit to achieve economic stability, its task lay very close to what Hawtrey had called for – the frequent adjustment of Bank rate with purpose of maintaining the wealth value of the currency. We now have a situation which Hawtrey would surely have endorsed.

By the act of publishing *A Century of Bank Rate* Hawtrey was appealing to empirical evidence to justify the superiority of his theory of interest-rate schedules over that of Keynes. His appeal was not to the superior logical internal consistency of his model but to the evidence provided by history. This raises the question of whether appeals to historical data – corresponding in some ways to the physical or biological scientist's appeal to experimental data – are a

¹²⁹ *Ibid.*

legitimate means of advancing economic theory. The works by Backhouse, and those edited by De Marchi and Blaug, use epistemological studies to try to locate economics within the spectrum of the sciences.¹³⁰

Backhouse pursues the questions of the extent to which the concepts of 'truth' and 'progress' are relevant to economic theories, and, if so, the ways in which 'truth' and 'progress' might be established.

The idea of 'progress' in economic theory implies that new theories are an 'advance' on older theories. To make this claim, Backhouse suggests, is to oppose a modernist or post-modernist view of economic science. This view would liken the idea of unidirectional 'progress' in economic theory to a Whig interpretation of history which judges a period of history by standards and conditions pertaining today, and the extent to which the period moved towards today's conditions. The post-modernist would argue that all theories contain a particular discourse which is only relevant to the time in which they were produced. Whilst agreeing that the science of economics could never meet the standards of empirical proof demanded by Karl Popper, Backhouse argues for the ideas of progress and truth in economics, and argues that '[i]n economics, theory is comparatively over-developed relative to empirical evidence'.¹³¹ He

¹³⁰ R. E. Backhouse, *Truth and Progress in Economic Knowledge* (Cheltenham, Edward Elgar, 1997).

N. B. De Marchi and M. Blaug, *Appraising Economic Theories: studies in the methodology of research programmes* (Aldershot, Edward Elgar, 1991).

¹³¹ Backhouse, *Truth and Progress in Economic Knowledge*, p.119.

argues for the establishment of empirical generalisations capable of acting as constraints on theorising.

Generally Backhouse steers a course between that of Frank Hahn and Mark Blaug. Hahn has dismissed the importance of methodology in economic theorising, arguing that a good theory, independent of empirical data, aids understanding and acts as an analytical tool. Blaug has been critical of economists' methodology, arguing that it is essential that empirical progress advances alongside theoretical progress.

Backhouse is generally approving of the approach of Milton Friedman whose theoretical advances sprung from his historical study with Anna Schwartz.¹³² Friedman believed that, in the absence of controlled experiments, historical episodes provided the economist with much relevant data. It seems likely that both Backhouse and Friedman would have supported Hawtrey's recourse to historical evidence in his dispute with Keynes over the relative importance of long- and short-term interest rates.

¹³² M. Friedman and A. Schwartz, *A Monetary History of the United States 1867-1960* (Chicago, 1963).

Chapter 1

Paving the Way for the Return of Gold

1919-1924

By 1922 the post-war boom was well and truly over. An anti-waste campaign in the popular press, targeting two mythical civil servants 'Dilly and Dally', took hold of public opinion.¹³³ Lloyd George's Coalition Government responded by appointing a committee, chaired by Sir Eric Geddes, to recommend cuts in public expenditures. McDonald has argued that campaigns by the *Daily Mail* and the *Daily Express* marked the beginning of a new phase in British politics whereby, because of the recent enlargement of the franchise, politicians were required to respond to public opinion as it was perceived through the pages of the popular press. The idea of the Geddes Committee was Lloyd George's; ever the populist politician.¹³⁴

The Treasury, whilst wanting to reign in the costs of the spending Ministries, feared that the Geddes Committee would upset its own model of expenditure control. The Finance section of the Treasury had set great store by the 'return to gold' providing the necessary discipline to control expenditure but feared that the enlarged franchise had made monetary stability more difficult to achieve; the Treasury wanted reduced spending for the redemption of debt, the Geddes

¹³³ A.J.P. Taylor, *English History 1914-1945* (Oxford, OUP, 1965), pp. 183-4.

¹³⁴ A. McDonald, 'The Geddes Committee and the formulation of public expenditure policy, 1921-22', *Historical Journal*. 32(3). Pp.643-74.

Committee wanted reduced business taxes. The broad alliance of objectives forced the Treasury and the Geddes Committee to work together in an uneasy relationship.¹³⁵

The execution of this committee's recommendations, the 'Geddes Axe', was probably the most notable series of fiscal measures undertaken by the Treasury during the period 1919-24. Hawtrey seems to have played no part in the process. The Financial Enquiries Branch produced no memoranda commenting upon the cuts, nor was Hawtrey involved in any discussions relating to cuts in expenditure.¹³⁶

In Hawtrey's 1966 interview with Sir Alec Cairncross, Cairncross was concerned to understand the way in which the inter-war Treasury operated; whether it had regular chaired, and minuted, meetings, or whether special Treasury meetings were convened to discuss the implications of Geddes, or May. Hawtrey could not recall being present at any such meetings, nor was he aware of any such meetings taking place - lack of recall was improbably due to failing memory, since Hawtrey could well remember crossing Horse Guards Parade in 1919, to dine and discuss the leaving of the Gold Standard with Sir John Bradbury and Sir Basil Blackett.¹³⁷ If, in fact, Hawtrey's memory had failed him,

¹³⁵ A. McDonald, 'The Geddes Committee and the formulation of public expenditure policy, 1921-1922', *Historical Journal*, 32(3), pp.643-74.

¹³⁶ Interview with Sir Alec Cairncross, 1966. HTRY 13/5

¹³⁷ *Ibid.*

it was probably because fiscal detail had always held less interest for him than the vicissitudes of gold.

Maintenance of the wealth value of the currency unit was of central ethical, as well as economic, importance to Hawtrey. He believed that the Gold Standard, whilst incapable of guaranteeing the stability of sterling by itself, could be part of a more complex mechanism whereby values could be preserved. This chapter will consider Hawtrey's role in the process of preparing to return to the Gold Standard in the years 1919-24.

The 1914-18 war had been marked by price inflation, a growth of the money supply which included the printing of bank notes by the Treasury as well as the issuing of notes by the Bank of England in excess of its normal fiduciary limits, and the propping of the pound at close to its pre-war value by dollar loans.

Under normal peace-time conditions the receipts of government from taxation are often irregular compared to the regular outward flows arising from government expenditure. Under such conditions, it is perfectly normal and proper for governments to raise money, to cover periods of low receipts, by selling three-month Treasury Bills. These bills are later re-purchased, with interest paid, by using subsequent incoming taxation. During the First World War the sums that could be raised through taxation and long-term loans were insignificant compared to the demands of fighting the war. The British Government resorted to the selling of Treasury Bills to raise money without having any hope of being able to settle these bills through the proceeds of

taxation. Ultimately they were repaid by the Government resorting to Ways and Means loans from the Bank of England. The subsequent enlargement of the money supply was the main source of the war-time inflation.

Given the financial demands of war on *their* governments, France, Germany, Russia and Austria-Hungary abandoned the Gold Standard at the beginning of the 1914-18 war - Britain, despite a commonly-held view, did not.¹³⁸ Remaining on the Gold Standard did, for a time, stave off the depreciation of the currency which would be expected to follow inflationary finance. Throughout the war it was still possible to present a pound note and demand a given measure of gold. Under *normal* circumstances, with a country's note issue inflating, much of the inflated currency would have been used to demand gold, and much of that gold would have been exported (in effect, as Hawtrey pointed out, the Government would have been financing itself by the sale of its gold).¹³⁹ Under the normal mechanism of the gold standard the loss of gold through exportation would have forced the authorities to suppress the note issue (or, possibly, raise taxation to the extent that it would have been capable of financing the issue of Treasury Bills). The circumstances of war forbade the easy shipment of gold abroad, and as a result, the British monetary authorities were shielded from the consequences of the mushrooming of currency notes. The mechanisms of the gold standard had failed, and Britain was enabled to nominally remain on the

¹³⁸ Hawtrey, *The Gold Standard in Theory and Practice*, p.93.

¹³⁹ *Ibid.*, pp. 93-4.

standard without having to comply with its disciplines. Additionally, most of the belligerent governments paid for their war supplies by selling off their supplies of gold (much of it to America); the gold-receiving nations were swamped with more gold than they needed. The price of gold fell in relation to other commodities, and gold-denominated currencies, such as sterling, were worth less for the purpose of buying commodities on the international markets. The effect was to exacerbate British inflation. As the United States entered the war in 1917 it prohibited the free movement of gold and, for the time being, destroyed any semblance of a world gold market.¹⁴⁰

After the war it once again became possible to ship gold abroad without it being endangered. America withdrew its prohibition on gold movements in 1919, and thereafter it was no longer possible for Britain to maintain the pretence of the pre-war parity under a gold standard. To have continued to do so would have resulted in the total loss of gold reserves and so the Prohibition of the Export of Gold Order, on 1 April 1919, effectively removed Britain from the Gold Standard. It was to remain outside the standard until 1925.

Post-war reconstruction and capital investment for peace-time produced a boom which lasted, according to Susan Howson, from April 1919 to April 1920.¹⁴¹ During this period, the director of one bank recollected, 'we ladled out money; we did it because everybody said they were making and were going to make

¹⁴⁰ *Ibid.*, p.94.

¹⁴¹ S. Howson, *Domestic Monetary Management in Britain 1919-38* (Cambridge, C.U.P., 1975), pp.9-10.

large profits'.¹⁴² Charles Feinstein has estimated that the Consumer Price Index rose from 222.9 in 1919 to 257.2 in 1920;¹⁴³ the pound's exchange rate with the dollar fell from its war-time pegging of \$4.765, on 20 March 1919, to \$3.40 in February 1920.¹⁴⁴ In the middle of this price boom and currency collapse the British Government, somewhat uncomfortably, accepted a report from a committee which had been instituted at the very end of the war.

In 1918 the Treasury and the Ministry of Reconstruction had set up a 'Committee on Currency and Foreign Exchanges after the War' – the Cunliffe Committee. Its report had stated that before the war 'the country possessed a complete and effective Gold Standard [which] operated effectively to correct unfavourable exchanges and to check undue expansion of credit'.¹⁴⁵ Cunliffe provided the classical justification for the Gold Standard, describing it as a 'jewelled' mechanism - a piece of exquisite, self-correcting engineering; as precise as any clock's pendulum or any steam engine's governor. The Gold Standard would have imposed its disciplines upon the market for credit in such a

¹⁴² R.H.Brand, director of Lloyds Bank. Quoted in Howson, *Domestic Monetary Management in Britain*, p.10.

¹⁴³ J.Tomlinson, *Public Policy and the Economy since 1900* (Oxford, O.U.P.), 1990), p.47. A later retrospective estimate of inflation by Pigou (1947) gives R.P.I. inflation during 1919-1920 as over 50 per cent .

¹⁴⁴ Peden, *British Economic and Social Policy*, p.61.

¹⁴⁵ Cunliffe Committee. *First Interim Report of the Committee on Currency and Foreign Exchanges After the War*, Cd. 9182, Parliamentary Papers 1918, VII, paragraph, 47.

way as to stabilise the external value of the pound, and thus provide a basis for restoration of international trade.

The Cunliffe Committee's *First Interim Report* in August 1918 had reflected the desires of its in-built majority of bankers when recommending:

[i]n our opinion it is imperative that after the war the conditions necessary to the maintenance of an effective Gold Standard should be restored without delay.¹⁴⁶

The report set out three pre-requisites for the restoration of an effective Gold Standard: the cessation of government borrowing, the raising of 'the Bank of England discount rate' to check 'a foreign drain of gold and the speculative expansion of credit in this country', and that the issue of bank-notes not backed by gold be limited by law.¹⁴⁷ No mention had been made of an exchange rate; only a presumption that the pre-war rate would be restored. In August 1918, when the *First Interim Report* was published, the pound was still pegged at its war-time level of \$4.765, the extent of the deflation which might be necessary to achieve a rate of \$4.87 was not envisaged, and the mechanism by which it might be brought about only vaguely understood. However, given that the Cunliffe Report received the virtually unanimous support of the committee of highly respected advisors and financiers, the Chancellor of the Exchequer, Austen

¹⁴⁶ Cunliffe Committee, *First Interim Report*, para. 47.

¹⁴⁷ Moggridge, *The Return to Gold 1925*, p.13.

Chamberlain, had little option but to urge its acceptance upon Lloyd-George's Cabinet. Cabinet acceptance was confirmed to parliament in December 1919. By February 1920, with the pound at \$3.40, a depreciation of some thirty per cent from its pre-war value, the extent of the deflation that would be necessary if the Gold Standard was to be restored to its previous level became uncomfortably clear.

Hawtrey's involvements in the years leading up to the restoration of the Gold Standard were in two distinct areas. First, on the nature of the Gold Standard itself; he believed that the pre-war Gold Standard had defects which made it incapable, without modification, of preserving the wealth value of the monetary unit. He had views on ways in which the Gold Standard might be improved; views which were eventually to be put before, and accepted by, the Supreme Council of the Allies' Genoa Conference of April 1922. Secondly, he had strong and somewhat unorthodox views about the most appropriate credit policy by which the United Kingdom monetary authorities might, without inflicting trade depression on Britain or the rest of the world, restore the pound to its pre-war exchange value with dollar. At the risk of losing chronological continuity, these two issues will be dealt with separately, beginning with Hawtrey's views regarding the structure of the Gold Standard.

Shortly before his appointment as Director of Financial Enquiries, on 12 September 1919, Hawtrey addressed the Economic Section of the British

Association on the subject of the 'The Gold Standard'.¹⁴⁸ He noted that, a year after cessation of hostilities, America was showing the first signs of re-establishing a Gold Standard, but having accumulated gold during the war she was now 'saturated' with gold. In consequence, the value of its gold had fallen in relation to other commodities.

This decline in the purchasing power of gold has disclosed a weakness in the Gold Standard. The stability in the value of gold depends on the accumulated stocks being large in proportion to the annual supply. . . . The demand for gold as currency, by withdrawing this large quantity from other uses, tends to keep the value of gold up.¹⁴⁹

Here, Hawtrey began to underline the fact that widespread restoration of the Gold Standard involved dealing with two distinct problems: firstly, nearly all monetary units had depreciated, to different degrees, against their nominal gold parities, and secondly, gold itself had lost its value against a range of other commodities.

In Britain, in order to restore pre-war parities – that is, the value of the monetary unit to the fixed weight of gold to which it equated before the war - a modest degree of deflation in money prices would be necessary to bring the

¹⁴⁸ The text of this address is to be found in Hawtrey, *Monetary Reconstruction*), pp. 48-65.

¹⁴⁹ *Ibid.*, p.52.

value of the monetary unit (the pound) back in line with its nominal gold value. This would involve a reduction in the money price of all commodities including the commodity of labour. Hawtrey acknowledged this as being a painful process. Within his model of the economy it would involve raising short-term interest rates. The usual consequences would flow from this: the higher interest rates would deter traders from holding stocks bought using credit, and would encourage them to reduce their indebtedness. To do this they would have to reduce the prices of their goods in order to sell off their stocks more rapidly, and they would reduce their orders to manufacturers. Eventually, after a process involving some unemployment, this would lead to a new equilibrium at lower prices and wages. But – and this is the crux of Hawtrey’s argument – the general restoration of the Gold Standard in its pre-war form, by a large group of countries, would cause such a surge in the demand for gold by the various central banks, that the price of gold would be driven up in relation to other commodities. Since the value of monetary units would be tied to gold this implied that the real value of a fixed monetary wage would be driven up. In consequence, the monetary deflation of wages, in Britain, would have to be correspondingly greater in order to restore the equilibrium between the value of wages and that of other commodities. Under such circumstances restoring the Gold Standard would require even greater deflationary measures than the already overvalued pound demanded, since the actual process of a general return to gold would drive up the value of the pound even further.

Nevertheless, despite the problems and dangers associated with the return to a Gold Standard Hawtrey felt it was the only practical way in which trust in the currency could be restored and maintained.

Distrust of the unit shows itself in a general desire to get rid of balances of money . . . in exchange for commodities So the distrust accentuates the depreciation and, of course, the depreciation accentuates the distrust. It is in such conditions that trade is brought to a standstill by the sheer want of any tolerable medium in which debts can be measured. For the last two years we have seen communities starving, not because there was no food, but because the peasants and farmers would not sell food for paper money.¹⁵⁰

In the light of the problems associated with any return to gold, Hawtrey, in looking for a monetary system which economised on the use of gold, and prevented the world's banking systems from distorting its value by their fluctuating demands for it, was led to extol the virtues of a *Gold Exchange Standard*. Such a system, by permitting central banks to use gold-related currency as fully equivalent to gold in their reserves, would have economised on the use of gold, and, by suitable management, ironed out the currency instability.

¹⁵⁰ *Ibid.*, p.58.

Within his envisaged 'Gold Exchange' system the world's central banks would, in addition to holding stocks of gold, hold reserves of paper money of all the *other gold-standard currencies*. These paper monies would be 'gold equivalent', freely available for exchange for notes of any other currency, and acceptable as payment for imported goods 'on terms just favourable enough to compete successfully with . . . gold'.¹⁵¹

The system would require safeguards – merely substituting foreign currency for gold offered no security from an almost indefinite expansion of paper money with a fixed substructure of gold reserves. There was no clear indication of how this could be done. One of Hawtrey's suggestions seemed to foreshadow the current mode of operation of the Bank of England's Monetary Policy Committee in setting the Bank's base rate.

The scientific economist will be tempted to look for a solution in the regulation of currencies by index numbers of prices. . . . [but] the index number will be rather to give guidance, along with other data, in the administrative control of currency, than to play a part in the mechanical rigidity of a statutory system.¹⁵²

Hawtrey also felt that some international agreement was necessary by which countries agreed, by law, to limit the quantity of paper money which was not

¹⁵¹ *Ibid.*, p.59.

¹⁵² *Ibid.*, p.60.

backed by gold. In operating the gold exchange standard it was important that foreign currencies be treated as equivalent to gold only for the purpose of settling foreign debts, not as a basis for the printing of paper currency – this must only be done on the basis of the possession of metallic gold. According to Hawtrey, under these rules, if any country indulged in inflation and allowed its currency to devalue (despite, apparently, abiding by the rules of the exchange standard in limiting its fiduciary issue) then it would find 'more and more of its paper money locked up in the exchange reserves and withdrawn from circulation. This would operate like the export of gold'.¹⁵³

Whilst the operation of the gold exchange standard under these rules might serve to control inflation and currency devaluation occurring through excessive printing of paper money, Hawtrey noted that the principal means of payment in business was credit, and that any system designed to maintain the value of the currency should have an effective means of controlling credit. Since possessors of credit were free to draw cash from the banks, the running down of the commercial banks' cash levels should be an indication that credit was being granted too freely. It was, however, a lagging indicator.

If we rely on the limitation of paper money, and the bankers do not succeed in keeping control of credit, the inevitable result will be that, when the bank reserves in some or all countries

¹⁵³ *Ibid.*, p.62.

threaten to melt away to nothing, the limitation of paper money will be suspended.¹⁵⁴

For the purposes of controlling credit Hawtrey returned to the use of an index number of prices.

The rise in prices precedes the drain of legal tender money into circulation. It will be the function of the principal banks . . . to watch the index of world prices, and to put the brake on by raising the rate of interest as soon as a material rise is recorded. But . . . a rise in prices may be due not to credit expansion but to a scarcity of one or two important commodities. . . . The banking authorities must take into account not only the statistical data, such as index numbers, but also all that they can learn about the state of business from their relations with traders.¹⁵⁵

Hawtrey had faith in an Anglo-American hegemony to control the world's gold supplies: such a hegemony, he believed, would coerce other countries into adopting similar practices. If these two countries were to reach agreement on limiting their uncovered paper monies to an amount determined by their gold holdings, operate an external payment system on a gold-exchange basis using gold-equivalent currency rather than pure gold, and control credit with a view to keeping the value of gold in line with an index-number evaluation of

¹⁵⁴ *Ibid.*

¹⁵⁵ *Ibid.*, p.63.

commodities, then he believed the rest of the world would follow.¹⁵⁶ This, he believed, would restore the gold standard as a more trustworthy standard than it had been in the past, and enable the restoration to be carried out with minimal deflation.

The first joint effort to restore the International Gold Standard was the International Financial Conference in Brussels called by the Council of the League of Nations in September-October 1920. In an attempt to prevent the discussions becoming mired in recriminations over reparations, the League of Nations resolved to exclude from discussion all 'the questions which are the subject of the present negotiations between the Allies and Germany'.¹⁵⁷ It may, in a strict sense, have been successful in this move but an air of mistrust, linked to war reparations, hung over the conference. Judging by the personnel appointed to represent Britain at the conference, a retired Governor of the Bank of England and a retired Joint Permanent Secretary to the Treasury (Cokayne, by then Lord Cullen, and Chalmers), the Brussels meeting was to be treated as a diplomatic rather than a financial exercise. No progress was made on the question of gold.

¹⁵⁶ Hawtrey frequently called for the maintenance of prices with reference to an index number, and discussed the construction of index numbers at some length in his book *The Art of Central Banking*. He was concerned that an index of prices should be constructed in such a way that it revealed *causes 'which affect[ed] all prices'* (p.330), and eliminated causes (such as crop failures) arising from non-monetary events. To this end he suggested removing the prices of certain goods from a weighted arithmetic mean if their change in price could be attributed to a non-monetary cause. His conclusion was that 'monetary causes [of price changes] . . . are causes affecting the amount of consumers' income and outlay otherwise than in proportion to the factors of production'.

¹⁵⁷ R. S. Sayers, *The Bank of England 1891-1944* (Cambridge, C.U.P., 1976), p.153.

Hawtrey was not directly involved with the Brussels conference. Five leading economists, including Pigou, had prepared a joint statement which set out the agenda for the conference.¹⁵⁸ The gist of their analysis was that exchange rates could only be stabilised by subduing inflation; inflation could be subdued only by countries eliminating budget deficits; budget deficits could only be eliminated by the resumption of economic growth; the principal barrier to the resumption of economic growth was the shortage of capital, and international financial institutions found it impossible to raise the necessary capital because of the instability of exchange rates. Given such circularity of analysis, entrenched attitudes over reparations, and concern over the deflationary implications of the proposals, it is unsurprising that nothing came of them.¹⁵⁹

The next attempt at international co-operation over monetary stabilisation was at Genoa in April 1922 when the Supreme Council of the Allies convened its International Economic Conference. Hawtrey was a member of the British Delegation, and his ideas were to provide the focus for discussion. The Treasury's Controller of Finance at the time of the run-up to the Genoa negotiations was Sir Basil Blackett. Blackett had been a close friend and colleague of Hawtrey for a number of years, and over the course of those years they had had many discussions together over policy ideas.¹⁶⁰ The Genoa

¹⁵⁸ B. Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919-1939* (Oxford, O.U.P., 1992), p.154.

¹⁵⁹ *Ibid.*, pp.156-7.

Conference seemed to be an ideal venue for Hawtrey to present his ideas relating to a gold-exchange standard, and Blackett encouraged him to frame his ideas into the form of a series of resolutions for discussion.

Hawtrey consulted with the Bank of England in framing his resolutions.¹⁶¹ As a later part of this chapter will describe, there were, in the period 1920-22, tensions between the Bank of England and the Treasury over the level of interest rates. Initially, Hawtrey gave his support to the Bank of England's desire to impose higher interest rates as a means of quelling the post-war boom, and as a result he, for a short time, established a good relationship with the Bank's Governor, Montagu Norman. The discussions with Norman were, therefore, cordial.

Hawtrey framed his ideas into twelve resolutions. Resolutions 1, 4, 5, 6 and 8 stated that economic reconstruction depended upon stability, that stability required currencies to be based on a common standard, and that since gold was the only standard upon which agreement was possible, then establishment of a Gold Standard and a programme for its implementation should be agreed on - each country individually should decide whether its currency should revert to its pre-war value, or whether a new parity was more appropriate. Resolutions 2, 3 and 12 stated that all countries should have a central bank of issue which was

¹⁶⁰ Account of lecture by Hawtrey to the Royal Statistical, April 25 1933. *Journal of the Royal Statistical Society*, Vol. 96, No. 3. (1933), p. 459. When moving a vote of thanks to Hawtrey for a presentation to the Royal Statistical Society, Blackett told the audience that 'in the course of long years of discussion with [Hawtrey], I have never found myself able to disagree both with his premises and with his conclusion'.

¹⁶¹ Sayers, *Bank of England 1891-1944*, p.158.

free from political interference, and that an early meeting of these banks should be convened by the Bank of England to establish an agreed policy for regulating credit. Resolution 7 called on all participating countries to balance their budgets. Resolution 9 stated that any new Gold Standard should embody some means, such as maintaining reserves in the form of foreign currency, for economising on the use of gold. Resolution 10 called for co-ordination of policy between Europe and the United States, and Resolution 11 set out a series of proposals which would form the basis for the discussions at the meeting which it was intended that the Bank of England should convene. The important proposal under Resolution 11, which is pencil-marked and arrowed in the Treasury's own copy of the 'Resolutions', stated that –

'[c]redit will be regulated, not only with a view to maintaining the currencies at par with one another, but also with a view to preventing undue fluctuations in the purchasing power of gold. It is not contemplated, however, that the discretion of the central banks should be fettered by any definite rules framed for this purpose, but that their collaboration will have been assured in matters outside the province of the participating countries.¹⁶²

Immediately before being taken to Genoa, the 'Resolutions' were submitted to, and almost completely accepted by, expert representatives from different

¹⁶² Treasury Papers T176/5. Niemeyer Papers. 'The Genoa Currency Resolutions', a report on the progress of discussions by R.G.Hawtrey, April 1922.

countries who met in London. Resolution no. 11, providing a detailed scheme for a Convention was felt to be too detailed to be taken forward to the Conference. At Genoa Sir Robert Horne, then Chancellor of the Exchequer, presided over the Financial Commission, and Sir Basil Blackett chaired the committee of experts. The experts adopted all Hawtrey's resolutions and *reintroduced* the detailed proposals for an international conference that had been dropped by the committee of experts in London.¹⁶³ The whole scheme was then taken back to, and adopted by, the Financial Commission. On the question of the reintroduction of Resolution no. 11, Hawtrey, in a later interview with Professor Spreng, recalled that '. . . after the day's proceedings . . . someone pointed out that it was desirable that this proposal . . . should be made in more detail . . . it was passed on to me prepare more extended proposals. Of course I simply copied out those that I originally made to the committee in London. And they received no further criticism . . .'¹⁶⁴

Hawtrey's Resolutions succeeded in making the Genoa Conference more focussed than that at Brussels. Delegates did not hope for ambitious schemes for international recovery, but concentrated upon the restoration of exchange rate stabilities; a move which it considered to be the first important condition to be satisfied before world economic recovery could take place.¹⁶⁵

¹⁶³ *Ibid.*

¹⁶⁴ F.J.Spreng, mimeograph 'Conversations with Sir Ralph Hawtrey'. Quoted in Howson, 'Hawtrey and the Real World', p.156.

One dilemma of the delegates to the Genoa conference was between stabilising exchange rates at current parities and stabilising them at their traditional rates. To stabilise them at the prevailing rates ran the risk of undermining confidence in the international monetary system – if the exchange rates could, at this point, be arbitrarily decided by administrative decision, then there might be little confidence in exchange rates which could be modified by administrative decision at any time in the future. However, to stabilise them at their traditional rates would have involved many countries in a painful deflationary process. Eichengreen notes that there was an irony in that it was the countries which were in the strongest position to return to pre-war parities that tended to advance the argument for stabilising currencies at close to their current exchange rates. This, in 1922, was the position taken by the British delegation, whilst countries such as France, Belgium and Italy, which had suffered far greater inflation, refused to accept any increase in the price of gold relative their domestic currencies. Eichengreen notes the further irony that despite arguing at Genoa for stabilisation at prevailing rates, when Britain did eventually re-enter the Gold Standard it was at pre-war parity, whilst the countries which, at Genoa, refused to consider stabilising at depreciated rates ultimately opted to do that very thing.¹⁶⁵ Hawtrey warned the conference of the point which he had earlier stressed in his 1919 address to the British Association, that the competition to recover gold by countries returning to the Gold Standard

¹⁶⁵ Eichengreen, *Golden Fetters*, p.157.

¹⁶⁶ *Ibid.*, p.158.

would drive up the world price of gold and leave the participating countries with a more severe deflationary task than they had ever anticipated. In drafting the proposals of the Financial Commission Hawtrey had prepared plans, which by judicious use of foreign currency reserves, were designed to head off this competitive struggle. In practice, the holding of foreign reserves had been commonplace before the war, but the Genoa Resolutions sought to institutionalise this practice. Principal centres such as London, New York, Tokyo and Paris would be encouraged to establish a free market in gold.

Keynes had attended the Genoa Conference as correspondent for the *Manchester Guardian*.¹⁶⁷ Prior to leaving for Genoa he had written an article, 'The Stabilisation of the European Exchanges: A Plan for Genoa', which eventually appeared in the paper on the morning of 20 April 1922.¹⁶⁸ He had considered the virtues of stabilising currencies at their existing relative values against restoring them to their pre-war relative values, and had come down in favour of stabilisation over restoration since restoration, 'so far from fixing the exchanges, mean[t] a deliberate policy of altering them'.¹⁶⁹ He had advocated the presentation of resolutions being brought before the conference based on three general principles: countries should not attempt to restore their currencies

¹⁶⁷ J.M.Keynes, *The Collected Writings of John Maynard Keynes: XVII*, (ed. Johnson) (London, Macmillan, 1977). Articles and letters relating to Genoa are reprinted pp.354-425.

¹⁶⁸ *Ibid.*, pp. 355-369.

¹⁶⁹ *Ibid.*, p.357.

to pre-war values if it entailed increasing their gold value by more than 20 per cent; currencies should be exchangeable against gold at a fixed rate as soon as possible; gold-holding by individuals should be prohibited, with gold only being made available for export and the settlement of international debts.¹⁷⁰ Keynes inserted the last principle as a means of preventing gold-holding by individuals causing fluctuations in its value – he had wanted to see a gold-bullion standard rather than Hawtrey’s gold-exchange standard. His ‘plan of action’ had included certain flexibilities: wider bands between buying and selling prices than the old gold-points, and provision for limited annual adjustments in gold values. Keynes had circulated copies of his article among the delegates at Genoa, and (as he presumably had hoped) the possibility of putting his proposals before the Conference was considered – although decided against - by the Chancellor of the Exchequer, Sir Robert Horne.¹⁷¹

Keynes continued to file reports from Genoa back to England throughout the Conference. On 15 April 1922 Keynes put his finger on one serious defect of the Genoa Resolutions; that there was nothing in them which committed governments to action.

Actually, nothing is being considered at present but a series of pious declarations of general principles. Many of these are old and stale. It does not help much to repeat in general terms that

¹⁷⁰ *Ibid.*, pp. 361-362.

¹⁷¹ *Ibid.*, letter from Keynes to the E.T.Scott, 15 April 1922.

currencies should be stable, that budgets should balance, and that banks of issue should be free from political pressure. . . . In short some day, somehow, at some parity we must have gold again. But when, how, or at what parity Genoa shrinks from declaring.¹⁷²

Keynes acknowledged that in the proposal for a conference of central banks to establish measures for continuous cooperation were 'some germs for future action', but he felt that the time was ripe for much more. On 17 April 1922 Keynes elaborated further on the lack of practical progress being made. He thought that those countries such as Britain, France and Italy – the countries which were no longer suffering progressive depreciation – should declare an early date for returning to gold. However, he pinpointed the weakness which prevented this from being done; Britain's insistence on returning to gold at its pre-war par with the dollar was delaying the rest of Europe from fixing their parities. Furthermore, he felt the question of the stabilisation of the wealth value of gold might be steadied by agreement between the American Federal Reserve Board and the central banks of those European countries which decided to return to gold. The tone of his report was that such matters were delaying progress, they could be settled once the decision to return had been made, and he rather regretted that the 'theorists, Professor Cassel and Mr. Hawtrey, [had] persuaded the practical bankers that such considerations [were] really

¹⁷² *Ibid.*, pp. 382-3.

important'.¹⁷³ In a final dispatch on the work of the Genoa finance sub-commission, on 27 April 1922, Keynes deplored the lack of firm commitment; only a vague agreement to another assembly. He saw no evidence of progress from the Conference, and suggested that:

. . . progress must come from the action of individual countries.

The experts of Genoa [seemed] to recognise this in a rather pathetic passage where they 'venture to suggest' that 'a considerable service will be rendered by that country which first decides boldly to set the example of securing immediate stability in terms of gold' by devaluation.¹⁷⁴

Reviewing the Genoa Conference, in 1923, Hawtrey would probably have been inclined to agree with much of Keynes's comment. He did, however, offer a defence of the proceedings at Genoa.

That there should be twelve propositions on the subject of currency, which command the agreement of all Europe, would seem to be a fantasy hardly deserving serious consideration, [inviting] the suspicion that the resolutions must be strictly confined to pious platitudes And there is no difficulty supporting such criticisms with quotations from the resolutions themselves. That stability is desirable, that Central banks should

¹⁷³ *Ibid.*, pp. 384-385.

¹⁷⁴ *Ibid.*, p.409.

be independent of political pressure, that all European currencies should be based on a common standard, that the only possible common standard is gold, and that so long as budget deficits are met by the creation of paper money then currency reform is impossible¹⁷⁵

Hawtrey went on to argue that these, apparent pious platitudes, were no more than the necessary placing on record that the most 'flagrant examples of currency inflation . . . have been due to the action . . . of Government', and that 'Government action of this kind must cease if anything whatever is to be done with the currency'.¹⁷⁶ The real success of the conference, he claimed, lay in the passing of Resolutions 3, 10 and 12, which recommended a meeting of representatives of central banks of Europe, to be summoned by the Bank of England, and to which representatives of the United States be invited. The importance of this meeting, to Hawtrey, was that it recognised the principle 'that currency policy is ultimately credit policy (and) the direction of credit policy is the special function of a Central bank'. Again, writing in 1923 and looking back on the Genoa Conference, Hawtrey felt that there were elements in which the Genoa Resolutions were unsatisfactory.

¹⁷⁵ Hawtrey, *Monetary Reconstruction*, p.131. The quotation is taken from his 1923 essay, 'The Genoa Resolutions on Currency'.

¹⁷⁶ *Ibid.*, p.132.

It is impossible to point to any particular time at which effect can be given to them. [They] must wait for the balancing of budgets before they can take effect in the weaker countries. . . . [they] must wait for the establishment of a gold parity, whether the restoration of the old one or the adoption of a new. England [is] within less than 10 per cent of par. But no one can say for certain how long it will take to bridge the gap. . . . Some countries whose currencies are at less than half their pre-war parities, are nevertheless extremely unwilling to give up the prospect of restoring them. France, Belgium and Italy all took this attitude at Genoa. It seems to involve an almost indefinite postponement of stabilisation as far as they are concerned.¹⁷⁷

Indeed, the years passed and no conference of Central Banks was ever called. The idea went no further than Montagu Norman, Governor of the Bank of England, sending out letters to European central banks with a view to the possibility of such a meeting in September 1922.¹⁷⁸ Co-operation over currency stabilisation was submerged under protracted wranglings over war reparations. Additionally, many central bankers doubted whether such a convention could be effective: the practice of central banking had long been carried forward under a shroud, by personal and informal contacts, and many central bankers felt that an open convention was foreign to their culture. There was also a feeling at the Bank of England that Hawtrey had trespassed on their territory. Hawtrey, of

¹⁷⁷ *Ibid.*, p.147.

¹⁷⁸ Black, 'Ralph George Hawtrey', p.381.

course, was a Treasury official, and so far as Bank of England officials were concerned, Treasury officials should concern themselves with taxation and spending; international monetary negotiations were the Bank's domain. Montagu Norman, whilst keen to return to gold for the exchange-rate stability that would enhance the City of London as a world financial centre, had little concern for internal stability of prices. To him this was an irrelevant and impracticable ideal. In a letter to Benjamin Strong, Governor of the Federal Reserve Bank, he dismissed Hawtrey as a 'leading light of the Treasury who made it his particular business to quarrel with the policy of the Treasury and the Bank of England'.¹⁷⁹ The Americans themselves needed little further discouragement from entering into such a convention since they were suspicious that the Europeans would use currency stabilisation as a pretext for liquidating war debts, and on these grounds they had refused to participate in the discussions at Brussels and Genoa. Furthermore, Benjamin Strong clung to an old fashioned view of the gold standard's automatic mechanism and believed that the gold-exchange standard with foreign reserves, as recommended by Hawtrey, represented a political act of interference, or a 'watering down' of the standard which could only lead to lax financial policies and uncontrolled creation of credit.

¹⁷⁹ G.C. Peden, *The Treasury and British Public Policy 1906-59* (Oxford, O.U.P., 2000) pp. 155-6. Peden is quoting from R.W.D.Boyce, *British Capitalism at the Crossroads* (Cambridge, 1987), p.41.

Eichengreen has suggested that, despite the agreement which the proposals were accorded at Genoa, there was a strong element of British self-interest in the form which the proposals took. The Act of Parliament prohibiting the export of gold was due to expire in 1925, putting a degree of pressure on Britain to return to the gold standard, in all probability at pre-war parity, before the expiry date. It was seen as vital to Britain's interests that she reduced deflationary pressures in the rest of the world and took steps to inhibit possible rises in the price of gold in order to reduce the price deflations that would have to be imposed before returning to the Gold Standard.¹⁸⁰

Undoubtedly, if the Genoa resolutions could have been followed through, there would have been less pressure on Britain's gold reserves after 1925, and lower interest rates could have prevailed with less aggressive deflationary policies being pursued. Hawtrey's vision of a gold-exchange standard which preserved the value of the monetary unit, maintained exchange-rate stability and stabilised the value of gold was considerably more ambitious and had greater vision than the narrow reactionary recommendations of the Cunliffe Committee, to which the government was committed. In the end it is difficult not to see such a gold-exchange standard, as envisaged by Hawtrey, collapsing under the weight of its administrative structure. The failure of governments to adopt the Genoa Resolutions remained a source of huge disappointment to him. He always felt that if Sir Basil Blackett had remained as Controller of Finance at the

¹⁸⁰ Eichengreen, *Golden Fetters*, p.159.

Treasury, then Blackett would have steered the Genoa Resolutions into effect. Blackett had been at Genoa with Hawtrey; he had a close affinity with Hawtrey, and besides having a professional interest, his friendship with Hawtrey gave him an added personal interest in the progress of the Resolutions. But, late in 1922, Blackett was replaced as the Treasury's Controller of Finance by Sir Otto Niemeyer. He was a strict adherent to the canons of sound finance and a believer in the efficacy of the conventional Gold Standard – he did not have the same interest in the Genoa resolutions as Blackett nor did he have the same personal or professional affinity with Hawtrey. Hawtrey's 'Genoa Resolutions' withered through lack of support from the Bank of England and from his superiors at the Treasury. Despite work which received widespread approval, Hawtrey was never again to play such a high-profile role as a member of a British delegation to a major international conference.

Alongside his interest in a reformed Gold Standard, Hawtrey maintained an interest in credit policy. The Cunliffe recommendations, accepted in 1919, committed the country to a number of years of financial retrenchment and high interest rates in preparation for returning to the Gold Standard at a parity which, by generally assumption, was going to be the pre-war parity. The inflation, which accompanied the 1919-20 economic expansion, gave the Bank of England cause to move towards a dearer money policy with even greater urgency. The movement began in late 1919. The Bank rate, which had stood at five per cent

for 135 weeks, from 5 April 1917 to 6 November 1919, was raised to six per cent.¹⁸¹

Until the end of 1919, even the relatively high Bank rate of 5 per cent had had little effect on curbing the money supply and inflation. Bank rate could only be effective as a means of curbing lending if it forced the commercial banks to pass on the higher rate to their customers, and this would only happen if they were put in the position where they might have to use the Bank of England's lending facility. There was little danger of the commercial banks having to do this. They were flush with three-month Treasury bills which the government was continuing to sell through the Bank of England. These bills paid only 3.5 per cent. If a commercial bank's lending operations endangered its currency reserve, then it was far more economical for it to boost its reserves by failing to renew its holding of maturing Treasury bills – which only paid 3.5 per cent – than by having to borrow from the Bank of England at 5 per cent. In effect, they were happy to forego the 3.5 per cent benefit in order to avoid the 5 per cent penalty, whilst continuing to lend profitably at rates above the effective floor of 3.5 per cent. Thus the only effective check on the level of bank lending was the Treasury Bill rate, and the banks' failure to renew Treasury bills was leading to even greater lending, as the day to day requirements of the Government had to be met by borrowing, on Ways and Means, at 3 per cent from the Bank of England. According to Hawtrey,

¹⁸¹ Hawtrey, *A Century of Bank Rate*, p.296.

[i]t was not the [banks] but the Government that was then driven to borrow from the Bank of England. It was the advances from the Bank to the Government on Ways and Means that supplied the cash foundation on which the inflationary superstructure of bank credit was being built up. . . . But if Treasury bills [had been] made more attractive relatively to advances to traders, the banks would [have raised] their charges for loans and overdrafts as well as for discounts, and so [discouraged] trade borrowing.¹⁸²

During August and September of 1919, Bank of England officials had been urging the Chancellor of the Exchequer, Austen Chamberlain, to help make its Bank rate effective by increasing the Treasury bill rate to 4.5 per cent.¹⁸³ The Bank, on 25 September 1919, sent a letter to the Chancellor (having been invited by the Chancellor, who believed that he would have had difficulty in putting the move past the Cabinet, to put its case in a 'reasoned statement'), in the course of which it argued that, since the pound had fallen to 15 per cent below parity, dearer money was essential to prevent further erosion of the value of the pound, and that an increase in the Treasury bill rate would assist in making its 5 per

¹⁸² *Ibid.*, p.133.

¹⁸³ S. Howson, 'The Origins of Dear Money, 1919-20' *The Economic History Review*, New Series, Vol. 27, No. 1. (Feb., 1974), 97.

cent effective. On 6 October 1919 the three-month bill rate was raised to 4.5 per cent and the six-month bill rate was raised to 5 per cent.¹⁸⁴

Figures culled from various sources by Howson suggest that from December 1919 the money supply began to grow at a slower rate, and that high-powered money (the sum of the currency in circulation and the currency held in reserve by the Bank of England) fell in the first four months of 1920.¹⁸⁵ This was followed by a few months' fluctuation in the money supply, with a steady rise between June 1920 and January 1921.¹⁸⁶ Hawtrey, writing in 1937, held the view that after the raising of the Treasury bill rate there was 'a pause in the progress of inflation, but [by] March 1920 the pace was as great as ever'.¹⁸⁷ However, whether primarily for purposes of controlling price inflation, or primarily through a desire to apply deflationary measures for restoring sterling parity, by February 1920 the Bank was again seeking Chamberlain's support in raising Treasury bill rates in order to support a still higher Bank rate. Chamberlain was also under pressure from some of his Cabinet colleagues who wanted to see *lower* rates as a means of facilitating programmes such as housing development. His instincts seem to have been to support the Bank; seeing them as the agents of 'sound finance'. But, needing backing with which

¹⁸⁴ *Ibid.*, 98.

¹⁸⁵ *Ibid.*, 98-100.

¹⁸⁶ *Ibid.*

¹⁸⁷ Hawtrey, *A Century of Bank Rate*, p.132.

to resist Cabinet pressure, he once more sought a 'reasoned statement' in support of their proposals from the Bank. Additionally, he sought advice from Treasury administrators (Blackett and Niemeyer) and from the Treasury's economist (Hawtrey). He also looked outside both the Treasury and the Bank in seeking advice from Keynes.

The five replies to Chamberlain's request for guidance have been collected together in a single Treasury file.¹⁸⁸ They were collected together during the Second World War – presumably with the hope that they might afford some guidance to conditions after that conflict. Keynes produced a fascinating foreword to the collection, which it is worth revisiting after considering the various replies.

With his customary brisk efficiency, Niemeyer was the first to reply, on 3 February 1920, with a brief memorandum listing six numbered arguments in favour of 'substantially' higher money rates. London money rates needed to be higher than those in other financial centres to make sterling an attractive currency to hold for investment and thus help 'bridge the gap between gold and sterling'; 'inflated credit' needed to be checked; high rates would discourage 'merchants' from holding stocks and encourage them to de-stock by reducing their prices (Hawtrey's influence is evident here); the current high rates were starting to encourage the holding of Treasury bills, and discourage the issue and purchase of new investment vehicles at home and abroad (points 4 and 5);

¹⁸⁸ Treasury Papers, T 172/1384. 'Dear Money Papers of 1919-20', collected together by David Waley with a foreword by J.M.Keynes (7 January 1942).

finally, 'cheap money [would] undo all the educative effects of [the prevailing 6 per cent rate]' and as people believed the need for economy was over 'the shilling [would go] the way of the franc and the mark'.¹⁸⁹

On the following day, 4 February 1920, Hawtrey produced his reply in the form of a six-page memorandum 'Cheap or Dear Money'.¹⁹⁰ It was a longer, more thoughtful, piece than Niemeyer's in which he looked at some of the more commonly held views regarding interest rates, and examined the theoretical basis of them. In the manner of most of Hawtrey's writings, it was the memorandum of an economist rather than that of a financial administrator, and probably of limited use to a politician looking for arguments to justify a policy decision.

He first challenged the argument that no realistic rate of interest could check the borrower – the argument that since prices were rising at 3 per cent per month it would remain worthwhile to borrow up to an interest rate of 36 per cent per annum. Such an argument, Hawtrey argued, would only hold if there was an expectancy that price inflation would continue unabated; the raising of interest rates would dampen the *expectation* of a further general rise in prices and thus quell the borrowing which was the cause of price rises. He felt that rates 'not necessarily higher than the 9 or 10 per cent which had been resorted to occasionally in the past' would be sufficient deterrent. To those who might

¹⁸⁹ *Ibid.* Untitled memorandum from Sir Otto Niemeyer to Sir Basil Blackett, 3 February 1920.

¹⁹⁰ *Ibid.*, 'Cheap or Dear Money', memorandum by R.G. Hawtrey, 4 Feb. 1920.

argue that such high rates would cause an 'utter collapse of business' he conceded that it was 'very difficult to choose a rate just high enough to be deterrent and yet not so high as to cause a crash'.

Hawtrey then turned to the argument that cheap money was 'a desirable if not indispensable aid to floating loans'. Such advocates subscribed to the view that cheap money encouraged the purchase of longer term Government bonds at reasonable rates of interest, and that 'successful[ly] funding loans [enabled] the Government to restore a sound currency'.¹⁹¹ He took this view of the effect of cheap money to be 'completely fallacious' since low rates encouraged an artificial demand for investments using *borrowed* money – the borrowed money adding to the aggregate stock of purchasing power and being the source of inflation. A *genuine* funding operation, he suggested, should draw upon the savings of the community. Moreover, the industrial expansion and rising prices associated with cheap money tended to swell industrial dividends, making shares more attractive investment propositions against Government fixed-interest stock. Hence, to Hawtrey, a check to the expansion of credit through higher interest rates was desirable to restore the foreign exchanges *and* to reduce prices *and* to encourage the purchase of Government bonds.

To the point that dear money was a cost to the Exchequer due to the high rates of interest on Treasury bills, Hawtrey responded that –

¹⁹¹ *Ibid.*

. . . high rates, if made effective, do not have to last long. Once the artificial stimulus to trade derived from rising prices is dispelled, quite moderate rates are sufficient to keep credit in check. The total loss to the Exchequer would be as dust in the balance and ought to be more than made good by the natural fall of rates when expansion stops.¹⁹²

The essential message of Hawtrey's memorandum was that high rates, effectively applied to change expectations of rising prices, could very soon be followed by the lower rates which would stave off depression.

The views of Keynes were ascertained by Chamberlain in an interview at the Treasury on 4 February 1920. On 15 February 1920 Keynes forwarded to Chamberlain a summary of the views he had expressed in the interview. In the course of fifteen carefully argued points Keynes thought that dear money was essential in –

. . . bringing the mind of the business world to a better realization of the true position At present . . . goods and labour are so fully employed that almost all new credit puts prices up, or puts exchanges down, by leading the borrower either to compete with other purchasers for home products, or to buy something from abroad.¹⁹³

¹⁹² *Ibid.*

¹⁹³ *Ibid.*, 'Notes by Mr. Keynes of interview with the Chancellor of the Exchequer on 4 February 1920'.

Keynes thought it 'vital' that the rate in London should exceed that in New York, and that bank rate should be increased to 7 per cent, with an increase to 8 per cent 'soon after'. He was of the opinion that 10 per cent Bank rate might be required, but even at this level, and although there might be some financial crisis, he believed order books in the staple industries were so full that there was little risk of unemployment.

Blackett, the Treasury Controller of Finance responded on 19 February 1920.¹⁹⁴ Blackett, at this point, did not directly advocate a rise in Bank rate, stating at one point that '[f]or the moment a Bank rate of 6 per cent is probably as high as it is safe to go on political and social grounds'.¹⁹⁵ However, since his concern was that the commercial banks should find Treasury bills attractive enough to buy sufficient numbers to prevent the Government from having to borrow on 'Ways and Means', his advice implied that a rise in Bank rate might be inevitable. There is strong evidence that Hawtrey's views on the deterrent effect of higher rates influenced Blackett's memorandum. On the rise of Treasury bill rates, Blackett added –

. . . every rise in Treasury bill rate successfully checks some borrowers and that once it is realized that deflation is being pursued steadily and being achieved, the hope of huge profits

¹⁹⁴ *Ibid.*, 'Memorandum on Dear Money', Sir Basil Blackett, 19 February 1920.

¹⁹⁵ *Ibid.*

from continually rising prices will no longer operate, and deflation will succeed by success.¹⁹⁶

The Bank of England's memorandum was dated 10 February 1920, but was only sent to Chamberlain, with a dated covering letter, on 25 February 1920. It stated that the current rate of 6 per cent was not sufficient to bring about the deflation of prices which would be necessary to return to the gold standard at the old parity, and that the bank would be shortly asking the Chancellor to support a further rate rise of 1 per cent.¹⁹⁷

Keynes, reviewing this set of memoranda in 1942, called them 'fascinating papers' which 'call[ed] back to one's mind a vanished age'.¹⁹⁸ He was struck by the absence of controls – the lack of rationing, control over capital use, or ability to discipline the commercial banks. In retrospect he would like to have seen higher rates imposed earlier. Even so, he doubted if 'all the evils of 1921 could . . . have been avoided'. In so far as there were lessons to be learned for the aftermath of the subsequent conflict, he felt the papers pointed to the need for 'all controls – rationing control, new material control, new issue control, bank credit control' to be retained for at least two years after the end of conflict, and only gradually released when consumption goods became more easily available.

¹⁹⁶ *Ibid.*

¹⁹⁷ *Ibid.*, Bank memorandum, 10 February 1920.

¹⁹⁸ *Ibid.*, 'Dear Money Papers of 1919-20', collected by D. Waley and reviewed by J. M. Keynes.

Looking back at his own advice, Keynes felt that with the benefit of hindsight he would have given exactly the same advice – ‘a swift and severe dose of dear money, sufficient to break the market, and quick enough to prevent at least some of the disastrous consequences which would otherwise ensue’.¹⁹⁹ This retrospective view of his own advice is somewhat at odds with Susan Howson’s contention that ‘while Keynes had argued that a prolonged period of high interest rates might well be needed, Hawtrey . . . thought that the high rate should only be for a short duration’.²⁰⁰

If Blackett’s word of caution had been the restraining factor in holding back an interest rate rise in February 1920, then that word was withdrawn the following month as Treasury bill sales fell and the Government had to resort to further borrowing from the Bank of England.²⁰¹ On 15 April 1920 Bank rate was raised to 7 per cent and Treasury bill rate to 6.5 per cent.

The 7 per cent Bank rate was maintained for over a year. On 19 April 1921, with Bank rate still at 7 per cent, Hawtrey produced a long memorandum on ‘The Credit Situation’.²⁰² He regarded the developments over the previous twelve months as vindicating his theory of the deterrent effect of an increase in the discount rate.

¹⁹⁹ *Ibid.*

²⁰⁰ S. Howson, ‘Hawtrey and the Real World’, p.159.

²⁰¹ S. Howson, *Domestic Monetary Management in Britain 1919-1938*, pp. 21-23.

²⁰² Treasury Papers, T.176/5, ‘The Niemeyer Papers’. ‘The Credit Situation, R.G.Hawtrey, 19 April 1921.

A year ago we were experiencing intense business activity, rising prices and wages, and scarcity of labour and commodities. Today we have business stagnation, falling prices and wages, unemployment, a glut of commodities This is a most remarkable confirmation of the theory of control of credit through the discount rate. . . . The prevalent opinion in the City was that the rise of rates was no better than a vexatious pin-prick, [that] nothing short of 10 per cent would make any impression²⁰³

Such business stagnation ought to have brought about a marked improvement in sterling's exchange-value as falling imports reduced its availability on the foreign exchanges. Sadly, New York's Federal Reserve was pursuing similar policies, with similar deflationary results, having also raised its discount rate to 7 per cent shortly after the Bank of England. Between April 1920, when Bank rate went to 7 per cent, and February 1921, sterling sank from \$3.96 to \$3.20. Hawtrey calculated that if, after the raising of Bank rate, the purchasing power of sterling could have been raised by 23 per cent, then provided the purchasing power of the dollar had remained the same, the exchange could have been restored to par (\$4.86). The high rate increased the purchasing power of sterling not by 23 per cent, but by over 50 per cent. The trouble was that the corresponding policies being pursued in America had raised the purchasing power of the dollar by 60

²⁰³ *Ibid.*

per cent.²⁰⁴ To Hawtrey it seemed that each country was waiting for the other to reduce its rate first. He offered his solution to the impasse:

. . . [for] the restoration of gold we need that the dollar be cheap and that it should be stable. . . . It would be in our power to hasten in some degree the advent of cheap money in America by sending more gold thither.²⁰⁵

It was to be Hawtrey's continuing refrain that sending gold to America would permit credit expansion there. American credit expansion, he believed, would create a demand for imports which, by putting more dollars on to the international currency exchanges, would reduce the international demand for dollars in relation to the pound, and thus assist the pound climb back to its old parity. In the process, British exports would be boosted and trade depression staved off. With American rates lowered, Britain would be in a position to follow suit. Hawtrey explained his reasoning:

[i]t is for us to follow, and not to lead, because we are still aiming at restoring the exchange at par. To achieve this aim, all we shall have to do will be to hold the value of sterling approximately steady while the dollar depreciates. This does not mean continuing deflation here, but establishing stable

²⁰⁴ *Ibid.*

²⁰⁵ *Ibid.*

conditions. . . . [The] inflation, or cheapening of the dollar will be our opportunity. If we avoid the corresponding inflation, the dollar will sink to the level of sterling, and the gold standard will be in action again.²⁰⁶

In an earlier part of this memorandum Hawtrey, from a theoretical standpoint, pointed out that central banks tended to change their interest rates in response to the state of their reserves, but that since the reserve level was a lagging indicator, interest changes were usually applied too late. He did not, as Howson seems to imply, use the memorandum to criticize the authorities for maintaining the 7 per cent level for too long.²⁰⁷

The Bank of England did not, even if it would have preferred to, wait for American interest rates to fall and then follow them. From February 1921 sterling began to strengthen against the dollar, unemployment continued to rise, and the Treasury continued to feel the burden of the high interest payments on its loans. The Treasury, in turn, did not wait for the Bank, but took the initiative and reduced its Treasury bill rate in March 1921.²⁰⁸ The Bank, once more anticipating its rediscount rate proving ineffective, but fearing an adverse effect on the sterling exchange-rate if it allowed its rate to drop below that of New York, sought the co-operation of the Federal Reserve Governor, Benjamin

²⁰⁶ *Ibid.*

²⁰⁷ Howson, 'Hawtrey and the Real World', p.160.

²⁰⁸ Sayer, *Bank of England 1891-1944*, p.124.

Strong, in lowering interest rates together. Strong, at this stage, refused to make any corresponding reduction, and the Bank of England had to go it alone in reducing its rate from 7 per cent to 6.5 per cent on 28 April 1921. The move was not without its wider effect, since it put Strong under pressure at home, and on 4 May 1921, against his own judgment, he was forced to lower the New York rediscount rate to 6.5 per cent.²⁰⁹ Henceforth, in line with Hawtrey's recommendation, London followed New York as rates fell to 5.5 per cent in London on 21 July 1921.

On 5 July 1921, Hawtrey produced a memorandum, 'Bank Rate', in which he was critical of the tardiness with which the rate was being gradually reduced.²¹⁰

Such an inflationary movement as existed at the beginning of 1920 could only be checked by measures drastic enough to start a contrary movement almost equally violent. . . . About six months ago at the new year it might fairly be claimed that both America and England had passed through the ordeal. . . . Since that time however both countries have persisted in the policy of dear money. . . . It is hardly too much to say that the economic troubles from which we are now suffering are mainly traceable to the continuance of dear money.²¹¹

²⁰⁹ *Ibid.*, pp. 124-5.

²¹⁰ Treasury Papers, T176/5, Niemeyer Papers. 'Bank Rate', R.G.Hawtrey, 5 July 1921.

²¹¹ *Ibid.*

Hawtrey thought, given the general understanding that it was Britain's intention to return to the gold standard at the old parity, that the fault lay principally in America rather than Britain. Credit restriction in America was pushing up the purchasing power of the dollar and forcing Britain to pursue similar policies. He questioned whether, due to business depression and unemployment, Britain might not find it 'worth considering part[ing] company from America, and tak[ing] steps as soon as possible to revive business by easy credit, without regard to the policy of the Federal Reserve Board'.²¹² In the event of the Americans stabilizing the dollar and not allowing its value to fall, Hawtrey thought that the degree of deflation necessary to return to the pound to 'parity' would be so great that parity would be unsustainable, and thus he regarded it as 'futile' to continue to inflict the 'agonies of deflation' upon the country any longer. Moreover, he felt that, in the absence of American initiative, it was better for Britain to take the lead.

. . . immediate relaxation of credit here is enormously strengthened by the Federal Reserve Board's want of initiative. . . If we set the example of a rapid reduction of bank rate (say, by two or even three per cent in fortnightly steps of one per cent at a time) they will follow. We shall have lost nothing in regard to the restoration of the exchange, and the prospect of a revival

²¹² *Ibid.*

of business in America as well as in Europe will have been enormously improved.²¹³

Hawtrey warned that, even with a low Bank rate, the immediate difficulty of stopping a deflationary movement would not be easy since once businesses were in a rut of falling prices it was difficult to get out again.

After July 1921, the London and New York rates continued their downward progress. On 21 September 1921 the New York rate was moved down from 5.5 per cent to 5 per cent. London held out for a little longer – seeing the value of sterling rise from below \$3.60 to \$3.92 as a result – and did not take its next 0.5 per cent drop until 3 November 1921.²¹⁴ The strength of the pound on the foreign exchange market (from April 1922 it moved within the range \$4.42 to \$4.47) encouraged further Bank rate reductions, with the rate reaching 3 per cent by July 1922. Based on fundamentals – the relative purchasing power of the pound and the dollar, or the relative values of interest rates – this strengthening of the pound was hardly justified, in which case the strength could only have been due to speculation that the authorities were determined to restore the old parity. A pound which was worth \$4.40 at the beginning of 1922 must have seemed worth holding on to when in the near future it might be worth \$4.86!

²¹³ *Ibid.*

²¹⁴ Sayers, *Bank of England 1891-1944*, p.125.

On 21 February 1921 the New York rediscount rate, now higher than the Bank of England's rate, was raised from 4 per cent to 4.5 per cent with the aim of checking American inflation. Hawtrey feared that the Bank of England would follow suit. On 5 March 1923, with the pound getting ever closer to its old parity with the dollar and Bank rate still at its low point of 3 per cent, Hawtrey produced a memorandum in which he returned to the question of the export of gold to America.²¹⁵

It is quite a mistake to suppose that the payment of our debt to America is an affair requiring heroic measures. . . . The question of sending gold to America ought to be considered primarily from a monetary point of view.²¹⁶

Monetary policy, he suggested should have regard to the twin objectives of avoiding further deflation and restoring the gold par as soon as possible. Hawtrey feared that if the American move were to successfully check its price rises, then the progress towards the traditional par value for the pound would be reversed and the Bank of England would attempt to recover lost ground by raising Bank rate. His solution was to send £100 m. of gold to America. The gold would have been an advance payment on agreed war debts.

²¹⁵ Treasury Papers T176/5, Niemeyer Papers. 'Export of Gold to America', R.G.Hawtrey, 5 March 1923.

²¹⁶ *Ibid.*

In that case, rather than recover parity by a renewal of deflation and depression here, it would be far better to send large sums of gold to America . . . in order to create a redundancy of sterling there. For these consignments of gold the payment of our debt would supply a very suitable pretext.²¹⁷

Hawtrey conceded that there were methods by which the Americans might be able to absorb gold, even to the level of £100 m., without it occasioning any inflation, but he thought it '[did] not seem likely . . . that the Federal Reserve would adopt any systematic policy of this kind'. His 'presumption' was that any large-scale export of gold would hasten the inflationary tendency there.

America already held a gold reserve far in excess of that required to support its issue of dollar notes, and so the question must arise as to why it could not simply continue to build up excess reserves of gold – technically, to 'sterilise' the gold – without, in any way, creating inflationary credit. There were probably two reasons behind Hawtrey's 'presumption'. First, on purely commercial grounds, the holding of gold, in itself, earns nothing, whilst its use for creating deposits earns income in the form of interest charged for the loans of currency. Secondly, there was a powerful American lobby which was already critical of measures being taken to check the expansion of credit. Hawtrey 'presumed' that any large addition to America's gold stock would have tipped the balance in favour of its *use* rather than its sterilization.

²¹⁷ *Ibid.*

Hawtrey had floated this idea in 1921, and it had been passed on to the Bank of England, without any positive response, by the then Controller of Finance, Sir Basil Blackett. Similarly, Blackett's replacement, Sir Otto Niemeyer, himself anxious to avoid excessive deflation, passed on Hawtrey's memorandum to the Bank. The Bank considered Hawtrey's proposals. The sticking point was the Fiduciary Issue - that part of the currency note issue in excess of the Bank of England's gold holdings. The number of permitted currency notes in circulation was fixed by a Treasury Minute of 1919, set at a value recommended by the Cunliffe Committee.²¹⁸ In accordance with the Cunliffe Limit, the total permissible issue of notes which were not backed by gold (Treasury plus Bank notes), in 1923, was £290 m. Added to the total gold holdings of £153 m., this gave the authorities scope to issue £443 m. of currency notes. The sudden loss of £100 m. of gold would have drastically reduced the permissible number of notes in circulation and depressed trade. The plan would have required some, at least temporary, relaxation of the Cunliffe Limit. This proposal was considered by a secret *ad hoc* committee which included Lord Bradbury and former the Prime Minister, Herbert Asquith.²¹⁹ The majority of the members of this committee were generally sympathetic towards the proposals and to any adjustments to the fiduciary note regulations required to effect them. Hawtrey's old mentor, Lord Bradbury, strongly dissented. He had been influential in

²¹⁸ Sayers, *Bank of England 1891-1944*, pp.126-129.

²¹⁹ *Ibid.*, p.128.

creating the Cunliffe Limit and objected to any weakening of monetary discipline. By May, sterling had weakened, British prices were rising in relation to American prices, and the whole of the gold-export scheme seemed dangerously speculative. In particular, £100 m. seemed dangerously large in relation to Britain's total gold reserves, whilst somewhat insignificant in relation to the American stock. The plan was dropped and the Bank looked once more to rising interest rates to do the work of restoring sterling to \$4.86.

On 1 June 1923 the Governor of the Bank of England, Montagu Norman, met with Niemeyer and Hawtrey at the Treasury. The Treasury men attempted to dissuade Norman from putting up interest rates.²²⁰ This interview was followed up by a note from Niemeyer, to Norman, in which Niemeyer pointed out that unemployment was already rising and would be exacerbated by putting up Bank rate. He reiterated Hawtrey's suggestion of shipping gold in excess of that required for debt payment. On 5 July 1923 Bank rate went up from 3 per cent to 4 per cent.

On 31 October 1923 Hawtrey produced a memorandum commenting on monetary policy.²²¹ He once more called for the shipment of gold to America, at a level over and above that required for debt repayment. He also answered the criticism that his plan weakened monetary discipline, in that it involved a reduction of the gold backing for the sterling note issue. Credit expansion in

²²⁰ *Ibid.*, pp.129-30.

²²¹ Treasury Papers T176/5, Niemeyer Papers. 'Monetary Policy (October 1923)', R.G.Hawtrey, 31 October 1923.

America, he argued, would increase American imports and would lead to the Bank of England possessing more dollars. The dollars, a gold-backed currency, would be a reserve equally valid as gold for the issue of sterling currency notes.²²²

Niemeyer followed up Hawtrey's memorandum with a note to the Governor of the Bank on 20 November 1923.²²³ In this note Niemeyer expressed concern that various electoral pledges and some extravagant electoral oratory were having an adverse effect on the sterling exchange rate. Niemeyer termed all these pre-election undertakings as 'funk'.

Unfortunately funk having set up a fall, the fall itself generates more funk, until things get so bad that you will want to put up Bank rate – if only as a sign that we have not given up the fight.

. . .

Now is there nothing we can do to encourage the faint hearted to believe that sterling is not down and out? . . . there is one course which ought to be considered. We still have considerable reserves of gold – which . . . are not seriously needed in U.K. to meet notes. Ought we not to use these reserves, somewhat as was contemplated in Genoa, rather than sit and look at them? . . . It seems to me that we might properly hold dollars against Currency Notes . . . If this is admitted, we

²²² *Ibid.*

²²³ Treasury Papers, T176/5, Niemeyer Papers. Note from Sir Otto Niemeyer to Montagu Norman, 21 November 1923.

could now sell in New York up to say £80 millions of gold . . . replacing it in the reserve by dollars.²²⁴

On the following day Norman replied to Niemeyer, saying that although he was personally 'in principle' in favour of shipping gold to America, at that moment it was 'impracticable'.²²⁵

The immediate object of such shipment would be to restore confidence in the £ sterling. It is quite possible, however that the withdrawal of gold from the Currency Note Reserve would in itself have the opposite effect. It might be taken as showing that the Treasury themselves were apprehensive of the future, and were of the opinion . . . that 'novel' action was necessary to check a fall that was otherwise likely to occur.²²⁶

Niemeyer went on to add that he doubted whether the shipment, which would necessarily be only a 'moderate and gradual' addition to the large existing stock of American gold, could have the effect of 'turning the exchange'.²²⁷ This seems to have been the last word on the export of gold, and on this matter, at least, the view of the Bank prevailed.

²²⁴ *Ibid.*

²²⁵ Treasury Papers T176/5, Niemeyer Papers. Note from Montagu Norman to Sir Otto Niemeyer, 21 November 1923.

²²⁶ *Ibid.*

²²⁷ *Ibid.*

The Bank did not entirely have its own way over interest rates. True, it had increased its rate by a full percentage point in July 1923, but without a corresponding rise in the Treasury bill rate that rise could not, as we have previously seen, have had any substantial effect on the lending practices of the commercial banks. The Treasury bill rate did not follow Bank rate up in July 1923.²²⁸ As a result, revival in trade, which had been caused by interest rate reductions between April 1920 and July 1922, continued through into 1924. In July 1924, however, Treasury bill rate followed Bank rate up, Bank rate was made effective, and all signs of trade revival stopped.

Hawtrey, by this time, had given up hope of affecting exchange rates by export of gold, and switched his advice; a switch designed to avoid a sustained period of depression and unemployment. In July 1924 he produced a memorandum, 'Sterling and Gold'.²²⁹ Having noted that achieving parity with the dollar, whether by high Bank rate or by export of gold, would involve some contraction of credit, he suggested that there might be an alternative method which would involve restriction of credit for only a shorter period of time.

Suppose that instead of raising the exchange by actual sales of gold, a future date is named at which free exports of gold will be allowed without restriction. If the date is a fairly early one (say, not more than six months off) and the intention to allow exports

²²⁸ Hawtrey, *A Century of Bank Rate*, pp. 134-5.

²²⁹ Treasury Papers, T208/54. The Hawtrey Papers, 'Sterling and Gold' by R.G.Hawtrey, July 1924.

of gold is really believed in, the effect must be to raise the exchange immediately very nearly to par. No one will sell sterling appreciably below 4.86 if it is certain that in six months it will command that price.²³⁰

The artificially high level of sterling would stimulate imports at the expense of exports, thus creating a surplus of sterling on the foreign exchanges, but the speculative demand for sterling would hold up its price.

Even this method, Hawtrey conceded, would involve some credit restriction, due to the need to inhibit imports during the period of artificially high sterling.

It is essential therefore to effect a suitable contraction of credit in the early stages . . . enough to counteract the effect of the high rate of exchange in attracting imports and retarding exports. . . . The whole advantage hoped for from the plan is to get through the period of falling prices quickly.²³¹

Such an announcement was never made, but general anticipation of a return to gold at the old parity ensured that speculation contributed to maintaining the pound nearer \$4.86 than would otherwise have been the case.

²³⁰ *Ibid.*

²³¹ *Ibid.*

Chapter 2

The Return to the Gold Standard

1925

By 1925, the situation of having banknotes issued by both the Bank of England and the Treasury needed tidying. Sir Montagu Norman was anxious to regularise the bank note issue in such a way that it was once more controlled by the Bank of England. He understood Labour Chancellor Snowden's adherence to the orthodoxy of 'sound' finance, and in June 1924, with the aim of reclaiming the Bank's prerogative to issue notes, he persuaded Snowden to appoint a 'Committee on Currency and Bank of England Note Issues'. This committee was originally chaired by Austen Chamberlain. Of the other four members, two had extensive Treasury experience, Sir John Bradbury and Sir Otto Niemeyer; one was a merchant banker, Gaspard Farrer; and the other was an academic, Professor Arthur Pigou. Bradbury, Farrer and Pigou had been members of the Cunliffe Committee which had recommended the return to the gold standard in 1919. Given that the newcomer, Niemeyer, yielded to nobody in the strength of his devotion to 'sound finance', it was hardly surprising that the committee's agenda should follow closely that of Cunliffe. Indeed, since the Cunliffe Committee had recommended that amalgamation of the fiduciary issue should await at least a year's experience of the gold standard, then it was inevitable

that the primary concern of the Chamberlain Committee should be the timing of the return to the gold standard.

On 11 July 1924 the Chamberlain Committee took evidence from Keynes. He expounded the ideas which he had recently published in his book, *A Tract on Monetary Reform*, warning the committee that a return to gold at the pre-war parity would raise the gold value of sterling to such a level that 12 per cent more gold would be required to purchase British exports – effectively a 12 per cent increase in British export prices. Whilst this would also mean that fewer pounds would be required to purchase the gold for procurement of imports – effectively a 12 per cent reduction in import costs – labour costs would continue to be paid in pounds which had a 12 per cent greater gold content, since money wages would not automatically fall by 12 per cent to accommodate this change in the gold value of the pound. The result would be increased costs in terms of world prices for British manufacturers, loss of profits, loss of export trade, and ultimately unemployment. The excess of imports over exports (paid for in gold) would lead to credit restrictions to stem the outflow of gold, with the consequence of declining trade and further falls in employment. Keynes's warnings did not go unheeded since the committee's draft report of 14 September 1924, written by Pigou, recommended waiting 12 months before returning to the gold standard in the hope that, by then, American prices would have risen sufficiently to avoid the inconvenience of the deflation of British prices. Successive drafts from this committee varied only in marginally in their

suggestions of the actions which might be taken by the authorities to bring sterling back to its pre-war par with the dollar.

The November 1924 General Election saw the Conservatives returned to power, with Baldwin as Prime Minister, and Churchill as his Chancellor of the Exchequer. Prior to that election, £1 equated to \$4.50. Speculators, anticipating that the Conservative victory would hasten the restoration of the gold standard, and the pound would be returned to its previous parity of \$4.87, used their dollars to purchase pounds. The increased demand for sterling drove up its value and in December, a month after the election, the pound had climbed to a value of \$4.70. A further consequence of the Conservative victory was that Austen Chamberlain was appointed to the position of Foreign Secretary, and thus the chairmanship of the Chamberlain Committee, for its brief remaining life, passed to Sir John Bradbury.

On taking up office, one of the key decisions facing Churchill was the possible renewal, at the end of 1925, of the enabling legislation which prohibited the export of gold. The various restricting regulations had been consolidated in the Gold and Silver (Export Control) Act 1920 – the Act which effectively removed Britain from the gold standard. The Act was due to expire on 31 December 1925. The choice before Churchill was to either to let the Gold and Silver (Export Control) Act expire, or to legislate for its renewal for another period of years.

As Chancellor, Churchill was far more open-minded than Snowden. He could not be led down the paths of conventional finance with quite the same ease as

his Labour predecessor. Indeed, Sir Montagu Norman was given to expressing, in private, that he wished Snowden could have remained as Chancellor.²³² Churchill, unlike Snowden, was not a man of firm financial conviction, and lacking convictions of his own he operated by continuously and rigorously testing his officials with the counter-arguments which he knew that his opponents would use. Only when convinced that he possessed a set of water-tight arguments, which he could deploy against his critics, was he prepared to move forward with any kind of policy programme.

Moreover, Churchill was an old friend of Beaverbrook, the proprietor of the *Daily Express* and the *Evening Standard*, and on 28 January 1925 the *Express* published an article attacking the Treasury in general, and Niemeyer in particular, for favouring the City at the expense of industry. On the following day, 29 January 1925, Churchill sent out a minute setting out the arguments against a return to the gold standard, and asking for the counter-case. The minute, referred to in the Treasury files as 'Mr. Churchill's Exercise', was sent out to test Norman, Bradbury, Niemeyer, and Hawtrey.²³³ Sir John Bradbury, one of the examinees, was given to remark that 'the writer [of the minute] . . . appears

²³² A.Boyle, *Montagu Norman* (London, Cassell, 1967), p.179.

²³³ 'Mr. Churchill's Exercise' is set out in full in, as an appendix, in D.E. Moggridge, *British Monetary Policy 1924-1932: The Norman Conquest of \$4.86* (Cambridge, C.U.P., 1972) pp. 260-2.

to have his spiritual home in the Keynes-McKenna sanctuary but some of the trimmings of his mantle have been furnished by the *Daily Express*.²³⁴

'Mr. Churchill's Exercise' - headed 'Most Secret' - set out, in a cogent and clear manner, six arguments against the restoration of the gold standard.²³⁵

First (paragraph 2), it proposed that the holding of gold was no more than a token of good faith, held so that others might have confidence in the country's currency. Such a token of good faith, it suggested, was a survival of 'rudimentary and transitional stages in the evolution of finance and credit' and should be unnecessary in a country such as Great Britain which upheld the reputation of its currency by 'a strict financial policy and healthy trade'. Secondly (paragraph 3), it suggested that the return to gold was being urged by the United States which, being in possession of nearly three-quarters of the world's public gold, would thereby be able to play a more dominant role in world finance. Thirdly (paragraph 4), it advanced an argument for an alternative course of action. It argued that Britain might renounce the gold standard and ship one hundred million pounds of gold reserves to America as part-payment for war debts. This would, in the short term, allow the authorities to replace expensive foreign debt by cheaper domestic debt and, in the long term, encourage

²³⁴ Moggridge, *British Monetary Policy*, p.64.

²³⁵ *Ibid.*, pp. 260-2. Churchill's questionnaire is reprinted in full in Moggridge. The replies of Norman, Bradbury and Niemeyer are reprinted in full in Moggridge, pp. 262-76. .

American credit expansion to the eventual detriment of the dollar – thus making the rest of the repayment of Britain's war debt to America less onerous.

The fourth argument (paragraph 5) against restoration was a political rather than an economic one. Churchill, in the event of maintenance of the gold standard requiring increases in Bank rate, wished to avoid accusations of favouring the interests of finance over those of industry. The fifth point in the memorandum (paragraph 6) was that over the past three years during which the currency had been managed without gold, price stability in Britain had been better than that in the United States, 'for all her Gold'. 'Why then should we not continue on the basis of 'managed' finance? What risks shall we run? What evils shall we encounter?' Pursuing this point of why we should not maintain the current strategy for longer, Churchill again looked to his own position and the ease with which he might be able to defend his decision within parliament – 'if the Bank Rate had in the ordinary course of events to be raised, no one could attribute it to the action of the British Government. It could with justice be said, had we restored the Gold Standard it would have had to be raised still higher'. The sixth, and final point, in Churchill's memorandum (paragraph 7) was that since restoration of the gold standard was perceived as being so much in the interest of the United States, then delaying any decision as long as possible might enable the Government to extract better terms, in respect of repayment of war debts, from the Americans. This last point is expressed in rather vague

terms; that American 'persuasion may take the form of greater facilities than are now offered'.

These, then, were the six points upon which Churchill sought answers from his 'wise men': the role of gold in a modern credit economy; the extent to which restoration of the gold standard was in American rather than British interests; the drawbacks of ignoring the gold standard and exporting gold to America, partly as war-debt repayment and partly as a driver of American inflation to ease the burden of future repayments; the responses available to a Chancellor accused of favouring finance over industry; the drawbacks of continuing with the present, apparently successful and stable, managed currency; the drawbacks of delaying restoration of the gold standard in order to wrest concessions from the Americans. Within four days, on 2 February 1925, he had received answers from Norman, Niemeyer and Hawtrey. He had to wait a further three days, to 5 January 1925, before receiving Bradbury's response. By 6 January 1925 Churchill had completed the reading of the submissions.

The reason for choosing Sir Montagu Norman to take part in the exercise seems fairly straightforward; as Governor of the Bank of England he would be ultimately responsible for managing the restored gold standard. He was an aloof, neurotic patriarch. The revelation that he made his frequent transatlantic crossings under the name of his secretary, Skinner, gave rise to a hostile biography *Professor Skinner alias Montagu Norman*. Norman believed that an electorate which demanded increased business activity through the adoption of

an inflationary policy resembled a group of shareholders who, unconcerned by a company's need to invest for the future, demanded ever larger dividend payments.²³⁶ Such shareholders needed protecting from themselves by a wise far-seeing board of directors. So far as Norman was concerned the public needed protecting from itself by an independent central bank committed to the principle of sound money.

Norman mistrusted politicians generally; Churchill, egged on by his friend Beaverbrook, reciprocated the sentiment.²³⁷ It would probably have delighted Churchill to have been able to frustrate Norman over the return to gold.

If Norman's was the first submission to be read by Churchill then he may have remained unconvinced of the need to return to gold. It was weak on analysis whilst strong on rhetoric, and used language which was clumsy, excruciatingly punctuated, and at times, intemperate. To Norman's credit, he was the only respondent who attempted to frame his response in such a way as to directly answer, point by point, the particular questions raised by Churchill.

Regarding the status of gold in the conduct of world affairs Norman was dogmatic:

National credit needs . . . good faith Gold is the guarantee of good faith. . . . A Gold Reserve and the Gold Standard . . . are necessary: so is a Police Force or Tax Collector: it is as

²³⁶ P.Einzig, *Montagu Norman* (London, Hutchinson, 1932), p.82.

²³⁷ Clarke, *The Keynesian Revolution in the Making 1924-36*, p.36.

dangerous to abandon the former as the latter. . . . there is no alternative to gold in the opinion of educated and reasonable men.²³⁸

He dismissed any notion that returning to gold was to the particular advantage of the Americans rather than the British: 'the interests of Great Britain, of the U.S. and of most other countries are the same. You cannot . . . have 'patchy prosperity'.²³⁹ As regards shipment of gold to America to promote American inflation, he raised the spectre of German-style inflation occurring in Britain:

. . . the result . . . would be psychological . . . our note-circulation would be discredited at home . . . [the] exchange would fall . . . and fall: and the world-centre would shift permanently and completely from London to New York.²⁴⁰

Furthermore, on technical grounds, he repudiated the suggestion that exporting gold to America could act as a means of inflating the American economy, arguing that the Americans would use gold for European investment rather than credit creation at home - 'The Federal Reserve Bank have learned how to sterilise any amount of gold'.²⁴¹

²³⁸ Moggridge, *British Monetary Policy 1924-1931*, p.270.

²³⁹ *Ibid.*

²⁴⁰ *Ibid.*

On the question of the position of the Chancellor, should he be forced into explaining interest rate rises to industry, Norman was the unrepentant patrician:

. . . the merchant, manufacturer, workman, &c., should be considered (but not consulted any more than about the design of battleships) 'cheap money' is the Industrialists' big stick and should be treated accordingly restoration of Free Gold will require a high Bank Rate: the Government cannot avoid a decision for or against Restoration in the former case (Gold) he will be abused by the ignorant, the gamblers and the antiquated Industrialists: in the latter case (not Gold) he will be abused by the instructed and by posterity [this apparently random selection of capital letters is directly from Norman's document].²⁴²

Norman answered the Chancellor's point regarding the success of the 'managed' currency in the years 1922-25 by asserting his belief that stability had only come about because 'the whole world' believed that the country would return to gold in 1925, and advised against delaying the restoration of gold since he believed this would 'shatter' London's position as a centre for international finance.

²⁴¹ 'Sterilisation' of gold is the act of using it in such a way that it does need lead to an extension of credit, and ultimately inflation. The easiest way in which to do this is to simply leave it idle in the bank's vaults, but in this case it would be a wasting asset, not earning income for the central bank, whereas using the gold to create bank deposits for customers (enlarging credit) would earn interest for the bank. As an alternative to 'sterilising' the gold by leaving it idle the American Federal Reserve Bank was increasingly using its gold to acquire investments in Europe.

²⁴² *Ibid.*, p.271.

The reason for inviting Bradbury to take part in 'Mr. Churchill's Exercise' would seem to be that he was a highly respected senior figure in financial matters who could be relied upon to give a balanced judgement. A Manchester Grammar School boy, he had entered the Civil Service, after Oxford, in 1896. As a principal clerk he had been the senior civil servant responsible for drafting Lloyd George's National Insurance Act of 1911. In this task he had been assisted by Hawtrey and W.J. Braithwaite of the Inland Revenue. Braithwaite, wearied by Bradbury's detailed criticisms described him as 'all teeth, talk . . . spectacles and argument'.²⁴³ Hawtrey was to remain an admirer of Bradbury's abilities.²⁴⁴ Bradbury rose to become Joint Permanent Secretary to the Treasury in the years 1913-19. He moved from the Treasury to become the Principal British Delegate to the Reparation Commission, was a member of the Cunliffe Committee, and assumed the Chair of the Chamberlain committee on the amalgamation of note issues after Austen Chamberlain's appointment as Foreign Secretary. Later that year, 1925, he was created a peer.

Bradbury did not attempt, as Norman did, to respond point-by-point to Churchill's memorandum. His response took the form an essay (or even a sermon) contrasting the gold standard against monetary management without the gold standard. If, indeed, his response could be more likened to a sermon, he took as his text a quotation from Churchill's memorandum:

²⁴³ Peden, *The Treasury and British Public Policy 1906-59*, p. 60.

²⁴⁴ R.D.C. Black, 'R.G.Hawtrey', 371.

Gold is no longer a currency token, but simply a reserve guarantee or test of good faith between man and man and one country and another. If good faith were universal gold could be left to the fine arts.²⁴⁵

But this text was not taken as Bradbury's thesis – more his anti-thesis. To Bradbury, the writer of this statement showed 'an entire misconception of the function which gold plays in international economics'. He then proceeded to set out the reason why he believed that gold played a vital function in international trade.

However little we may like it, gold is still the international standard of value and the medium in which, in the long run, any ultimate debt against one country in favour of another must, if it is to be liquidated at all, be liquidated.

It is quite easy to conceive of a state of affairs in which each country would have a currency of its own, having a real value, in terms of commodities, of the commodities which it is capable of purchasing, which would be accepted by other countries in discharge of debts owing to them. It is conceivable, but not in fact feasible, since certain countries which are debtors on international account would never be able to resist the temptation to reduce the value of their currencies in order to diminish the real burden of their debts. For that reason a

²⁴⁵ Moggridge, *British Monetary Policy 1924-1931*, p.272

prudent creditor would never permit a debt due to him to be expressed in the currency of these countries.²⁴⁶

Bradbury's submission went on to suggest that whilst it might be more nearly feasible for Britain and America to maintain the relative value of their currencies in terms of commodities, leading other countries to settle their debts in dollars or pounds rather than gold, such a process would, indeed, leave gold to 'the Fine Arts'. But America, as the principle holder of gold, could not be expected to co-operate in anything which would reduce the value of gold.

In contrasting the gold standard with a 'managed' currency Bradbury pointed out that there was no way, under either system, of eliminating the credit cycle since the same steps were necessary to stem rising commodity prices as were required to stem the outflow of gold – the 'chief opponents of the gold standard are not the advocates of the 'managed' pound, but the inflationists pure and simple'. Bradbury concluded by warning that there would be 'no advantage' and 'serious inconvenience' in waiting, since in the absence of any immediate announcement of the intention to restore the free gold market at an early date there would be an appreciable set-back in the exchange value of the pound.

It was inevitable that Niemeyer would be asked to respond to Churchill's document. From 1922-7 Niemeyer was the Treasury Controller of Finance – effectively the chief financial advisor to the Chancellor of the Exchequer.

²⁴⁶ *Ibid.*, p.273.

Niemeyer was a man with conservative ideas but outstanding ability. After graduating in 'Greats' from Balliol College, Oxford, Niemeyer's promotion had been rapid. From coming top in the Civil Service examinations of 1906 – the year Keynes came second – he had risen to his present position by the age of thirty-nine. Churchill needed to be absolutely clear of Niemeyer's reasons for wishing to return to gold - he would be the Chancellor's principal advisor throughout the whole process. Churchill needed to have total confidence that, whatever decision he might take, Niemeyer could steer him through the stormy political waters. In the event, Niemeyer's submission was a masterfully argued advocacy for returning to the gold standard. The 'steely logic' with which Niemeyer marshalled the argument was probably the deciding factor in Churchill decision.²⁴⁷ He felt confident that Niemeyer would provide him with the answers to any criticisms.

To Niemeyer, the return to the gold standard was a test of political will. It was a test of the authenticity of the Government's commitment to honest money. He reminded Churchill that all governments since the war had endorsed the Cunliffe Committee's recommendation that the gold standard should be returned to at the earliest possible moment; with this intention being repeated at successive international conferences. He also reminded Churchill of the imminent expiry, some eleven months hence, of the order prohibiting the export of gold, and that manufacturers, exporters and bankers were expecting notice of

²⁴⁷ Clarke, *Hope and Glory: Britain 1900-1990*, p.132.

the government's intentions in order that they might 'fix their course with certainty against the appointed day'.

So great is the expectation of a return that a decision to continue the export prohibition would not be a continuation of the present state, but would start us immediately in the opposite direction It would reverberate throughout a world . . . convinced that we never meant business about the gold standard because our nerve had failed when the stage was set.²⁴⁸

He then proceeded to summarise the reasons why the Chamberlain Committee, whose report awaited signing, recommended returning to the gold standard; the principal reason being that the committee adjudged price differences between Britain and America to be within four and a half per cent of each other, with American prices still rising and British prices still falling. The conversion of prices was such that the Committee believed that only a further deflation of British prices by one and a half per cent would be required to achieve par; an 'extra sacrifice' that would be 'negligible'. Niemeyer gave his opinion that an early move was desirable since exchange demands were light in spring, but heavy in December when, on the expiry of the gold export prohibition order, the Chancellor might be tempted to make his move.

²⁴⁸ Moggridge, *British Monetary Policy 1924-1931*, p.263.

Niemeyer concluded his submission by discussing the criticisms which the move back to gold might elicit; that the move would be in American rather than British interests; that the move was in the interests of finance rather than industry; that the move would require dear money from which unemployment would ensue.

Regarding the adoption of a gold standard being predominantly in American interests, Niemeyer argued that failure to stabilise the pound using gold would result in more of the world's trade being financed by dollar Bills (or even Bills in the newly-stabilised Marks) rather than sterling Bills, resulting in an even more rapid displacement of London from the position of being the world's financial centre. As for the gold standard favouring banks at the expense of factories, Niemeyer regarded it as a 'mistake to imagine that the Banks want dear money', since 'cheap money (and rapid circulation) suits them better'. He felt that the real antithesis was between bankers taking the long view and manufacturers taking the short view. Finally, Niemeyer argued that the best cure for unemployment was restoration of trade, and the gold standard was the basis for restoring international trade.

On a long view . . . the gold standard is in direct succession to the main steps towards economic reconstruction . . . and is likely

to do more for British trade than all the efforts of the Unemployment Committee.²⁴⁹

Throughout February 1925 Churchill refused to allow Niemeyer to leave his side, and such was the dependence of the Chancellor on his Controller of Finance that Frederick Leith-Ross, Niemeyer's deputy, was later to say that Churchill eventually went down the path of gold standard restoration 'because he knew that if he adopted this course Niemeyer would give him irrefutable arguments to support it'.²⁵⁰ Conversely, if he had opted not to return to gold, then he would have stood alone.

Churchill's fourth request for a response to his memorandum went to Hawtrey. Now Hawtrey was, by considerable degree, the most junior of the respondents. Norman, as Governor of the Bank of England, and Bradbury, distinguished ex-Permanent Secretary to the Treasury, were very senior figures. Niemeyer held a position below that of Permanent Secretary, but in his position as the Chancellor's closest financial confidante, it was essential that Churchill was clear about his views. Hawtrey held a position in the Treasury two rungs below that of Niemeyer. It might have been a formality for the Chancellor to ask for a response from Hawtrey – after all, his Financial Enquiries Department was set up explicitly to 'to collect information upon all subjects of general financial interest

²⁴⁹ A reference to the 'Unemployment Grants Committee' - which had been set up in 1919 in order to initiate public works.

²⁵⁰ F.W.Leith-Ross, *Money Talks: Fifty Years of International Finance* (London, Hutchinson, 1968), p.92.

and to prepare reports from time to time . . . upon any question which may be referred to it by the Chancellor of the Exchequer' – but it is possible that Churchill, faced with criticisms from the an economist such as Keynes, might have wished for the response of an economist to go alongside those of the banker and the two financial administrators – to have a response with which to answer criticisms at a different level from that of the political.

The reply of Hawtrey's is the only one that Moggridge does nor reprint in his account of the return to the gold standard.²⁵¹ His reference to Hawtrey's reply is somewhat dismissive: 'there was a long, rather involved reply from R.G.Hawtrey'²⁵² (Since the preface to the book thanks, amongst others, 'Sir Ralph Hawtrey', for having read drafts and providing comments and encouragement, it seems that Hawtrey himself might not have demurred from this assessment). Hawtrey's response was thoughtful, but untidy, over-technical, and unfocussed. He still believed that his authorship of the 1922 Genoa resolutions on currency reform through a gold-exchange standard held the answers to the currency problems of the day, and he used the exercise to preach the efficacy of these resolutions. It is extremely unlikely that his response, thoughtful as it was, would have provided Churchill with the kind of armour that he would have required to carry gold standard legislation through the Commons, or even to have responded to a savage press polemic from J. M. Keynes.

²⁵¹ Moggridge, *British Monetary Policy*.

²⁵² *Ibid.*, p.71.

Hawtrey took, as his cue, the questions from 'Mr. Churchill's Exercise' relating to continuation of a 'managed' currency – 'What risks should we run? What evils should we encounter?' He pointed to the fact that the success of the 'managed' currency in maintaining stable prices during the years 1922-24 had been during a period of recovery from depression when cheap money was necessary to encourage economic expansion. He queried whether such currency management would be as effective when credit restriction was called for during an economic boom and, without the gold standard in place, 'the accustomed symptom of a loss of gold does not occur'. Moreover, he asserted that stabilisation of internal prices was but one characteristic of sound currency – it should, at the same time, be capable of stabilising its foreign exchange value since the 'injurious effect of unstable exchanges on international trade has been generally recognised, but . . . by no means well understood'.²⁵³ He proceeded to elaborate upon this.

Before the war, Hawtrey explained, purchases of goods and raw materials throughout the world had been financed by Bills of Exchange drawn on London. The Bill of Exchange was a device for satisfying both the provider of goods, who became a creditor, and the receiver of goods, who became a debtor. The provider usually wanted instant payment for materials (say) whilst the receiver was not in a position to pay until those materials had been converted into saleable goods. The Bill of Exchange bridged the gap. It was a document which

²⁵³ Treasury Papers, T 172/1499B. 'The Gold Standard', a memorandum by R.G.Hawtrey, 2 February 1925.

was a written order to pay a definite sum at a future date (often three, or six months hence), 'drawn' by a creditor and 'accepted' (signed) by a debtor. The debtor acquired a period of grace before settling his debt, and the creditor could, if he so wished, obtain immediate payment (at a small discount) by selling his bill of exchange to one of London's specialist Discount Houses – leaving the Discount House with the task of ensuring that the debtor fulfilled his commitment. The debtor, whatever his local currency, would use that currency to obtain sterling in order to pay his debt to the Discount House. This system had been the source of London's financial strength, but it had shrunk after the war. According to Hawtrey it had shrunk because of exchange-rate instability; foreign traders had not been prepared to take on debts, repayable to London in sterling, when they were unsure of what that liability would be in their local currency. Similar uncertainties had thwarted the attempts by New York to establish itself as a centre for short-term loans. The result had been a falling away of world trade. Hawtrey's recommendation was clear.

It is emphatically a British interest that the pre-war system should be restored. But it is . . . also a worldwide interest. . . . Exchange stability cannot be obtained at present by any other method than a gold standard.²⁵⁴

²⁵⁴ *Ibid.*

The possibility of establishing exchange-rate stability on a managed sterling standard rather than on gold was considered. Hawtrey acknowledged that this would be technically possible, but the practicality of holding sterling instead of gold as a means of transacting international trade would involve all countries holding sterling assets, such as Treasury bills, in London, and there would be objections to having large currency reserves held in a foreign centre where they might be blocked during periods of tension such as wartime.

Hawtrey then explored the possible disadvantages of the gold standard to set against the advantage of stable exchanges. The fundamental problem, as he saw it, was that once the pound was tied to gold, the Americans, as possessors of half the world's gold, were capable of exerting undue influence on its purchasing power. If the Americans were to release large quantities of gold on to the market then its value and purchasing power would fall and prices would rise – currencies tied to it would keep the same relative value, but their purchasing power in terms of commodities other than gold would decrease. Conversely, a decision by the American monetary authorities to absorb gold would cause a fall in the general price level. The rises, or falls, in prices would lead to pressures to increase or decrease money wages, with consequential disturbances to economic equilibrium.

Hawtrey then used the next part of his submission to discuss the recent history of exchanges and price movements in the United States. His view was that a recent American credit expansion, begun in June 1924, would eventually

bring American prices up to British levels, concluding that the 'present moment is therefore particularly favourable to a return to parity'. Looking ahead, and if America continued with its expansionist policies once parity had been reached, then Hawtrey predicted that that increased trade activity would be communicated to this country. But Hawtrey then inserted a paragraph bearing news which Churchill would not want to hear:

There is, however, the possibility that before this has happened, steps may be taken in America to restrict credit and to raise the commodity value of the dollar. In that case we should be faced with the alternatives of relapsing from the gold standard or suffering a contraction of credit here.²⁵⁵

Here was nourishment for Churchill's seeds of doubt. The thing he would most dread would be restoring free movement of gold, only for him to then have to renege upon the implied commitments – to 'relapse from the gold standard'. Hawtrey went on to emphasise this point:

. . . if the gold standard could be defended only by an increase of Bank rate to 5 or even 6 per cent, a very serious check would be administered to trade, industry and employment. In present conditions, with employment still severe it would be better to let sterling relapse than to raise Bank rate to a deterrent level.²⁵⁶

²⁵⁵ *Ibid.*

Hawtrey explained that such measures would not have to take effect immediately an adverse movement appeared in the exchanges, since we possessed a large gold reserve and that could be used, for some time, to maintain sterling's value: 'a large gold reserve is an advantage, but only if it is *used*'²⁵⁷ [Hawtrey's Italics]. Nevertheless, he warned, that if the Government intended to maintain the gold standard at all costs, and this entailed the exportation of gold to support the exchange, then eventually Bank rate would have to be raised in order to prevent the reserves from becoming exhausted. In a sense, Hawtrey was playing devil's advocate here, for he acknowledged that such measures would only be required if, having gone back to the gold standard with the exchanges at parity, America then began to apply a credit contraction. This, he did not expect to happen.

What is far more likely is that the credit expansion will continue in America for some months, and that the consequent expansion here will restore the prosperity of our own trade. When the turn of the tide comes, we shall be able to stand a rise in Bank rate without trouble.²⁵⁸

²⁵⁶ *Ibid.*

²⁵⁷ *Ibid.*

²⁵⁸ *Ibid.*

Having set up one potentially disastrous scenario, and dismissed it as unlikely, Hawtrey then raised a further caveat. America, since the war, had increased its investments in Europe, with the demand for European currencies to make these investments having had the effect of depressing the exchange rate of the dollar against European currencies, including sterling (Hawtrey suggested that increased overseas investment by America had been due to its recently imposed immigration restrictions – it no longer needed the money that it had been using to equip the previous growth of immigrant workers). If America were to repatriate these investments, then this might adversely affect the exchange rate, bringing into play a whole sequence of reactions which would end with higher Bank rate. But again, Hawtrey felt that increased American investment abroad would be a permanent part of the post-war economic scene.

In his submission to the Chamberlain Committee, Keynes had warned of the dangers of excessive credit expansion in America affecting the British economy – 1919-20 had seen huge inflation in America. Hawtrey felt that with the gold standard in place in both countries, its normal mechanisms would be sufficient to prevent excessive credit leading to high American inflation. If it did not, and there was a danger of high inflation spreading to Britain, there was a series of technical measures which could be taken as protection. Hawtrey proceeded to explain these measures (including, once more, the suspension of the gold standard) in somewhat tedious detail.

Towards the end of Hawtrey's 3,000 word submission he reiterated the efficacy of the 1922 Genoa Resolutions of which he had been author, under which a gold-exchange standard would be supported by credit agreements between the central banks. He suggested that these held out the promise of 'the best of both worlds – stable prices and stable exchanges'. He did not attempt to link these proposals to Churchill's questionnaire, but in an interesting paragraph, set out his reason for believing that, in the event of failure to co-ordinate interest rate strategy, British credit policy need not necessarily be dictated from New York:

The great wealth of the United States is . . . important But British wealth is far more mobile. American wealth is derived mainly from production, British from commerce and finance. In the regulation of credit the merchant is more sensitive than the producer. The pre-eminence of the Bank of England in the control of credit before the war depended on this fact. Credit conditions in London affected the action of merchants all over the world. Producers depend on the orders they receive from merchants, and credit in a producing country is less affected by the action of the country's own banks than by that of the banks which finance the merchants who buy the produce.²⁵⁹

Hawtrey seemed to imply that the conditions which governed interest rates and credit in America were more localised than those in Britain – therefore it would

²⁵⁹ *Ibid.*

be possible for there to be a degree of independence between the credit policies of the two countries – Britain need not necessarily follow America in the setting of interest rates. At another level the paragraph suggests that Hawtrey regarded London rates as far more important than those of New York in determining the world's trading climate.

After this lengthy economic analysis Hawtrey had remarkably little policy advice for the Chancellor. In fact, he advised inaction.

What then is the upshot of the foregoing arguments in relation to the action to be taken in this country between now and the 31st December next? No active measures at all need be taken. It is to be hoped that the exchange will come to par of itself. If it does not, a credit contraction is still undesirable.²⁶⁰

Hawtrey did not quite leave it at this. Whilst advising the Government (and, I suppose, by implication) the Bank of England to restrain from active measures, he did suggest that if, on the pound achieving par with \$4.87, there was a subsequent reaction, then the authorities should be prepared to let large quantities of gold go to America, and, even if this should prove unsuccessful in restoring the exchange rate, there should be no increase in Bank rate or attempt to restrict credit – 'it would be better to let sterling fall to a discount'.

²⁶⁰ *Ibid.*

Norman, mistrusted by Churchill, had, however crudely, articulated the interests of the City. Bradbury, respected by Churchill, had provided a polished advocacy of the 'jewelled' mechanism which was incapable of political corruption. Niemeyer, relied upon by Churchill, had emphasised the psychology of confidence, and the consequences of people perceiving that the Government lacked political will. Hawtrey, Churchill's 'learned man', had provided the typical 'two-handed' response of the economist. Churchill, like Harry S. Truman, might well at this point have prayed for a one-handed economist. On a superficial reading Hawtrey's submission could be accused, as Churchill feared *he* might be accused, of favouring City interests at the expense of industry. It was not Hawtrey's intention. To him, industry could only prosper if conditions were favourable to traders who wished to place orders for industry's products. Theirs was an essential function in a free, healthy and democratic economic society, and they could operate with greatest confidence in a world where currency exchange rates were stable. On balance, Hawtrey felt that such stability was best achieved through a gold standard – hence his guarded recommendation. On the other hand, unlike Norman, to whom exchange-rates and gold reserves were City virility symbols, to be defended, if necessary by high interest rates, Hawtrey cared for neither as ends in themselves. He would have been prepared to see gold lost, the exchange fall, or the gold standard itself fall into abeyance, if its perpetuation entailed high interest rates stifling industry. There may have been economic logic in such measures, but for a Chancellor they would have

been political suicide. Despite three ringing endorsements, and one guarded recommendation, Churchill remained unhappy about returning to gold.

Niemeyer was due to attend a conference in Geneva during February 1925. Churchill refused to let him go and so Niemeyer's deputy, Frederick Leith-Ross went in his place. Whilst he was in Geneva, Niemeyer sent Leith-Ross an informal note which included a reference to Churchill's state of mind: 'Gold is excessively active and very troublesome. None of the witch-doctors [Niemeyer's view of economists] see eye to eye, and Winston cannot make up his mind from day to day whether he is a gold bug or a pure inflationist'.²⁶¹ This, perhaps rather unguarded, communication from Niemeyer is probably more revealing than many his official memoranda. Not only did he regard Churchill as a ditherer, but he dismissed advocates of a managed currency as 'inflationists'.

Niemeyer's personal view, as implied in his letter to Leith-Ross, was that Churchill was a 'ditherer' over the question of the return to gold. This may be true, but it is not necessarily so. Booth and Glynn, in questioning the value that can be put on public records, have suggested that the Treasury records regarding the return to the Gold Standard are almost certainly incomplete since there is no indication as to whether the move to return was initiated by Churchill or Niemeyer.²⁶² They suggest it probable that, all along, Churchill was politically committed to returning to the Gold Standard, but he was aware of the barrage of

²⁶¹ Leith-Ross, *Money Talks*, pp. 91-2.

²⁶² A. E. Booth and S. Glynn (1979), 'The Public Records and recent British Historiography', in *Economic History Review*, 32(3), pp. 303-15.

criticism he would have to face from industry as a result of the high interest rates that would be necessary to maintain the Gold Standard. Thus it is equally valid to suggest that, far from being a ditherer, Churchill's exercises were a means of testing his officials to the limits of the support they would be capable of giving him in pursuing the course he had chosen.

If, indeed, Churchill harbored doubts, then these would have been fuelled by an article of Keynes's in *The Nation* on 21 February 1925 in which Keynes pleaded for a managed currency and drew attention to 'the paradox of unemployment amongst dearth'. On the following day, 22 February 1925, Churchill wrote to Niemeyer:

The Treasury have never, it seems to me, faced the profound significance of what Mr. Keynes calls 'the paradox of unemployment amidst dearth'. The Governor shows himself perfectly happy in the spectacle of Britain possessing the finest credit in the world simultaneously with a million and a quarter unemployed. The community lacks goods and a million and a quarter people lack work. . . . I do not pretend to see even 'through a glass darkly' how the financial and credit policy of this country could . . . bridge the gap between a dearth of goods and a surplus of labour I would rather see Finance less proud and Industry more content. You and the Governor have managed this affair . . . (which is) surely a cause for the deepest heart searching.²⁶³

Niemeyer's response was immediate and there is no evidence of Hawtrey having played any part in its formulation. It was uncompromising:

You can by inflation (a most vicious form of subsidy) enable temporarily, spending power to cope with large quantities of products. But unless you increase the dose continually, there comes a time when having destroyed the credit of the country you can inflate no more, money having ceased to be accepted as value. Even before this, as your inflated spending creates demand, you have claims for increased wages, strikes, lock-outs etc. I assume it be admitted that with Germany and Russia before us we do not think plenty can be found on this path.

If that be admitted, economic employment can only be given to the extent to which commodities can be produced at a price which existing uninflated wealth can pay for them. As a result of war there has been a great decrease in wealth, and there is consequently less effective demand. The only permanent remedy is to recreate the losses of war, really – not by manufacturing paper – and what we have to do for this purpose is (1) to stabilise our currency in relation to the main trading currencies of the world, (2) to reconstruct the broken parts of Europe and (3) to encourage thrift and the accumulation of capital for industry. These methods . . . are going to remedy unemployment.

²⁶³ T172/1499B, Churchill to Niemeyer, 22 February 1925. The text of this letter together with Niemeyer's reply (T172/1499B, Niemeyer to Churchill) are reprinted in Moggridge, *British Monetary Policy 1924-31*, pp.75-77.

This reply could only have left Churchill with the understanding that, whatever his misgivings, if he went against his advisors, then he could not rely on committed official support. During the war he had gone against official advice in ordering the Dardanelles operation, which turned into a disaster. He was surely haunted by the thought of a similar disaster.

Still not content, Churchill sought further reassurance from Hawtrey. He requested a note on the return to the Gold Standard after the Napoleonic wars. In 1816, the Coinage Act had created legislation for the establishment of a Gold Standard. In 1914 the price of gold had been well over its coinage price and parity was not achieved until 1919. The free-coinage of gold at the parity rate of just over £3 17s. 10d. did not occur until 1821. Hawtrey's note, running to eight pages, was probably heavier reading than Churchill had anticipated, and would not have allayed his fears. According to Hawtrey the 'outstanding fact in the process of returning to the gold standard after the inflation of the Napoleonic Wars was the tremendous fall of prices which started in 1814 showing a fall of nearly 40 per cent in two and a half years'.²⁶⁴ According to Hawtrey, the 'commercial crisis of the years 1814 to 1816 brought about by the fall in prices was one of the most severe recorded in history' and the fall in prices drove British traders 'to the verge of ruin by the collapse of values'. However, his opinion was that the 'drifting' of the price of gold in the years prior to parity

²⁶⁴ Treasury Papers, T172/1499B. 'Restoration of the Gold Standard after 1815' by R.G.Hawtrey (undated, but around 1 March 1925).

being achieved had been 'at the cost of great unsettlement to business'.²⁶⁵ The only message to be extracted from this memorandum of Hawtrey was that 'if it were to be done, it were best done quickly'.

Churchill made one last effort to resolve his conscience. On 17 March 1925, Churchill hosted a dinner party. His purpose was to involve the proponents and opponents of the gold standard in discussion, presumably hoping to remove any lingering doubts over the wisdom of the impending move.²⁶⁶ Niemeyer and Bradbury were pitted against Keynes and McKenna. He was well aware of the views of Niemeyer and Bradbury. Keynes and the former Liberal Chancellor of the Exchequer, McKenna, had been the two most vociferous opponents of the return to gold. Churchill's private secretary, Grigg, was also present that evening and his autobiography remains the only record of the encounter.²⁶⁷

Grigg records that in the course of the evening McKenna gave way to opposition arguments.

CHURCHILL (to McKenna)

But this isn't entirely an economic matter, it is a political decision, for it involves proclaiming that we cannot . . . complete the undertaking which we all acclaimed as necessary in 1918 . . . You have been a politician; indeed you have been Chancellor of

²⁶⁵ *Ibid.*

²⁶⁶ Grigg, *Prejudice and Judgement*, pp. 182-3.

²⁶⁷ *Ibid.*

the Exchequer. Given the situation as it is, what decision would you take?

McKENNA

There is no escape. You will have to go back, but it will be hell.²⁶⁸

Thus, left by himself, Keynes failed to impress Churchill. Grigg, as recorder of the encounter, was not sympathetic to Keynes, but was particularly struck by Bradbury's reference to the gold standard as being 'knaveproof' – a phrase which Grigg attempted to encourage into common usage. There was little appreciation of the fact that Britain's position in the world had changed and that the Bank of England might not be in the same position of strength which had previously enabled it to manage the Gold Standard in Britain's interests.²⁶⁹

²⁶⁸ *Ibid.*

²⁶⁹ B. J. Eichengreen, *Golden Fetters: the gold standard and the great depression, 1919-1939* (New York, O.U.P., 1992). Eichengreen has rejected Kindleberger's [C.P. Kindleberger, *The World in Depression* (Berkeley, University of California Press, 1973)] thesis that the stability of the Gold Standard before the First World War depended upon its effective management, in its own interest, by a British hegemony. Eichengreen has argued that even before the Great War there was no such hegemony, and that the success of the pre-war Gold Standard rested on the twin pillars of credibility and cooperation. Before the war the Gold Standard had been credible because there was hardly any conception of the Gold Standard's role in maintaining external equilibrium being inconsistent with its role in maintaining internal stability. Where a country was experiencing difficulties in operating the Gold Standard, the world's central banks, generally by loans, had been willing to assist in overcoming problems. After the war, Eichengreen has argued, cooperation and credibility were eroded.

Bordo and Rockoff [M.D. Bordo and H. Rockoff, 'The Gold Standard as a "Good Housekeeping Seal of Approval"', *The Journal of Economic History*, Vol. 56, No.2, (June 1996), pp. 309-428] have put forward the suggestion that between 1870 and 1914

On Friday 20 March 1925 the decision was taken to announce the return to the gold standard. Those present at the decisive meeting were Prime Minister Baldwin, Chancellor of the Exchequer Churchill, Foreign Secretary Chamberlain, Norman, Bradbury and Niemeyer.

Peter Clarke has spoken of the verdict to return hinging only very loosely upon the evidence supplied by the relative values of index numbers of prices in Britain and the United States. Rather its return depended upon the 'charm of its austere purity. It spoke with the purity of a dead language; it operated with the perfection of calculus; and as such it captivated minds that had been schooled to esteem elegance and rigour . . . the Oxford classicists and Cambridge mathematicians who staffed the Treasury'.²⁷⁰

Middleton (1998) has identified six characteristics of the policy style which marked the episode; principally, that the return to gold was driven by political considerations rather than economic analysis.²⁷¹

adherence to the gold standard was a signal of financial rectitude that facilitated access by peripheral countries to capital from the core countries of western Europe.

²⁷⁰ P. F. Clarke, 'The Treasury's analytical model of the British economy between the wars' in M. O. Furner and B. E. Supple (eds.) *The state and economic knowledge: the American and British experiences*. (Cambridge, C.U.P., 1990), p. 197.

²⁷¹ R. Middleton, *Charlatan's or Saviours: economists and the British economy from Marshall to Meade* (Cheltenham, Edward Elgar, 1998). pp. 186-196.

Chapter 3

The Gold Standard and High Interest Rates

1925-1931

The return to the gold standard did not herald a prosperous period of international trade as its advocates had anticipated, but neither did it bring about the disastrous collapse of British trade which the doomsters, critical of the return to the old parity, had predicted. With the return to the gold standard, in one of Professor Pigou's more memorable phrases, Britain entered 'the Doldrums'.

The ending of the slump was the beginning of the Doldrums. In these we might say the country remained more or less – not of course completely – becalmed until the Wall Street crash in 1929 heralded a second and greater slump.²⁷²

Hawtrey, however, writing in a personal capacity in 1938 – and despite his guarded recommendation to Churchill in favour of returning to the gold standard - viewed the return to gold as an interruption of a long period of progress from depression.

²⁷² A.C.Pigou, *Aspects of British Economic History 1918-25* (London, Frank Cass, 1947), p.7.

The return to the gold standard, with the re-imposition of dear money, had interrupted the progress of recovery from the severe depression of 1922. . . . the true efficacy of dear money as a support for the gold position was to be found in the deflationary effect on this country.²⁷³

Hawtrey deplored the way in which the authorities operated the gold standard by maintaining unnecessarily high interest rates. The Bank of England was reluctant to *use* its gold and purposely maintained deflationary rates. Others have seen the problem differently; Sayers, for instance, has suggested that the gold standard acted as a brake on the economy in ways other than through its requirement for dear money – rather it was through the way in which maintaining the high level of the pound demanded the maintenance of high export prices.

There is little sign that the Bank consciously used Bank Rate to force a deflation of the home price and income structure. Depression in the export trades and the competition of imports were the powerful deflationary forces at work; it was through these conditions rather than through high interest rates that the gold-standard policy was depressing the British economy.²⁷⁴

²⁷³ Hawtrey, *A Century of Bank Rate*, pp. 136-7.

²⁷⁴ R.S. Sayers, 'The Return to Gold, 1925', in S. Pollard (ed.), *The Gold Standard and Employment Policies between the Wars* (London, Methuen, 1970), p. 93.

The dissent to the return to the Gold Standard was led by Keynes. His name and reputation had been made by a post-war best-seller in which he pointed out the disastrous economic and political consequences which would flow from the heavy reparations imposed on Germany by the Treaty of Versailles, and he enhanced that particular reputation in 1925 with his criticism of Churchill's restoration of the gold standard at the pre-war parity of \$4.86.

On 22, 23 and 24 July he wrote three articles in Beaverbrook's *London Evening Standard* under the general title of 'Unemployment and monetary policy'. These articles were shortly to be expanded and published in pamphlet form as *The Economic Consequences of Mr. Churchill*.²⁷⁵ They laid out many of his criticisms of Britain's financial system. Keynes accused the Chancellor of incompetence and of having 'no instinctive judgment to prevent him from making mistakes'.²⁷⁶ Consequently, the Chancellor had been 'deafened by the clamorous voices of conventional finance' and 'gravely misled by his experts'.²⁷⁷

Keynes argued that entry upon the standard at the \$4.86 level would involve a 10 per cent upward re-evaluation of the pound, rather than the 2-3 per cent which Treasury officials had calculated. They had, he suggested, by comparing wholesale index numbers here and in America, been guilty of using the wrong

²⁷⁵ J.M.Keynes, 'The Economic Consequences of Mr. Churchill' reproduced in Pollard, *The Gold Standard and Employment Policies between the Wars*, pp. 27-43.

²⁷⁶ *Ibid.*, p. 30.

²⁷⁷ *Ibid.*

index, since the wholesale price indices were weighted towards internationally traded commodities which would, under conditions of international trade, have tended towards a uniformity of price.²⁷⁸ A study of retail prices would, he suggested, have revealed greater discrepancy in prices. Hawtrey, who later recalled 'watching the American indices like a hawk' in those years, always remained adamant that the appropriate index for comparison was the wholesale index.²⁷⁹ Keynes also suggested that the authorities had readily assumed that lower prices would bring about lower costs without them having any understanding of the mechanisms by which this would be brought about.

In the second part of his pamphlet, Keynes went on to outline the role which he envisaged the Bank of England would be forced to play in maintaining the balance of trade. The high value of the pound would strangle exports and suck in cheap imports with a tendency to deplete the Bank of England's gold deposits – and thus bring into action the appropriate sequence of corrective measures. 'The Bank of England is compelled to curtail credit by all the rules of the gold standard game.'²⁸⁰ The rules of the game, of course, included raising interest rates – a move which would have had the effect of exacerbating the unemployment problem. According to Keynes this was the opposite measure to that required.

²⁷⁸ *Ibid.*

²⁷⁹ Hawtrey Papers, HTRY 13/5. Interview with Sir A. Cairncross in 1966.

²⁸⁰ J.M.Keynes, 'The Economic Consequences of Mr. Churchill', p.36.

What we need to restore prosperity today is an easy credit policy. We want to encourage business men to enter on new enterprises, not, as we are doing, to discourage them. Deflation does not reduce wages 'automatically'. It reduces them by causing unemployment. (The miners) represent in the flesh the 'fundamental adjustments' engineered by the Treasury and the Bank of England to satisfy the impatience of the City fathers to bridge the 'moderate gap' between \$4.40 and \$4.86. They (and others to follow) are the 'moderate sacrifice' still necessary to ensure the stability of the gold standard. The plight of the coal miners is the first, but not – unless we are very lucky – the last of the Economic Consequences of Mr. Churchill.²⁸¹

Although *The Economic Consequences of Mr. Churchill* had, through its criticism of the authorities' pricing comparisons, been implicitly critical of Hawtrey, the policy prescriptions of Keynes and Hawtrey remained very close at this stage. In the next six years, even as Keynes moved towards recommending public works and import tariffs, Hawtrey continued to produce memorandum after memorandum appealing for lower interest rates and the extension of credit.

The Treasury was anxious to prevent Keynes's ideas getting a foothold in the Government, and Niemeyer, the Treasury's Controller of Finance, responded immediately to the *Evening Standard* articles with a memorandum to the

²⁸¹ *Ibid.*, pp. 36-38.

Chancellor in which he laid out the official Treasury line.²⁸² He pointed out some of Keynes's recent inconsistencies.

In reading Mr. Keynes's three articles one must remember that he has always avowedly wished to desert the gold standard for a standard under which money rates would vary in accordance with internal prices. If prices rose, he would increase money rates, and vice versa. Accordingly last autumn when United Kingdom wholesale prices had risen from 159 to about 170 Mr. Keynes was advocating an increase in Bank rates – several months before it actually took place (a measure which) one would think, would have had just the results which he now regards as the deplorable consequences of the rise in Bank rate of March last . . . ²⁸³

Niemeyer's memorandum went on to criticise Keynes's proposed remedy of lowering Bank rate in order for the consequent outflow of gold to encourage credit expansion in America with, hopefully, a rise in American prices. He argued that there was no certainty of such measures provoking an increase in American prices (indeed, the Federal Reserve had become increasingly skilled at 'sterilising' gold imports so that they were not inflationary), but the lowering of the Bank rate, with subsequent credit expansion in Britain, would increase prices in Britain.²⁸⁴ (Somewhat ironically, this was an argument that Keynes was later to

²⁸² T172/1499C. Memorandum by Sir O. Niemeyer, July 1925.

²⁸³ *Ibid.*

²⁸⁴ *Ibid.*

use, with devastating effect, when questioning Hawtrey's policy prescriptions during the course of the hearings of the Macmillan Committee on Finance and Industry).

There had been general satisfaction within the Treasury and the Bank of England at the restoration of the Gold Standard and Keynes was a largely isolated critic. Most of the remainder of 1925 augured well for its operation. Immediately prior to restoration, on 5 March 1925, the Bank had raised its rate by 1 percentage point to 5 per cent. Montagu Norman had expressed the opinion that the re-institution of the free movement of gold would necessitate a further rise to 6 per cent in order to prevent gold draining away from London.²⁸⁵ In the event, the 5 per cent Bank Rate was sufficient to attract liquid investment to London. Foreign investors wished to hold sterling, and they used gold and other gold-related currencies to buy their sterling holdings. The increase in the Bank's reserves enabled it, under some political pressure, to lower bank rate to 4.5 per cent on 6 August 1925.²⁸⁶ On 1 October 1925, again under some political pressure, there was a further lowering of Bank rate to 4 per cent. Sir Montagu Norman's view was that the situation was not as favourable as it seemed, since, given the growing speculation on the New York stock exchange, the gold which had found its way to London was only likely to spend a brief

²⁸⁵ Howson, *Domestic Monetary Management in Britain*, p.34.

²⁸⁶ Hawtrey, *A Century of Bank Rate*, p.135. According to Hawtrey the inflow of gold raised the Bank's holdings from £154 million on 29 April 1925 to over £162 million on 5 August 1925.

sojourn there, and before long higher interest rates would be necessary to prevent loss of gold in the direction of America.²⁸⁷

The rise in interest rates came on 3 December 1925, when Bank rate was raised to 5 per cent, a full percentage point increase. At this stage, it was difficult to put down such an increase to speculation on the New York Stock Exchange. Sir Ernest Harvey, Deputy Governor of the Bank, explained the course of events in November 1925 when he later gave evidence before the Macmillan Committee.

The market decided, so it appeared, to leave the Treasury bills severely alone. We had difficulty for a week or two, the Bank had to come to the rescue to cover the amounts required, efforts were made to reassure the market, but without success, and eventually at the end of the month, the last week, the amount which the bank had to provide in order to cover the required amount of tenders was very substantial. Finally we were compelled, simply in order to get the bills taken up, and to avoid our being driven into a very difficult position by reason of the very large additions of credit that we were having to create, to raise the rate from 4 per cent to 5 per cent.²⁸⁸

²⁸⁷ Howson, *Domestic Monetary Management in Britain*, p .34.

²⁸⁸ Hawtrey, *A Century of Bank Rate*, p.135. Hawtrey is quoting part of Sir Ernest Harvey's response to Question 7590 in the proceedings of the Macmillan Committee's enquiry into Finance and Industry.

This retrospective explanation by the Bank seems typical of the obfuscation by which the Bank of England conducted its policies at the time. The argument that Harvey seems to have been deploying was that general awareness had been growing that the short-term funds attracted to London by the increase in Bank rate in March had begun to seep away as a result of the two subsequent reductions in the rate. Thus, the commercial banks, who were the biggest purchasers of Treasury Bills, had anticipated an increase in the Bank rate to stem this outflow and, alongside the higher interest regime, heavier discounting of Treasury Bills. Consequently they were reluctant to purchase existing Treasury bills, and the Government, to cover the shortfall in its finances, had needed to borrow under Ways and Means from the Bank of England. Thus, his argument seems to imply, the Bank was forced into a regime of generally higher interest rates in order to encourage the sale of Treasury Bills and to prevent the Government from depleting the Bank's reserves. Hawtrey was sceptical about this explanation, and figures published by him for the weekly returns of Treasury Bill tenders, do indeed, cast some doubt on Harvey's explanation: in each week of October and November of 1925 the number of Treasury Bills applied for exceeded that being offered.²⁸⁹ The suspicion must remain that the Bank of

²⁸⁹ Hawtrey, *A Century of Bank Rate*, p.136. The relevant figures produced by Hawtrey are:

TREASURY BILL TENDERS 1925		
	Offered (£ millions)	Applied for (£ millions)
2 nd October	45	65.9

England, especially Norman, had resented political pressure to reduce Bank rate during 1925 and sought a justifying pretext to return to dear money in defence of the institution of the gold standard.

Hawtrey was furious with the Bank for this move. He later recalled, having just heard the news of the rise, storming angrily into Niemeyer's office and, unknown to him as he vented his anger, finding Norman seated behind the door. It was an incident from which Hawtrey's relationship with the Bank of England never recovered.²⁹⁰ On 5 December 1925 Hawtrey produced his own memorandum, entitled 'The Credit Situation', criticising the Bank's policy. He circulated the memorandum within the Treasury, and the marginal comments of Leith-Ross and Niemeyer reveal the divisions developing between the Treasury's senior officials and Hawtrey. Hawtrey was now arguing along similar lines to Keynes. Moreover the tone of the memorandum was one of anger; not only did he feel that the Bank of England was displaying callousness towards the problems of the unemployed, but he despaired of the Treasury itself, the institution within which he was employed, for failing to use its powers over the Bank – powers which he believed it to constitutionally possess.

9 th October	40	66.4
16 th October	35	41.9
23 rd October	40	48.4
30 th October	40	49.2
6 th November	45	47.9
13 th November	40	44.8
20 th November	40	43.1
27 th November	45	47.4

²⁹⁰ HTRY 13/5. Interview with Sir Alec Cairncross.

The attitude of the senior Treasury Officials to Hawtrey's ideas can be seen in the covering note with which Sir Frederick Leith-Ross passed on his copy of Hawtrey's memorandum to Niemeyer: 'This is almost pure Haverstein and I kept a copy for you.'²⁹¹

The ghost of German hyperinflation must have given sleepless nights to Bank and Treasury officials. Hawtrey, however, set out his case very clearly in his first paragraph:

The raising of the Bank rate to 5 per cent is nothing less than a national disaster. That dear money causes unemployment is a proposition which ought not to admit of dispute. Not only is it the generally accepted opinion of theoretical economists, but it was well recognised by practical financiers and men of business before economists paid much attention to it.²⁹²

In the margin of the memorandum, against this introductory assertion, and in Niemeyer's handwriting, is pencilled the comment 'turns on length of view'. Niemeyer, the most influential Treasury official, seemed to hold the classical view that 'in the long run' stable exchanges, stable currencies, and balanced budgets were the key to restoration of full employment. As with public works, the

²⁹¹ Treasury Papers, T176/13. The Niemeyer Papers. 'The Credit Situation', by R.G.Hawtrey. This is a handwritten note by Leith-Ross as he passed on Hawtrey's memorandum to Niemeyer.

²⁹² *Ibid.*

Treasury authorities regarded low interest rates as only short-term palliatives which in the end would only make the unemployment problem worse.

Hawtrey proceeded to develop his argument within the terms of his economic theory:

Many people, while admitting that monetary causes affect unemployment, nevertheless deny that they are primarily responsible for at any rate the present burden of unemployment. . . . Many theories of unemployment have been enunciated, but practically all those which have any plausibility can be reduced to particular applications of the monetary theory. Unemployment always arises in some way or other from consumers not having enough money to spend, and every theory of unemployment is directed to explaining why this is so. Falling prices are a symptom of a shortage of the means of payment. When markets are slack people will not borrow and because they will not borrow the supply of purchasing power is diminished, and the slackening of markets is aggravated. Trade thus falls into a vicious circle and an apparently moderate contraction of credit may have very severe results.²⁹³

Leith-Ross's marginal comment dismissed Hawtrey's idea of unemployment being due to lack of purchasing power: 'no doubt' he added 'but it is the comparative level between our internal prices and world prices which matters: and if our internal prices are above world prices, they must fall if we are to get rid of

²⁹³ *Ibid.*

unemployment'.²⁹⁴ Official Treasury thinking obviously remained that credit policy must continue to exert a downward pressure on wages and prices to bring them into line with levels seen in the rest of the world before inroads could be made into relieving unemployment.

Hawtrey's memorandum then went on to track recent unemployment figures and their relationship with Bank rate. He pointed out that at 'the present time we are still suffering from the effects of a contraction which was not moderate, but was perhaps the most intense in the history of the Bank of England'.²⁹⁵ He was referring to period between April 1920 and April 1921 when Bank rate stood at 7 per cent and, as a result of which, unemployment grew to 1,936, 000 in January 1922. He pointed out that, by 13 July 1922, Bank rate had progressively, by steps of 0.5 of a percentage point, been reduced to 3 per cent, and from that point there had been a slow but steady recovery in employment until the unemployment figure stood at 1,003,000 in June 1924. Hawtrey then proceeded to suggest that from this point the monetary authorities had begun to prepare for the return to the gold standard with a period of dearer money and that by steps of 1 percentage point the Bank rate had been increased to 5 per cent on 5 March 1925 with the result that unemployment resumed its upward path – to 1,354,000 in August 1925. To Hawtrey, the link between Bank rate and unemployment was undeniable.

²⁹⁴ *Ibid.*

²⁹⁵ *Ibid.*

Hawtrey turned his wrath against the Bank of England:

Why, it may be asked has the Bank of England seen fit to inflict this calamity against the country? The ostensible reason is hardly creditable, such is its triviality. The market rate, it is said, has approached close to Bank rate, and if it passes it, the Bank will be compelled to lend the market more than is desirable.

The Bank of England can do what it pleases with the market rate. It can at any moment force the market rate up to Bank rate by selling securities, since deposits decline *pari passu* with securities, and as soon as the market is short of cash it must borrow from the Bank. Or on the other hand the Bank can, if it chooses, buy bills or Government securities in the market and create cash for the money market. In order to get this cash used, the market will immediately reduce discount rates, which may thus go far below Bank rate The rise of the market rate very near Bank rate cannot be given as a reason for the Bank of England's action in raising Bank rate, for the former is as much the Bank's action as the latter. The real question is, why has the Bank been restricting credit at all?

Sometimes it is desirable to put up Bank rate to check an excessive activity of trade. To speak of that now would sound like irony [The underlinings in this passage appear in Hawtrey's original document].²⁹⁶

This, to the general reader, is a somewhat technical extract, but the extent of Hawtrey's condemnation of the Bank's action pierces the technicalities, and his

²⁹⁶ *Ibid.*

anger could not be expressed more strongly. In order to clarify the nature of Hawtrey's criticism of the Bank of England it is necessary to examine the distinction between 'the Bank rate' and 'market rate', the reasons why 'Bank rate' might not be 'effective', and the actions which the Bank might have taken to make it effective.

'Bank rate' was, as it remains today, the interest which the central bank, the Bank of England, charged the commercial banks for loans of currency. Given the competitive nature of commercial bank operations, business, and profits, would go to the banks which charged the lowest rate, and if any bank could increase its business by charging a rate below 'Bank rate', then it would do so, and the Bank rate would become ineffective. If banks had sufficient spare currency to enable them to make loans without having to go to the Bank of England then they could offer loans (or, alternatively, discount bills) at a rate – the 'market rate' – below Bank rate. 'Market rate' could only be forced into line with Bank rate when the commercial banks lacked sufficient currency and had to approach the Bank of England to borrow money *at a rate determined by the central bank*. The Bank of England could ensure this by a process of 'open-market operations' whereby they made available Government securities, at sufficiently attractive rates of interest, to persuade the commercial banks buy them. In purchasing the securities, the banks would reduce their currency holdings and be forced into borrowing from the Bank of England in order to provide loans or discount commercial bills. The higher Bank rate would force the banks into heavier discounting and charging

higher interest rates, thus bringing the 'market rate' into line with 'Bank rate'. Were a situation to develop where the commercial banks were so short of currency that they were in danger of having to discount at a rate *greater* than 'Bank rate' – they would be in a position where they were able to borrow from the central bank at a rate *lower* than they were charging their customers. So long as this situation prevailed, the commercial banks would be encouraged to create deposits for their customers and discouraged from purchasing more lowly rated Treasury Bills.

The shortage of currency could have been remedied by the Bank of England *buying* Government securities from the commercial banks, and thus releasing currency. Thus, Hawtrey felt obliged to underline – 'rise of the market rate very near Bank rate cannot be given as a reason for the Bank of England's action for raising the Bank rate, for the former is as much the Bank's action as the latter'.²⁹⁷ He believed that Bank rate had been raised to protect the size of the Bank's gold reserve, and the action had been an aggressive gesture to affirm the authority of the Bank of England. Moreover he believed, as he proceeded to argue, that the preservation of the gold reserve at the prevailing level was unnecessary.

Yet before proceeding to argue that case Hawtrey turned his guns on his own institution, the Treasury. The gold policy of the country, he argued, was opaque – 'if it be asked what our gold policy is, the answer must be a matter of

²⁹⁷ *Ibid.*

inference. No one has ever disclosed what it is. . . . In order to discover what the gold policy of the country is the first thing is to find what authority is responsible for it.' ²⁹⁸ He then went on to point out that under the terms of the Bank Charter Act of 1844, the obligations of the Bank with regards to its gold reserves were subject to temporary suspension at the discretion of the Treasury. Therefore, he argued, ultimate responsibility for gold policy rested with the Treasury and that if the Bank, under the depressed conditions of trade which currently existed, believed that it needed to restrict credit in order to preserve the level of its gold stocks, it could only be because it believed that the Treasury would never use its powers. Hawtrey believed that the Bank of England 'could quite cheerfully let £50 million go (even £100 million might be contemplated without serious risk to the gold standard)'.²⁹⁹ The implication of Hawtrey's argument being that the Treasury was falling down in its responsibilities to the nation by failing to step in and prevent the Bank from tightening monetary policy.

Marginal comments by Leith-Ross indicate a dismissive attitude within the Treasury towards Hawtrey on these points. On the question of the Treasury's powers over the Bank, Hawtrey does seem to be invoking an obscure clause of a nineteenth century Act of Parliament which was at variance with almost a

²⁹⁸ *Ibid.*

²⁹⁹ *Ibid.*

century of central bank practice. On this particular point Leith-Ross's marginal commentary does not seem unreasonable:

The Treasury can only be justified in using this power (a) for a temporary emergency or (b) on condition that Bank rate was raised to such a point as to cause the excess issue to be retrieved. It is nonsense to speak of this power as one that could be used to keep Bank rate at 4 per cent. The only result will be to accelerate the weakness of sterling with the result either that we should have to go off gold or that we should in the end have to restrict credit much more violently than if it had been taken in hand at the time [underlinings in the original].³⁰⁰

In suggesting that the Bank of England could 'quite cheerfully' lose up to £100 million of gold without undue concern, Hawtrey was pursuing his own economic model within which he believed that the export of gold abroad would encourage credit expansion and price rises abroad. This, he believed, would bring foreign prices into line with home prices without the need for the deflationary measures which would be needed if the Bank of England insisted on maintaining the prevailing level of reserves. Holding this view, it can be seen that Hawtrey's thinking was very much in line with that of Keynes's as expressed in *The Economic Consequences of Mr. Churchill* – undoubtedly to the chagrin of both

³⁰⁰ *Ibid.* A marginal comment pencilled in by Frederick Leith-Ross. The comment is alongside Hawtrey's passage concerning the responsibility of the Treasury for the gold standard, and is to be found in the copy of the memorandum within the collection of Niemeyer's papers.

Niemeyer and Leith-Ross. Leith-Ross had no great pretension to be an economist, but he saw fit to pour scorn on such ideas as he continued to scribble marginal notes with his pencil.

This is bunkum. The actual gold is not of importance but the fact that it goes is of importance as indicating an unsound position. The gold is like the canary in the submarine. It doesn't matter if it dies: but if you don't bring the submarine up when this happens, you remain submerged for ever.³⁰¹

Frederick Leith-Ross was the Treasury's Deputy Controller of Finance from 1925 to 1932. He was an ambitious civil servant who 'aspired to fill Niemeyer's shoes.'³⁰² With Niemeyer's transference to the Bank of England in 1927 Leith-Ross was overlooked for the position of Controller of Finance in favour of Sir Richard Hopkins who had been head of the Inland Revenue. Leith-Ross seemed to resent this appointment and Clarke suggests that there was a suppressed rivalry between the two men.³⁰³ Between 1922 to 1927, nearly all the direct communication from the Treasury to the Chancellor had been through Niemeyer. After 1927 a fair proportion of the memoranda from the Treasury to the Chancellor came from Leith-Ross. This internal Treasury rivalry was only

³⁰¹ *Ibid.* Margin note by Leith-Ross in Hawtrey's memorandum 'The Credit Situation'.

³⁰² Clarke, *The Keynesian Revolution in the Making 1924-1936*, p. 68.

³⁰³ *Ibid.*, p.30.

resolved in 1932 when Leith-Ross was appointed to the position of 'Chief Economic Advisor to His Majesty's Government'. In this new role his responsibility was to the Cabinet rather than to Chancellor of the Exchequer (he, himself, described this title as a misnomer in that he was not an economist and he was principally engaged in economic diplomacy).³⁰⁴ In 1968 Leith-Ross published an autobiography, *Money Talks; Fifty Years of International Finance*.³⁰⁵ It is an exercise in self-justification and name-dropping. It includes unabridged copies of letters from, amongst others, Churchill, Snowden, Keynes and Margot Oxford (wife of Asquith), all complementing him on the quality of his work. Despite working with him closely, as a Treasury colleague for twenty three years, Hawtrey doesn't merit even a single mention.

Hawtrey's memorandum, suggesting that the Treasury might have a measure of responsibility in the matter of Bank rate, caused a stir of activity. It provoked Niemeyer (still Controller of Finance at the Treasury) to write to two former Joint Permanent Secretaries to the Treasury, Chalmers and Bradbury, to enquire if they regarded Bank rate as a matter for Treasury concern. Bradbury replied on 6 December 1925 and Chalmers replied the following day. Both informed

³⁰⁴ G.C.Peden, *Keynes, The Treasury and British Economic Policy* (London, Macmillan, 1988), p. 57.

³⁰⁵ F.W.Leith-Ross, *Money Talks; Fifty Years of International Finance* (London, Hutchinson, 1968).

Niemeyer that it was not the practice of the Bank either to consult the Treasury or to inform it beforehand of variations in Bank rate.³⁰⁶

During the mid-1920s criticisms of the Gold Standard and its workings, by such as Keynes and Hawtrey, were isolated events. There was no great general feeling of discontent. If, to Pigou, the period of Baldwin's second administration represented 'the doldrums', to A.J.P. Taylor they were 'five quiet years, with one alarming, and perhaps unnecessary interruption: the General Strike'.³⁰⁷ He perceived a sense of harmony between the Conservative and Labour leaderships: 'Baldwin would have been at home leading the Labour Party, and MacDonald . . . was well suited to lead the Conservatives'.³⁰⁸ Unemployment over this period, despite booming world trade, stabilised at around 10 per cent of insured workers.³⁰⁹ But for most workers in secure employment the times were good. Even if wages were no more than static, between 1924 and 1929 the index of wholesale commodity prices fell by 17 per cent while the cost of living fell by

³⁰⁶ Treasury Papers, Public Records Office, T176/13.

³⁰⁷ Taylor, *English History 1914-45*, p.227.

³⁰⁸ *Ibid.*

³⁰⁹ G.C. Peden, *British Economic and Social Policy: Lloyd George to Margaret Thatcher* (Oxford, Philip Allan, 1985), p.62. Peden reproduces the 1971 Department of Employment and Productivity figures (Table 160) for unemployed insured workers. The insured workers tended to be in the unprotected industries where unemployment was higher, thus giving a slightly exaggerated figure for the level of unemployment. C. Feinstein, [*National Income, Expenditure and Output of the United Kingdom 1855-1965* (Cambridge, C.U.P., 1972), Table 58] estimates the true level of unemployment at this time to be about 8 per cent of all workers.

over 6 per cent.³¹⁰ Thus, for the majority of the population, standards of living were rising whilst they read about unemployment in the newspapers. The gold standard was not a big issue, nor did it arouse strong passions. Taylor's view was that the restoration of gold was a half-hearted measure, since it no longer involved the use of gold coinage – 'men with gold in their purses had taken the gold standard seriously . . . [but now] . . . it was easy to guess which would win if it came to a clinch between Gold Standard and standard of life.'³¹¹

In this becalmed situation, economic debate also tended to stagnate. Keynes sensed that the British economy was ensnared between two sets of rigidly unadjustable prices – labour and gold – which would inevitably lead to higher unemployment when booming world trade began to subside. He was to spend the years of the 'doldrums' preparing his next major text, *A Treatise on Money*, a text which, in the end, assumed the gold standard as given, but included a raft of ingenious devices, of which public works was only one, by which Britain might co-exist with the gold standard.³¹² The novelties of his economics at this time were inextricably intertwined with his efforts on behalf of the Lloyd George

³¹⁰ P. Clarke, *Hope and Glory: Britain 1900-1990* (London, Penguin, 1997), p.133.

³¹¹ Taylor, *English History 1914-45*. pp. 223-4.

³¹² Clarke, *The Keynesian Revolution in the Making 1924-36*, p.78. Keynes's *Treatise* was not published until 1930, but early drafts - including one which states that capital expenditure financed by public borrowing could do 'nothing in itself to improve matters' and might 'do actual harm' – existed as far back as 1924. It is tempting, as his critics did, to level the charge of inconsistency against Keynes for such a reversal of views, but the context of the gold standard caused Keynes to exercise his inventiveness. In passing, it is worth noting this as an example of the closeness of Keynes's thinking to Hawtrey at this stage.

Liberals. At the Treasury, Hawtrey saw no need for such novelties. He had rounded on the monetary authorities for raising Bank rate to 5 per cent at the end of 1925 and for the next four years, in a stream of memoranda, he continued to preach the efficacy of cheap money.

The price of money remained relatively stable during this period. It stayed at 5 per cent from 3 December 1925 until 21 April 1927, a period of seventy-two weeks. For an even longer period, ninety four weeks, Bank rate remained at 4.5 per cent from 21 April 1927 until 7 February 1929. At this point the frenzy of speculation on the New York stock market encouraged speculators to use sterling to withdraw gold, with which they proceeded to purchase dollars in order to buy escalating stocks. The loss of gold caused the Bank of England to raise Bank rate once more – to 5.5 per cent on 7 February 1929, and further to 6.5 per cent on 26 September 1929.

Typical of Hawtrey's writings during this period was his response to a *Times* leader, 'Monetary Outlook', on 17 March 1927 (this leader happened to be published only four days before the reduction in Bank rate from 5 per cent to 4.5 per cent).³¹³ The article suggested that 'all monetary signs point[ed] to a continuance of credit stringency for some time to come'.³¹⁴ It gave four reasons for this analysis. First, an unfavourable exchange with New York, with the pound pressing hard against the lower limit of its gold-points [under the gold standard

³¹³ *Times*, 17 March, 1927.

³¹⁴ *Ibid.*

with both pound and dollar tied to fixed weights of gold, if exchange dealers offered less than \$4.867/£, it became advantageous to convert pounds to gold, then export the gold to convert to dollars in America; the shipping cost setting a low limit of \$4.86656 below which the pound could not fall]. Secondly, there had recently been an increase in bank advances which had depleted bank reserves. Thirdly, New York had put out a statement indicating that its re-discount rate would not be reduced for some time to come. Fourthly, the spread of the use of the gold standard, particularly to India, had increased world demand for gold, raising its price and lowering the price of all other commodities in relation to gold and the currencies which were tied to gold. The article concluded that 'a lowering of the official minimum would merely increase the demand, while at the same time diminishing supply through the withdrawal of foreign balances, which would lead to a further loss of gold to the Bank, thereby restricting current supplies at a moment when an enlarged gold stock is desirable in order to broaden the basis of credit'.³¹⁵

The *Times* article provoked Hawtrey to send a memorandum to Niemeyer.³¹⁶ Marginal comments by Niemeyer once more show differences of view between Hawtrey and his senior colleagues. Hawtrey viewed the *Times* article with concern.

³¹⁵ *Ibid.*

³¹⁶ Treasury Papers. The Niemeyer Papers, T 176/13.

City Notes of the *Times* are often highly authoritative, and the opening paragraphs yesterday (17th March), if they are to be taken as an indication of the policy which is to be pursued in the City, are extremely disquieting. . . . With regard to the unfavourable New York exchange, the bank has now been trying to correct it by means of a 5 per cent bank rate (with one short interval) for two years. It has accomplished very nearly nothing [Hawtrey's underlining], and at the same time has brought about all the disastrous consequences of falling prices and depressed trade.³¹⁷

Hawtrey's opinion that the 5 per cent Bank rate had achieved 'very nearly nothing' obviously jarred with Niemeyer, and caused him to add in the margin that 'it had practically kept the exchange within the gold-points'. Niemeyer, along with the Governor of the Bank of England, obviously believed that if Bank rate had been lower, then the rush to take and export gold would have been so great that the Bank of England would have been left with nothing to protect the value of the pound. Hawtrey continued to believe that the loss of gold from London to the rest of the world would have encouraged lower interest rates and credit expansion throughout the world, with foreign prices rising to British levels. His confidence in London's power to sway the rest of the world in this direction remained unabated.

³¹⁷ *Ibid.*

He went on to repeat very similar advice to that which he had given over eighteen months previously, when Bank rate had been increased to 5 per cent on 3 December 1925:

A loss of gold arising either from the withdrawal of foreign balances or from Indian currency policy, is not evidence of an unsound currency position here. . . . We ought to be able to face withdrawals of that kind with complete equanimity. To say that gold withdrawals would 'restrict credit supplies when an enlarged gold stock is desirable in order to broaden the basis of credit', is an amazing confusion.

The confusion, to Hawtrey, was that the *Times*, presumably following the 'rules of the gold standard game', believed that the only basis upon which credit could be extended was by the Bank of England increasing its gold deposits – and this required higher interest rates. To Hawtrey this was nonsense; the only way in which manufacturers and traders could be encouraged to take on credit with which to invest was through lower interest rates. Niemeyer seemed to see nothing wrong in the statement of the 'Times', adding that it might be 'clumsily expressed: but surely axiomatic'.³¹⁸ As Hawtrey continued with his theme, pointing out that a stock of gold 'is of no value whatever . . . [and] . . . cannot broaden the basis of credit in any way, except by leading to a reduction of discount rates', Niemeyer underlined the word 'except' with the comment

³¹⁸ *Ibid.*

'exactly' in the margin. The Treasury Controller of Finance was clearly a believer in the 'long run'; that low interest rates and credit expansion could only come after a prolonged period of high interest rates to garner the necessary gold.

Hawtrey dismissed concerns over the Bank of England's gold stock, and the view that it was insufficient.

Insufficient for what? If the Cunliffe Committee recommended that we should hold £150 millions of gold, that was with a view to its being used [again, Hawtrey's underlining]. They repeatedly contemplated contingencies in which the entire gold reserve might be used up, and they recommended the power of suspending the limit of the fiduciary issue of the Bank of England should be retained.

It may be that the occasion for really drawing deeply on a reserve of £150 millions only comes once in a generation, perhaps only once in a century. But it has come now.³¹⁹

It is easy to see how such views could cause disquiet amongst the men of sound finance at the Bank of England and in the higher reaches of the Treasury. Nevertheless, three days after Hawtrey's memorandum the Bank rate was reduced from 5 per cent to 4.5 per cent.

Hawtrey, no less than Keynes, saw the reduction of unemployment as the paramount concern of economic policy at this time. And, like Keynes, he

³¹⁹ *Ibid.*

believed that lack of investment was the root cause of unemployment. Keynes had warned against restoration of the gold standard at its pre-war parity because he believed it implied a period of deflation with high interest rates in order to bring home and foreign prices into line. Hawtrey's response to 'Mr. Churchill's Exercise' on the gold standard was the most reserved of the replies, suggesting that going off gold would be preferable to the harmful effects of a prolonged period of high interest rates. For some time after the restoration of gold, both Hawtrey and Keynes continued to criticise the monetary authorities for the maintenance of high rates of interest. But Hawtrey continued to have faith in the power of the Bank of England to influence world rates, and thus influence world trade. He believed that if the Bank had the necessary courage it would cut its rates, and in the process stimulate both home and international trade – thus public investment was an unnecessary and, largely, wasteful exercise. The parting of the ways for the two men came largely because Keynes perceived that the war had financially enfeebled Britain to such an extent that it could no longer impose its interest rates on the rest of the world. If Britain were to go down the road of lower interest rates then it may well do so alone, with loss of gold eventually forcing it off the gold standard. Hawtrey may have been prepared to watch, with 'equanimity', as Britain's gold disappeared and it was forced off the gold standard, but this was a step too far for Keynes. He did not believe that interest rate reductions alone would provide the necessary investment to

overcome unemployment, and so alternative means of investment, such as public works, began to assume greater importance for him.

Hawtrey continued to press for radical new procedures which would give the authorities greater flexibility over credit policy. In May 1927, as the moment for amalgamation of Bank and Treasury note issues approached, he produced a memorandum criticising the proposed continuation of the ancient system of a fixed fiduciary issue.³²⁰ He argued that that there was no need of legislation to either predetermine a fixed fiduciary issue, or a proportionate reserve system.

There is no real need for the legislature to give any directions to the Bank of Issue except to maintain convertibility into gold. In 1844 that was not enough, because it was not clear by what practical measures that end was to be secured. Now that the means are fully understood, Parliament can content itself with prescribing the end . . . The science of credit regulation has been explored and there is no reason why full responsibility should not be placed upon the bank as the technical organ of the community established for the purpose.³²¹

³²⁰ R.S.Sayers, *The Bank of England 1891-1944* (Cambridge, C.U.P., 1976), pp. 288-289. Sayers describes Hawtrey as 'sail[ing] into the attack in his best style'. According to Sayers the only known copy of this memorandum is Niemeyer's own, and there is no indication that he showed to anyone at the Bank.

³²¹ *Ibid.*

Within a decade, Hawtrey's suggestion was to become standard practice, but Niemeyer, just about to move from Treasury to Bank, thought this radical idea 'far too theoretical: and dangerous for the Bank'.³²²

Between September 1928 and June 1929 Hawtrey took unpaid leave of absence from the Treasury to spend time as Visiting Professor of Economics at Harvard University. Before departing for America he wrote a series of memoranda relating the British and American rates of interest which showed the extent of his disillusion with the way in which the restored gold standard was operating.

In a short memorandum on 1 February 1928 Hawtrey noted that whilst the London Bank rate had remained at either 5 per cent. or 4.5 per cent., the New York discount rate had remained below 4 per cent.

. . . two contrasted policies, credit restrictions in London and credit relaxation in New York. The improvement of the sterling exchange is one of the consequences; dollars have been cheapened relatively to pounds. On the whole also the corresponding contrast in the state of trade has continued; trade is active in America and depressed here.³²³

³²² *Ibid.*

³²³ Treasury Papers T208/110. Hawtrey memorandum 'The Dollar and the Pound', 1 February 1928.

The cheapening of dollars relative to the pound was, of course, severely limited by the operation of the gold standard. Once the pound's exchange rate exceeded \$4.86656 beyond a given margin – the upper gold point – it became profitable to use dollars to purchase gold in New York and then ship it to London to exchange for pounds (the precise value of the gold points varied according to shipping and insurance costs at the time). This was the outcome of the difference in the two rates of interest - New York lost gold to London. To counteract this loss, on 3 February 1928, New York raised its rediscount rate to 4 per cent. This was to be followed by the raising of the rediscount rate to 4.5 per cent. at the beginning of May of that year. Hawtrey regarded this, at a time when complaints of depression were growing in America, as a series of disastrous moves, and evidence that London still had the power to influence world interest rates.

In so far as the motive is the outflow of gold, the raising of the rediscount rates illustrates once again the disastrous effects of gold hunger. Competitive demands for gold are being intensified. When some countries start accumulating gold, others follow their example, and those with excessive stocks are reluctant to part with it. The safeguards recommended at Genoa against this calamitous train of events have never been adopted.³²⁴

³²⁴ Treasury Papers T 208/110. Hawtrey Memorandum 'The Dollar and the Pound', 17 February 1928.

Hawtrey despaired of the situation, since the rise in American rates implied an intensification of the scramble for gold. He continued to believe that the Bank of England still possessed the power to take a lead and, by lowering its own rate, bring down interest rates world-wide. His own 'Genoa Resolutions', back in 1923, had provided for a convention of central banks which would co-operate and co-ordinate their interest rates in order to stabilise the world value of gold and avoid the unseemly scramble for the metal which was now in evidence. But he began to increasingly recognise that the Bank and the Government had painted themselves into a corner. While, he believed, they might still have the economic muscle to reverse the world-wide growth in interest rates, it was politically impossible for them to reverse their existing policies. They were in a corner from which there was no escape. Some of these views were expressed in a memorandum which he produced for the Treasury in July 1928, immediately prior to his departure for America.

Probably therefore we have to look forward not to a rise but to a fall in the world price level. . . . increased credit pressure will become necessary to maintain the gold standard. We must look forward to increased unemployment, increased budget deficits, renewed industrial unrest. . . . A reversal of policy would be hard to explain. . . . how can we justify a resort to cheap money at the very time when the exchange moves against us such a change would be regarded as a confession of error the

Government as well as the Bank will be open to accusations of having miscalculated.³²⁵

It was, incidentally, in this memorandum that Hawtrey introduced an idea which was to echo down through the following years.

It is possible for industry to get into a position of temporary equilibrium while seriously underemployed, and to remain so for a considerable time. Demand and supply, being equally restricted, balance.³²⁶

The years 1925-28 were depressing years for Hawtrey, and he probably looked forward with relative optimism to his year away from the Treasury, at Harvard.

There seems to have been no attempt to replace him by appointing an acting Director of Financial Enquiries during his nine months' secondment. His absence gave rise to a number of concerns, but the non-existence of a professional economist within the Treasury does not seem to have been one of them. Hawtrey's own overriding concern seems to have been that his forthcoming year should count towards his pensionable service. Despite considerable correspondence between Hawtrey and Mr. Rae of the Civil Service staffing section no such allowance could be offered. In order to minimise the loss to his pension rights, therefore, Hawtrey attended the Treasury up to the 14

³²⁵ Treasury papers T208/110. Hawtrey Memorandum 'The Credit Situation', July 1928.

³²⁶ *Ibid.*

September, before sailing to America on the 15 September 1928. By doing this he was able to use his annual leave for part of his time at Harvard, and in consequence his period of special leave did not start until 1 November 1928.³²⁷ He took similar measures to minimise the loss to his pension rights on returning:

With reference to my forthcoming visit to America . . . I understand that I will be able to return at the beginning of June . . . I propose that my special leave should end at the end of May and that I should count the week or two that will intervene before I actually attend at the Treasury as part of the annual leave . . . [for] . . . 1928-9. Will this be all right?³²⁸

It seems to have been 'all right' since a subsequent note from the staffing section accountant to the Treasury advised that 'Mr. R.G.Hawtrey has been granted special leave of absence without pay from 1 November 1928 to 31 May 1929'.³²⁹ The only areas which the Treasury seemed concerned about were his absences from certain standing committees, and his failure to complete the Treasury's First World War Book. On the second matter, Mr. Rae was given to write to the Treasury, rather stiffly, regarding Hawtrey.

³²⁷ Treasury Papers T268/11. Hawtrey's ('confidential') Civil Service Career file.

³²⁸ *Ibid.* The letter from Hawtrey to Mr. Rae of the Civil Service staffing section, dated 3-8-28, is to be found in Hawtrey's confidential file.

³²⁹ *Ibid.*, Accountant's note from the Civil Service Staffing section to the Treasury, 24 September 1928.

In 1921 he was appointed Chairman of the Treasury War Book Committee. . . . The Committee has not so far reported and I have occasionally drawn Mr. Hawtrey's attention to the fact.³³⁰

Despite assurances from Sir Richard Hopkins to Mr. Rae that Hawtrey had this matter in hand, there is no evidence that any Treasury World War I record was ever compiled (giving a little irony to Hawtrey's subsequent appointment to write the Treasury's World War II history). The other area of concern regarding Hawtrey's absence was his membership of various Civil Service standing committees – The Organising Committee on War Risks Insurance, The Standing Committee on Blockade and Enemy Trading, The Air Risks Insurance Committee and the Committee on Emergency Legislation in Time of War. Once it was established that David Waley, an assistant secretary within the Treasury, was prepared to represent the Treasury on these committees for the period of Hawtrey's absence, then there was no further problem regarding his period of secondment.³³¹

During Hawtrey's absence, the advice on financial matters which he might have been expected to undertake was taken on outside the Financial Enquiries section, much of it by Frederick Phillips, who had been appointed principal assistant secretary within the Treasury in 1927. It was a time during which the

³³⁰ *Ibid.*, Letter from Mr. J.Rae to Sir Richard Hopkins, 15 July 1928.

³³¹ *Ibid.*, Letter from Mr. J.Rae to Sir Richard Hopkins, 31 July 1928.

Treasury's new leadership team with a new leadership style began to emerge – a team with a style that would take the Treasury through the 1930's.

In 1927 Sir Otto Niemeyer, formidable defender of 'sound' financial policies and Churchill's 'minder' during the return to gold, had resigned from the post of Controller of Finance at the Treasury to take up a position at the Bank of England. After his rapid rise through the Civil Service ranks he had found his way to further promotion blocked by Sir Warren Fisher, who as Permanent Secretary and Head of the Civil Service was a mere four years older. After over two years dealing with Churchill as Chancellor, he had also had enough of Winston's unpredictability and rudeness towards his officials. For his part, Churchill was not unhappy to see Niemeyer go; privately he had had strong reservations about returning to the gold standard and resented the feeling that he had been manipulated in the matter by Niemeyer and Norman. Niemeyer was to remain at the Bank from 1927 until 1965, where every morning he could be observed walking up Threadneedle Street 'with an expression on his face that suggested that if he had come up against a brick wall he would have walked straight through it'.³³²

Niemeyer's replacement as Treasury Controller of Finance was Sir Richard Hopkins who had previously been Chairman of the Board of Inland Revenue. After King Edward's School, Birmingham, he had studied History and Classics at Emmanuel College, Cambridge, before entering the Inland Revenue. He was as

³³² G.C.Peden, *Keynes and his Critics: Treasury Responses to the Keynesian Revolution 1925-1946* (New York, O.U.P., 2004), p.14.

pragmatic regarding policy as Niemeyer had been dogmatic. On transferring to the Treasury he read widely on economic matters. He retired from the Treasury (as Permanent Secretary) in 1945, and his idea of retirement was, that year, to read through Keynes *General Theory of Employment, Interest and Money* – twice! He was interested in all aspects of economic theory, and was a member of the ‘Tuesday Club’ which brought City men, journalists, civil servants, academics (and Keynes) together to debate economic matters, but he nevertheless remained sceptical about the practical value of theory. Hopkins’s touchstone for pursuing any particular policy was not whether it could be justified by recourse to one or other economic theory, but whether it was administratively feasible. During the hearings of the Macmillan Committee he successfully re-orientated the Treasury’s arguments against loan-financed public works away from theoretical concerns over the ‘crowding out’ of private investment by public investment towards the administrative problems inherent in government sponsorship of public works.

Hopkins was a popular man with an impish sense of humour. He accepted the soubriquet of ‘Hoppy’ and most of his correspondents prefaced their letters with ‘My Dear Hoppy’ – Keynes refrained from this familiarity until after he had shared a working lunch with Hopkins on 1 November 1939, whereupon he, too, relaxed his form of address. In an early biography of Keynes, Sir Roy Harrod described Hopkins as someone ‘who might be taken for an ancient sage, who had somehow been wafted through the centuries to give wise counsel to a half-

baked generation'.³³³ Lionel Robbins described Hopkins as 'diminutive in stature, with the general appearance of an extremely intelligent monkey, on the general subject of government finance he was an intellectual match for anyone of his generation'.³³⁴ Hopkins is credited with persuading Keynes, during the 1930s, that practical and administrative feasibility must be considered alongside economic theory as determinants of economic policy. Sir Thomas Padmore, war-time Principal Private Secretary to the Chancellor of the Exchequer, once remarked that 'Keynes would talk to anyone, but he would listen to Hopkins'.³³⁵

The 'rising star' of the Treasury at this time was Frederick Phillips. Phillips had attended Aske's School in London and then, like Hopkins, Emmanuel College, Cambridge, where he read Mathematics. He had entered the Treasury in 1908, and though he had read a wide range of books on economics he never considered himself an economist (Phillips was to later tell an internal Treasury organisational enquiry in 1937 that he could not do without Hawtrey, since Hawtrey understood professional economists in a way that he did not, so that he could make intelligible what other economists were advising).³³⁶ Peden describes Phillips as being 'inarticulate in conversation, although lucid on

³³³ R.F.Harrod, *The Life of John Maynard Keynes* (London, Macmillan, 1951), pp. 529-30.

³³⁴ R.Skidelsky, *John Maynard Keynes: The Economist as Saviour 1920-37* (London, Macmillan, 1992), p. 698.

³³⁵ Peden, *Keynes and his Critics*, p.12.

³³⁶ *Ibid.*, p.16.

paper'.³³⁷ His characteristic response to every comment might have been a grunt, but his memoranda display a powerful analytical mind capable of taking scattered, diffuse arguments, sweeping away irrelevancies, posing the essential issues and expressing clear, balanced judgements on them. Phillips died, still relatively young at the age of 58, in 1943 and Keynes, who had grown to admire him, wrote an obituary on him in which he described him as 'a formidable figure who hated fluffy thinking'.³³⁸ From Hopkins's appointment as Controller of Finance in 1927 he increasingly turned to Phillips for advice. Leith-Ross remained, somewhat uncomfortably, from the Niemeyer regime, but when he was found an alternative position, in 1932, Phillips was promoted to the position of Deputy Controller of Finance.

Thus, while Hawtrey was in America a new structure was beginning to take shape within the Finance Section of the Treasury. A new leadership team was settling in; a team which, whilst generally sceptical about the value of economic theory, was nevertheless not wedded to the nineteenth-century canons of sound finance, but prepared to give consideration to the merits of new theoretical developments. For a time, this new team operated without the assistance of Hawtrey.

This newly-emerging team was called upon to give advice to Churchill on 19 January 1929 when Keynes published an article in the *Nation and Athenaeum* in

³³⁷ *Ibid.*, p.14.

³³⁸ *Ibid.*, p.15.

which he expressed concern about the adequacy of the world's stock of gold available for central banks to meet their international payments. Keynes's argument had been that since, by laws and regulations, central banks were required to keep a stipulated quantity of gold locked away in proportion of their note issue any attempts by the central banks to increase credit in order to alleviate unemployment necessitated, by law, that they should increase their gold reserves – leaving insufficient gold for the transaction of international business. This was driving up the price of gold and driving up the value of currencies tied to gold in relation to other commodities – hence driving down the money value of other goods and contributing towards deflation. His thesis had been that the requirement by the central banks to hold gold in proportion to their note issue, generally 30 to 40 per cent, was a useless convention.

Only a few months previously, Hawtrey, as the Treasury's Director of Financial Enquiries, had penned a memorandum deploring the intensification of the competition for the world's gold. Hawtrey's argument was so close to that of Keynes that it is difficult to see how Hawtrey, asked to comment on Keynes's article, could have shown any great measure of dissension. Hawtrey would, without doubt, have reiterated the need for co-operation between central banks, along the lines of the Genoa Resolutions, in order to stabilise the demand for gold. In the absence of such co-operation he would have urged the Bank of England to set the agenda for world interest rates by aggressively reducing bank rate. In the event of loss of gold he would have recommended that the Treasury

use its powers to permit the issue of notes in excess of the prescribed fiduciary limit, just as his mentor, Bradbury, had done during the 1914 crisis.³³⁹ In Hawtrey's absence, Hopkins forwarded comments from Phillips and himself to the Chancellor, Churchill, on 31 January 1929. Their comments are included here as indicative of new emphases and a new style.

Phillips's produced a characteristically measured document under numbered points.³⁴⁰ Firstly, by citing an article which Keynes had written in the Nation on 2 February 1924, urging the United States to 'buy all the mines in Africa and cement them down securely' since the excessive supply of gold was about to cause rampant inflation, Phillips painted Keynes as an obsessive who moved excessively between extreme positions. Phillips then proceeded to depict Keynes as an alarmist by taking the figures in his article – a 2 per cent annual increase in the world's output of gold whilst the annual increase in the world's demand for gold for monetary purposes was 3 per cent – and argued that, even if these figures were correct they implied a fall in world prices of only 1 per cent, which was far smaller than variations in world prices due to non-monetary causes. As regards the scramble for gold amongst the central banks, Phillips pointed out that in the previous year, 1928, the United States had, in fact, released £31 millions of gold reserves, and as for Keynes suggestion that gold might be released from the central banks in order to check its tendency to appreciate,

³³⁹ R.D.C.Black, 'Ralph George Hawtrey', p.378.

³⁴⁰ Treasury Papers, T172/2095. Memorandum by F. Phillips, 23 January 1929.

Phillips agreed that 'in theory' this problem might be solved, but he remained a pragmatist.

A release of gold by the Central Banks, unless it were of minute dimensions, is a potent cause of inflation. . . . the difficulty in practice is to detect and measure a minute change in prices due to a deficiency in gold, and second how to apply a remedy which is not ten or a hundred times too powerful.³⁴¹

Hopkins added his customary words of wisdom to Phillips's memorandum – '[Keynes's] argument rest[ed] on the belief that Central Banks would behave better if less restricted by law. This may be so but the picture of a Bank of France bursting to be generous with its gold but restrained by law is not convincing'.³⁴² He made two particular criticisms of Keynes's article, pointing out, firstly, that Keynes's description of the locking away of gold being 'merely a ritual observance' was untrue since this gold was a second-line reserve which could be used for trading purposes in an emergency; secondly, he took the opportunity to gainsay Keynes's accusation that the Bank of England had been greedy in their accumulation of gold, pointing out that the Cunliffe Committee had recommended a gold reserve of £150 millions, and this remained the Bank's holding.

³⁴¹ *Ibid.*

³⁴² Treasury Papers, T172/2095. Memorandum by Sir R. Hopkins, 31 January 1929.

This country, still the monetary centre of the world, liable to be drawn upon not only from all European quarters, but from North and South American quarters as well, liable to feel the repercussions of monetary disturbances in any part of the world, - disturbances accentuated by the proportional reserve adopted by most countries but eschewed by ourselves – is content with about £150 millions of gold. The United States have three and a half times that amount, an excess accounted for neither by population nor by needs. France with about the same population has 70 per cent. more gold Wherever the greed for gold may have been manifested, it has not been manifested here.³⁴³

Hopkins acknowledged that there was 'undoubtedly' something to be said about Keynes's thesis, but that a 'slight diminution in the reserves of those countries whose proportions are highest and a gradual substitution . . . of the holding of foreign currencies in place of gold seem to be the natural remedies' (the influence of Hawtrey's Genoa Resolutions can be seen here).³⁴⁴ In the mean time, Hopkins recommended that, while the matter was looked at by the League of Nations' Economic Committee, suspicions of foreign central banks could best be allayed by everyone, including Keynes, saying as little as possible about the matter in public. Neither Hopkins nor Phillips resorted to quoting the canons of 'sound finance', but challenged Keynes on his assumptions and the justification

³⁴³ *Ibid.*

³⁴⁴ *Ibid.*

of his conclusions. Hopkins in particular was prepared to acknowledge the justification of Keynes's case whilst questioning the wisdom of his approach.

This was a new style of regime, with a special competence of its own, to which Hawtrey had to accommodate as he returned from Harvard in June 1929. On appointment to his post, back in 1919, the Treasury Controller of Finance had been Sir Basil Blackett. To a degree, Blackett, like Hawtrey, had been a protege of Sir John Bradbury up to the time when Bradbury relinquished the position of Joint Permanent Secretary to the Treasury in 1919. Blackett had continued to encourage Hawtrey after the latter's appointment as Director of Financial Enquiries.

Blackett's successor, the austere but capable Niemeyer, gave some support to Hawtrey's early plans, such as his gold shipment recommendations, but ignored, and even derided, Hawtrey's later memoranda appealing for lower interest rates and extension of credit. The extent of the eventual polarisation of the positions of Niemeyer and Hawtrey can be seen in Niemeyer's evidence to the Macmillan Committee on Finance and Industry (by which time, of course, he was at the Bank of England): he expressed the view that Britain should have returned to gold 'at a higher rather than a lower parity' and that the joint-stock banks had been 'too ready to help industry'.³⁴⁵

Hawtrey left Harvard to return to work with the newly-settled Treasury team, as well as minimise his pension losses, in June 1929, just before a major

³⁴⁵ H.M.S.O. (1931), Committee on Finance and Industry (Macmillan), *Report*, (Cmd.3897), Questions 6705, 6755.

financial crisis was about to unfold. His return coincided with the formation of Ramsay MacDonald's Second Labour Government and the replacement of Churchill as Chancellor of the Exchequer by Philip Snowden. The Great Crash of October 1929, on the New York Stock Market, was still some months away. Deflationary forces, concealed by the world boom, had been in existence for some time; notably the falling prices of primary commodities in primary-producing countries due to their relative overproduction. The New York crash was but one of the symptoms of wider deflationary forces that were at work. The Great Crash destroyed confidence. It also brought about a liquidity crisis. Much of the share speculation had been with the aid of bank loans – loans which the borrowers hoped to repay when the shares had been re-sold at a profit. When the profits never materialised the banks were left with outstanding loans which the borrowers could not repay: many banks were forced into closure whilst many others had to severely restrict their lending.

The crash brought one kind of relief to Britain. The process of withdrawing gold to purchase dollars, and thence shares, was stopped in its tracks. The Bank of England was at last able to respond to critics of its high Bank rate. The rate was reduced by stages from 6.5 per cent on 31 October 1929 to 2.5 per cent on 14 May 1931.³⁴⁶ It was constrained by the slow rate at which the U.S. Federal Reserve was prepared to lower its interest rates in response to American

³⁴⁶ Hawtrey, *A Century of Bank Rate*, p.296

deflation. The clamp shackling the two sets of interest rates together was, of course, the gold standard system, and Britain's desperation to remain on it.

The Bank probably would have wished to drive interest rates down faster and further, but it was restricted by the developing problem of Britain's balance of payments.³⁴⁷ Deflation in primary-producing countries and the fall in demand from the United States reduced demand for British manufactured goods. An adverse balance of payments replaced Wall Street speculation as the cause of the haemorrhaging of gold. The current balance on foreign trade peaked, at a surplus of £124 million, in 1928 and then progressively deteriorated to a deficit in excess of £100 million in 1931.³⁴⁸ The Bank was in the position of having to maintain its gold reserves by attracting short-term funds to Britain – something it was only able to do by maintaining its short-term interest rates above those of New York.

Reflecting on this situation, in 1937, Hawtrey was convinced that it provided a validation of his sustained appeal for lower interest rates – irrespective of the loss of gold:

The conclusion to be drawn is that the Bank of England ought to have been willing to *let gold go* [Hawtrey's italics]. It ought in fact to have been willing to do so at any time since the return to the gold standard. If it could only retain its gold by a recourse to

³⁴⁷ Howson, *Domestic Monetary Management in Britain*, p.67.

³⁴⁸ J.Tomlinson, *Public Policy and the Economy since 1900* (Oxford, O.U.P., 1990), p.74.

deflationary measures, and could not otherwise maintain the gold standard, then either the return to the gold standard was premature or the restoration of the former parity was a mistake. It is, I think, not unreasonable to hold that a policy of cheap money and credit relaxation from the beginning would have had a favourable effect on economic activity throughout the world in 1925, and would have made the task of retaining the Bank of England's gold quite easy. But even if that had not been so, and credit relaxation had been found to involve a serious outflow of gold, an acquiescence of that outflow would have afforded the best prospect of maintaining the gold standard.

Even in 1929 it was not too late . . .³⁴⁹

The central issue to the Labour Chancellor of the Exchequer, Snowden, was confidence. If the Government were perceived to be spending an amount greater than its revenues, then two fears arose: that the government would have to resort to printing paper pounds out of proportion to its gold reserves, and thus be unable to guarantee the gold value of the currency; that the consequent increase in the money supply would draw in excessive imports, exacerbate the balance of payments deficit, and deplete the Bank of England's gold reserves – casting even more doubt on the Bank's ability to maintain sterling's fixed value against gold.

With confidence being the issue, very few dared mention the option of devaluation, or departing from the gold standard. Not even Keynes. During the

³⁴⁹ Hawtrey, *A Century of Bank Rate*, p.141.

Macmillan Committee discussions, Keynes was moved to express the opinion that:

. . . I should not recommend going off the gold standard at this moment; not until I had tried other expedients, but I should not have complete confidence in the efficacy of these alternatives. Meanwhile I think the dangers of going off are such, that I would not even talk about it.³⁵⁰

There was a very small number of exceptions. In the summer of 1930, Professor G. C. Allen canvassed a large group of economists on their views on the gold standard. He encountered only two who considered devaluation a permissible option – 'J. W. F. Rowe of Cambridge University and R. G. Hawtrey of the Treasury'.³⁵¹

For some time prior to Britain's gold standard exit, Hawtrey had refused to support any memorandum which implied an attempt to maintain the value of sterling at \$4.86. Writing in 1939, he noted that 'premonitory symptoms' of a doubt as to the continuance of the gold standard were already appearing in February 1931 when forward quotations of the pound on the foreign exchanges

³⁵⁰ J.M.Keynes, *Activities 1929-31: Rethinking Employment and Unemployment Policies*, Volume XX of *The Collected Writings of John Maynard Keynes* (London, Macmillan and C.U.P., 1981), p.29.

³⁵¹ G.C.Allen, 'Advice from Economists – Forty-Five years ago', *Three Banks Review* (1975), p.42.

fell below the gold export point – people, in effect, were undertaking three months hence, to buy dollars when the cost of the dollars would exceed the combined value of the pounds surrendered and the cost of shipping the equivalent gold from London.³⁵² Misgivings about Britain's willingness to make the efforts to maintain the gold standard were manifesting themselves. According to Hawtrey the reason for the failure of the gold standard lay deeper than either foreign bank failure or a deteriorating balance of payments:

The cause of the failure of the gold standard was simple. It was the appreciation of gold in terms of wealth. Gold had not supplied a stable unit for the measurement of values. . . . the immediate cause of the crisis, it is true, was the withdrawal of foreign money, first from Austria and Germany and then from England. But that was the result of distrust, and that distrust was directly due to the appreciation of gold. . . . It was the same fall in prices that had caused in Great Britain the unemployment, the shrinkage of exports and the budget deficits.³⁵³

As ever, Hawtrey felt that the central Banks had been culpable because they reinforced falls in world prices by their dear money policies – policies which were designed with the sole purpose of retaining as much as possible of the

³⁵² Hawtrey, *The Gold Standard in Theory and Practice*, p.134.

³⁵³ *Ibid.*, pp. 136-7.

appreciating metal. He harked back, yet again, to the lost opportunities afforded by the Genoa resolutions:

The responsibility of central Banks for determining the wealth-value of gold had been recognised at the Genoa conference, but by 1929 the Conference had been forgotten and the responsibility disclaimed. The central banks had reverted to the ideas of the nineteenth century gold standard, which limited their responsibility to restraining the expansion of credit whenever it outran the gold reserves. Here was an objective which made no demands on the reasoning faculty; it could be treated as an article of faith.³⁵⁴

As a final comment upon this act of faith Hawtrey permitted himself the indulgence of a short parable.

A man once set his dog to guard his clothes whilst bathing. Unfortunately the dog did not recognise his master naked, and guarded the clothes too faithfully. The man remained disconsolate and deflated; the dog barked and the caravan could not go on.³⁵⁵

³⁵⁴ *Ibid.*, pp. 140-1.

³⁵⁵ *Ibid.*, p.141.

Chapter 4

Unemployment and the Liberal Plan

1928-1930

To Hawtrey, the reason for the unemployment of the 1920s was straightforward – and consistent with his theory of currency and credit. Unemployment was due to lack of effective demand; effective demand could only be increased by extension of credit; high interest rates were a barrier to the extension of credit. He devoted a large section of his historical study *A Century of Bank Rate* to tracing the close relationship between Bank rate and the ensuing trade activity.

Edward Heath once criticised Nigel Lawson for being a 'one-club chancellor'; likening his one tool of economic policy, the raising or lowering of interest rates, to a golfer who attempted to play a round of golf with only a single club. Hawtrey was the original 'one-club economist'. Whether on, or off, the gold standard he regarded the manipulation of the Bank of England discount rate as the supreme instrument for controlling the economy. When there was evidence of an impending downturn of trade then easing of the discount rate would ward off depression. When there were signs of overheating, an early rise of the Bank rate would damp down any inflationary pressures. Provided the monetary

authorities were vigilant and prompt, appropriate adjustment of Bank rate would see everything right.

Keynes was no such 'one-club' economist. He proposed an array of measures. Different measures were required under a gold standard from times when it was absent. To charges of inconsistency, he replied 'If a situation changes, I change my mind; what do you do?'. During the Macmillan Committee deliberations he identified no less than seven different classes of remedy for unemployment. His favourite, government investment in public works, caused him frequently to cross swords with Hawtrey and the Treasury.

Between the onset of depression in 1922, and 1928, the demand, at a political level, for publicly funded works as a cure for unemployment remained muted. From 1921 Lloyd George's Liberal Summer Schools had discussed interventionist policies. Keynes became involved with these Summer Schools, and in 1924 both he and Lloyd George produced articles advocating capital development programmes in Keynes's journal, *Nation and Atheneum*. The *Nation* did not have a mass circulation and Lloyd George, by then, was discredited and mistrusted politician.

The long political silence on public works as a means of alleviating unemployment was broken, by Keynes, on 31 July 1928. He used the pages of the *Evening Standard* to attack Treasury policies in an article, 'How to Organise a

Wave of Prosperity'.³⁵⁶ Keynes was in no doubt about the root cause of low business activity – the return to the gold standard at too high a level. The Treasury copy of this article is heavily marked by officials, and the second paragraph below has been marked and initialled by Hawtrey.

. . . there can be no doubt about the explanation [for low business activity], it is as well to remind ourselves . . . Labour costs are exactly what they were three years ago

Meanwhile wholesale prices have fallen 9 per cent compared with 3 years ago and 13 per cent compared with 4 years ago, while the cost of living has fallen 5 per cent. But many industries have not enough margin of profit to employ men at the same wages as before and to sell their products 5 to 10 per cent cheaper.

The fundamental blunder of the Bank of England has been due, from the beginning, to their belief that if they looked after the deflation of prices the deflation of costs would look after itself . . . it is extraordinarily difficult to deflate costs.³⁵⁷

Keynes argued that it was beyond the power of individual businesses to reduce unemployment; they needed supportive measures from Bank and Treasury. He urged steps to increase credit and encouragement of capital projects by local authorities.

³⁵⁶ J. M. Keynes, 'How to Organise a Wave of Prosperity', *Evening Standard*, 31 July 1928. The copy of this article which I have used is the one pasted into the Treasury file 'Memoranda on Unemployment', Public records Office, Treasury File T172/2095.

³⁵⁷ *Ibid.*

When we have unemployed men and unemployed plant and more savings than we are using at home, it is utterly imbecile to say that we cannot afford these things . . .³⁵⁸

The phrase 'more savings than we are using at home' is underlined in pencil in the Treasury copy of the article, with a note by Leith-Ross asking 'is this true?' On the following day Leith-Ross wrote to Hawtrey raising two points regarding Keynes's article. First he queried Keynes's assertion that 'Labour costs . . . are exactly what they were three years ago . . .' – adding 'I should have thought that the average wage rates showed a substantial decline during the past 4 years'.

Leith-Ross seems to have been making certain assumptions about the consequences of the outcome of the General Strike. The outcome was generally seen as a defeat for labour, especially the miners, who were forced into returning to work at the reduced wages on offer - hence Leith-Ross's assumption that the general level of wages was being forced down. This was against the evidence of Bowley's figures. Laybourn has argued that strategically the General Strike acted in the long term interest of labour. It acted as a warning shot across the bows of employers who might be tempted to adopt an over-aggressive attitude towards wage reductions. The level of wages, which *had* been falling rapidly before 1926, started to level off after the General Strike.³⁵⁹

³⁵⁸ *Ibid.*

Secondly, Leith-Ross queried Keynes's assertion on the excess of savings over investment and wanted Hawtrey's view on Keynes's statement that we 'have more savings than we are using at home' – again adding his own view that 'this seems to be sheer perversion of the facts'.³⁶⁰ Hawtrey replied, on 4 August 1928, by drawing Leith-Ross's attention to 'Bowley's index of wages' which showed that there had been 'no appreciable variation since 1924'.³⁶¹ Again, he assured Leith-Ross, that given the capital exports of £96 million in 1927, the statement of Keynes's with regard to savings exceeding home-investment was also true.

The extent to which Keynes's criticism stung the Treasury can be gained from the tone of the memorandum with which Leith-Ross responded on 3 August 1928 – a memorandum rushed out before he had received Hawtrey's answers to his queries.

I am sorry to see that Keynes is renewing the Press propaganda which has done him little credit as a politician and considerable harm as an economist.³⁶²

³⁵⁹ K. Laybourn, *Britain on the Breadline: a social and political history of Britain between the wars* (Gloucester, Alan Sutton, 1990) pp. 124-132.

³⁶⁰ Treasury Papers, T 172/2095. Note from F. Leith-Ross to R.G.Hawtrey, 1 August 1928.

³⁶¹ *Ibid.*, note from R.G.Hawtrey to F. Leith-Ross, 4 August 1928.

³⁶² Treasury Papers, T172/2095. Memorandum by F. Leith-Ross, 3 August 1928.

He blamed 'political influences' for counteracting economic forces 'by means of subsidies' for the failure to bring down wage rates, adding that by 'paying the unemployed to remain idle rather than compete for jobs in the market, it tends to immobilise surplus labour . . . and to maintain wage rates at their existing levels . . .'³⁶³ He thought it 'absurd of Keynes to suggest that we have savings which are available and not being used'. He thought that inflation of bank credit could only encourage wage increases and excessive consumption, and that encouragement of local authority capital projects was 'the same principle that the Soviet Government is trying'. 'More of the same' seemed to be Leith-Ross's only answer to the unemployment problem.

On 5 August 1928 Sir Richard Hopkins received a note from the Chief Secretary to the Treasury, Sir Warren Fisher, bearing an instruction from the Chancellor of the Exchequer (Churchill) - that 'Sir Richard Hopkins, Mr. Leith-Ross and Mr. Hawtrey study Keynes's article . . . of last week, and to let him have . . . their observations'.

Leith-Ross toned down his original memorandum for Churchill's consumption. He omitted his abusive references to Keynes and also his criticisms of the National Insurance scheme. He paid no regard to Hawtrey's reminder that Bowley's index of wages had remained at the same level since 1924, but pointed out that 'miners wages had been very definitely and drastically reduced' –

³⁶³ *Ibid.*

against which someone has subsequently written 'and the worst unemployment of all is in the coal industry'.³⁶⁴

Hawtrey's (relatively short) note to Churchill reiterated his long-held view that public spending on capital account could only increase employment if were to be accompanied by appropriate credit expansion, and the latter would in any case increase employment whether accompanied by increased public spending or not. If the loans to finance the public spending diminished the export of capital, then this would permit a credit expansion which would not otherwise be possible. Hawtrey expanded on this idea.

If we started spending £60 million a year on capital works and thereby reduced our export of capital . . . imports and exports would have to be adjusted to the change in the balance of payments. A part might be . . . the import of materials . . . for use in the capital works But only a fraction of the [£60 million] could be disposed of in these ways.

Suppose that the discrepancy between the balance of trade and the balance of payment is thereby reduced to £50 million. Then there must be a sufficient monetary expansion so to increase the purchasing power of the community that additional imports to the amount of £50 million will be attracted. . . . With a given price level that would mean a substantial increase in activity. Even if part of the increased demand went to increase prices and wages, the increase in activity would still be

³⁶⁴ *Ibid.*, Memorandum by F. Leith-Ross, 9 August 1928.

considerable [in the margin, at this point, is written the word 'inflation'].³⁶⁵

Hawtrey added that the stimulus to trade brought about in this way would be similar to that obtained by exporting gold, but cautioned that '[t]he effect [was] only temporary', since it would be impossible to permanently increase capital outlay at home by £60 million per year [this point had been heavily marked in the margin]. He thought that the initially favourable effect on the balance of payments might prompt the Bank of England to lower interest rates, with all the beneficial effects of credit creation. However, to Hawtrey, it was 'hardly worthwhile to consider elaborate and roundabout devices for giving the Bank of England an opportunity of relaxing credit' when such things could be done more directly. This was a theme which Hawtrey was to develop as the debate over unemployment progressed.

Sir Richard Hopkins evidently felt that Churchill had sufficient to digest within the missives from Leith-Ross and Hawtrey, since he felt no need to add a note of his own. It is not known how Churchill responded. He could hardly have been reassured by his Treasury advisors. On the one hand Leith-Ross opined that 'What Keynes is after, of course, is a definite inflation of credit', adding that 'if the object is to reduce labour costs, the inflation of credit is the last possible thing that will do what is required'. On the other hand, Hawtrey was arguing

³⁶⁵ *Ibid.*, Note by R.G.Hawtrey, 4 August 1928.

that the need to increase the total consumers' income was paramount if unemployment was to be overcome, and the key to this was the relaxation of credit – advising that Keynes's pet remedy of public works would lead to relaxation of credit if only in a roundabout way. Hawtrey was on the point of leaving for America and would be unavailable to follow up his advice; he was also generally known to have views which were out of line with those of his senior colleagues. Leith-Ross was the senior figure; he would be on hand for advice during the coming year and Churchill must have realised that his view must have been close to that of most other senior Treasury figures. Churchill also had form. At the time of the return to the gold standard, he had wriggled before acquiescing to its return, but he had never felt confident enough to depart from the Treasury line – knowing that he would depend on Niemeyer's support at difficult times. Once again he kept to the line of his senior officials and articulated the 'Treasury View' in the face of Keynes's criticisms.

After the publication of the Liberal 'Yellow Book', *Britain's Industrial Future*, it became clear that public works as a means of combating unemployment would be a major theme of a future election campaign. Moreover the Treasury could not isolate it as the irrational brain-child of an untrustworthy politician and an unconventional economist. On 7 February 1929 the *Conservative's* Home-Secretary, Sir William Joynson-Hicks, prepared a memorandum, CP 27 (29), in which he set out a programme of public works, especially in the Dominions and Crown Colonies, aimed at stimulating exports and encouraging emigration – all

with a view to reducing unemployment. Close on the heels of this memorandum, on 16 February 1929, another memorandum by a *Conservative* minister appeared, produced by the Minister of Labour, Sir Arthur Steel-Maitland. Steel-Maitland's memorandum, CP 37 (29), called for an £8 million plan for trunk roads at home.³⁶⁶ As a response to these stirrings Churchill requested his officials to prepare a document to show the 'fallacies underlying the idea that a great loan would be a permanent remedy for unemployment'.³⁶⁷

The outcome was a Cabinet paper CP 53 (29), produced on 23 February 1929, and designed to bring recalcitrant cabinet colleagues to order. Perhaps, under normal circumstances, the task of preparing this document would have fallen upon Hawtrey, but he was away at Harvard, and not due to return until June 1929. In his absence Churchill called upon other civil servants to carry out this duty: Frederick Phillips, then a Principal Assistant Secretary, and Gilbert Upcott, then Deputy Controller of Supply Services. Additionally, a week later, when calling upon his officers for a reaction to Lloyd George's election pamphlet, he suggested that Alfred Hurst, another Principal Assistant Secretary, should be enlisted to assist in its preparation.³⁶⁸ All the Treasury preparation to meet the Chancellor's Cabinet critics, prepare Churchill for his 1929 Budget presentation,

³⁶⁶ Clarke, *The Keynesian Revolution in the Making*, pp. 54-62. Clarke gives a detailed account of unrest within the Conservative cabinet.

³⁶⁷ Treasury Papers, T.172/2095, 'Cure for Unemployment Memoranda of 1928 and 1929'. Memorandum by the Chancellor of the Exchequer, 13 February 1929.

³⁶⁸ Treasury Papers, T.172/2095. Note from the Chancellor of the Exchequer to F. Leith-Ross, 3 March 1929.

and counter the Liberal public-works proposals were being done by a *team* which included Phillips, Upcott, Hurst, Grigg and Leith-Ross. The team was overseen by the Controller of Finance, Sir Richard Hopkins. Even before his departure for America, Hawtrey had become something of an isolated figure amongst officialdom, a lone voice in the wilderness calling for lower interest rates and the exportation of gold to raise world prices. This new, increasingly collegiate approach within the Treasury increased the danger of Hawtrey becoming an even more isolated figure on his return. First, a new-found sense of confidence amongst the team of generalists would have seriously undermined Hawtrey's position as an 'essential' economic consultant. Secondly, policies and approaches developed in his absence might well have run contrary to those suggested by his own economic model; a model to which he was invariably faithful.

At the beginning of March 1929 Lloyd George's Liberals had launched their election campaign, making the 'conquering' of unemployment the centrepiece of their electioneering strategy. Lloyd George had launched the Liberal election campaign at the Connaught Hotel on 1 March 1929 with a pledge:

If the nation entrusts the Liberal Party . . . with the responsibilities of government . . . we are ready with schemes of work which . . . will reduce the terrible figures of the workless in the course of a single year . . . enrich the nation and equip it

successfully for competing with all its rivals . . . (and) . . . not add one penny to the national or local taxation.³⁶⁹

The press derided this as the pledge of a man who knew he would never have to honour it. A few days later the full programme was outlined in the pamphlet *We Can Conquer Unemployment*; the personal commitment of Lloyd George being emphasised on the cover, which depicted Lloyd George moving on from tackling the munitions factories to tackling the dole queues. The detail was a reworking of the 'National Development' of the 'Yellow Book' which had been produced by the Liberal Party's Summer Schools.³⁷⁰ Essentially it claimed that 600,000 men could be *directly* employed for two years at a cost of £250 million; this money to be raised by a special loan which would be largely repaid through the proceeds of the work itself. The new workers would have both added their tax contributions to the overall level of taxation, and not drawn on the unemployment fund. Thus, it was claimed that the schemes could be carried out without raising tax rates.³⁷¹ Within Treasury File T. 172/2095 at the National Archives there is a copy of *We Can Conquer Unemployment*. Hand-written across the front, in block-capital letters of increasing size, are the words:

³⁶⁹ *The Times*, 2 March 1929.

³⁷⁰ *Britain's Industrial Future: being the Report of the Liberal Industrial Enquiry of 1928* (London, Ernest Benn, 1928).

³⁷¹ Liberal Party, *We Can Conquer Unemployment* (London, Liberal Party, 1929).

EXTRAVAGENCE
INFLATION
BANKRUPTCY

The block-capital writing makes the task of determining the writer difficult, but the capital letters tally closely with those of the hand of the Deputy Controller of Finance, Frederick Leith-Ross. They leave little doubt as to the attitude of the Treasury.

As Lloyd George was launching his election programme Leith-Ross from the Treasury together with the Chancellor's Principal Private Secretary, P.J.Grigg, were preparing the ground for Churchill to use his Budget speech of 16 April 1929 as a means of re-stating the principle, in the face of opposition from within his own Cabinet, that no extra employment could be created as a result of government borrowing for the purpose of public works. Behind the confident Treasury facade, however, there were some shreds of doubt. In a hand-written note from Leith-Ross to Grigg, Leith-Ross mused over the fact that there 'just might be possibilities' of creating unemployment in the distressed industries by either loans or taxation – and maybe wishing he had paid a little more attention to one of Hawtrey's long memoranda. Generally, Leith-Ross continued to equate credit-expansion with inflation.

I suppose taxation must (a) abstract money which would otherwise be saved and invested, in which case the anti-loan arguments apply exactly or (b) cause abstention from expenditure – which would presumably have given employment in some form but most likely only in those trades, e.g. luxury goods, where there is little unemployment. . . . On the other hand . . . it would possibly be that the net employment effect of the transfer would be nil. Indeed, I have a clear recollection that Hawtrey has published a tract proving that relief works in general effect no increase in unemployment [sic] unless it produces inflation, which of itself adds to employment without the machinery of relief works. . . . I can't see my way through to the second order effects but perhaps Hawtrey clears up all these points.³⁷²

Churchill's P.P.S. had fewer doubts. On 2 March 1929, Grigg wrote to the Chancellor, again invoking the name of Hawtrey as guarantor of the soundness of the anti-relief work argument.

. . . I am increasingly coming to the view that the argument is unimpeachable. As I told you, Hawtrey (in 1925) wrote an article (of extreme obscurity) proving that relief was an absolute delusion unless they were accompanied by an expansion of banking credit, which would relieve unemployment without any

³⁷² Treasury Papers, T.172/2095. Undated, hand-written note from F. Leith-Ross to P.J.Grigg.

intervening relief schemes. Of course he ends up saying that all we want is 'a wise regulation of credit' i.e. inflation. . . . I shall have a copy of this tract by Monday.³⁷³

The tract in question was 'Public Expenditure and the Demand for Labour', originally a talk to the Economic Club on 10 February 1925, later published as an article in *Economica*.³⁷⁴ It is probably Hawtrey's best-known piece of writing.³⁷⁵ It was not an article designed with the intention of refuting public works, and indeed, at the time of its writing, in 1925, government-sponsored works were not the contentious political issue which they were to become by the end of the decade. As such, it may not have been the most useful material for Churchill to have had to hand as he sought to see off calls for Government action. In the article, Hawtrey carefully considered the necessary conditions required before public works would be capable of providing further employment. He explored, in a manner not unlike the way he developed his theory of the trade cycle in *Good*

³⁷³ *Ibid.*, Note from P.J.Grigg to the Chancellor of the Exchequer, 2 March 1929.

³⁷⁴ R. G. Hawtrey, 'Public Expenditure and the Demand for Labour', *Economica*, 5(1925), 38-48.

³⁷⁵ In terms of economic theory it may be open to dispute as to which was Hawtrey's 'best-known' piece of writing. However, with regard to economic policy Hawtrey believed the early version of the 'Treasury View' to be *his* view, and that view, within the Treasury, was understood to be based upon his 1925 essay 'Public expenditure and the demand for labour'. It is for this reason that the article has received more attention than any of his others.

and Bad Trade, the implications of borrowing in order to finance public enterprises, with a series of restricting conditions gradually lifted.

Hawtrey first limited the problem by assuming no additional creation of bank credit and no complicating foreign investments. Under such conditions, he argued, any sum borrowed by the government must be genuine savings and come out of the consumers' income. If it were withdrawn from consumers' cash balances then, unless habits changed, those cash balances would be restored, out of consumers' future income. Such diversion into the hands of Government would reduce, by an equal amount, the effective demand for consumer products and other investment products.

Here then is a shrinkage in the consumers' outlay equal to the new Government expenditure. But it must not be supposed to be self-evident that this shrinkage cancels the effect of the new expenditure of the Government and leaves the volume of employment unchanged. The question turns out to be a very subtle and elusive one.³⁷⁶

The subtlety turned on the public's desire for cash (or bank) balances, and the effect of public works on the velocity of circulation of money. Newly employed people would wish to build up cash-balances, which in the absence of credit (new money) would be at the expense of the cash balances of those in work.

³⁷⁶ *Ibid.*, 41.

Given the absence of new money, any individual who tried to restore his cash balance to its original level would do so at the expense of his neighbour, but overall individual cash balances would be lower and people, in general, with lower quantities of money available, would tend to reduce their outlays. But Hawtrey then asked the rhetorical question:

. . . is not this to take the old narrow rigid view of the quantity theory, and to disregard the fact that the ratio of consumers' income to the unspent margin may and frequently does vary?³⁷⁷

Hawtrey was putting forward the suggestion that increased economic activity might increase the velocity of circulation of money; in this way, the same overall stock of money might be capable of supporting a higher level of activity. This could happen if consumers were content to maintain their previous outlay from smaller balances. Hawtrey's (extremely convoluted) answer to this was that whilst increased trade activity, with prospects of profits, *did* increase the rapidity of circulation, there would be, 'except in cases of marked distrust of the currency', no tendency for cash-balances to be run down to release the money to *start* the expansion of trade which would increase the velocity of circulation.

He made one concession.

³⁷⁷ *Ibid.*, 42.

In a period of depression the rapidity of circulation is low, because people cannot find profitable outlets for their surplus funds and they accumulate idle balances. If the Government comes forward with an attractive gilt-edged loan, it may raise money, not merely by taking the place of other possible capital issues, but by securing money that would otherwise have remained idle in balances.³⁷⁸

In passing, it is worth noting that this seems to have been one the earliest references to 'idle balances', a concept of great importance to Keynes as he based the theoretical section of his *Treatise on Money* on 'idle balances' causing the divergence between savings and investments. To Hawtrey, at this stage of his argument, 'public expenditure [could] only give additional employment if it [increased] the rapidity of circulation of money', and it could only do this in the exceptional case described.

With Hawtrey's removal of the restriction against bank credit, the government could finance its operations without any diminution of the consumers' cash-balances.

If the new works are financed by the creation of bank credits, they *will* give additional employment.³⁷⁹

³⁷⁸ *Ibid.*, 43.

³⁷⁹ *Ibid.*, 43.

However, to Hawtrey, the key to creating employment was not the public works, but the creation of credit.

Is the case then proved? Not quite. What has been shown is that expenditure on public works, if accompanied by a creation of credit, will give employment. But then the same reasoning shows that a creation of credit unaccompanied by any expenditure on public works would be equally effective in giving employment.

The public works are merely a piece of ritual, convenient to people who want to be able to say that they are doing something, but otherwise irrelevant.³⁸⁰

Hawtrey acknowledged, once again, that exceptional circumstances might arise when the prospect of profit was so poor that no Bank rate, however low, might tempt businesses to borrow for investment. Even so, he thought that if low Bank rate were reinforced by the purchase of securities by central banks to create liquidity, it would be 'possible to find an escape from any depression, however severe'.³⁸¹

Finally, Government borrowing for public works, if the interest offered were sufficiently attractive, would divert part of the consumers' outlay on investment products away from foreign investment. From this would flow a chain of events

³⁸⁰ *Ibid.*, 44.

³⁸¹ *Ibid.*, 45.

linked by the need to maintain a stable balance of payments and stable gold reserves.

Foreign investment entailed an outflow of gold to pay for the investment. An attractive Government issue would curtail this outflow, and the resulting build-up of the reserves of gold would need to be reduced. This would be done by importing capital.

In order that people may buy more [imports] there must be an increase in the purchasing power of the consumers' outlay. Either the consumers' outlay must increase in terms of the currency unit, or the value of the currency unit in the foreign exchange market must rise. If there is a gold standard in operation, the exchange value of the currency is fixed. It follows that the consumers' outlay must increase: there must be a monetary expansion, and that means increased employment.³⁸²

By *monetary expansion* Hawtrey meant a relaxation of credit. Thus he came to what seems to be an anomalous conclusion: that the extent of the upward credit adjustment which provided for extra employment was measured by the increased imports necessary to maintain the balance of payments. He saw one 'fundamental flaw' in the mitigation of unemployment in this way. One country could only undertake the exercise at the expense of another, and where there existed groups of countries with a common monetary standard, the problem of

³⁸² *Ibid.*, 46.

unemployment became an international one. In this respect he likened the extension of credit through public works to an import tariff.

Hawtrey concluded that public works financed by borrowing would lead to an expansion of credit, and hence employment, but public works were not, under all but the most extreme circumstances, necessary for the expansion of credit. Under nearly all circumstances, Hawtrey held, low Bank rate supplemented by central bank purchases of securities, would supply the liquidity, and the incentive, for credit expansion.

I doubt whether Churchill felt any great increase in confidence at the prospect of having to face the Commons after having read Hawtrey's tract. Technical arguments relating levels of cash deposits with the velocity of circulation of money, and the importation of capital from abroad stimulating domestic credit expansion would not have provided him with the armour to stave off parliamentary demands for increased government spending on public works.

But, with the Chancellor in possession of Hawtrey's tract, Leith-Ross took charge of preparing Churchill for his Budget speech, hoping to prime his man in the way that Niemeyer had primed him prior to the return to the Gold Standard in 1925. Again, the preparation took place without Hawtrey's presence. The outcome of Leith-Ross's work was Churchill's budget speech of 16 April 1929 in which he gave the most famous public statement of the 'Treasury View', that in the process of borrowing for public works the Government competed for available funds with private industry and thereby raised 'the rent of money to all

who have need of it', and that prior experience of attempting to cure unemployment by such means had been so disappointing 'as to lend considerable colour to the orthodox treasury doctrine which has been steadfastly held that, whatever might be the political or social advantages, very little additional employment and no permanent employment can in fact and as a general rule be created by State borrowing and State expenditure'.³⁸³

Whilst the Treasury and the Government worked to undermine the validity of the Liberal proposals, there were others – people with influence – who were prepared to take the Liberal pamphlet more seriously. Beaverbrook, for one, was prepared to endorse the Liberal message.

Economists, men of affairs, industrial leaders and successful businessmen have all agreed that . . . this is no unworkable dream, or crazy-quilt policy of a party with no chance in office. It will succeed.³⁸⁴

There was support from other newspapers, but a measure of academic respectability was added to this support by Keynes and Hubert Henderson. On 10 May 1929 they published a pamphlet – *Can Lloyd George Do It?* Their answer, of course, was a resounding 'Yes'.

³⁸³ House of Commons Debates, Vol. 227, 1928-29. Columns 53-4.

³⁸⁴ *Daily Express*, 25 March 1929.

Can Lloyd George Do It? was, in part, a serious document intended to explain the economics of the interventionist position, and partly a satire on Treasury arguments. The introductory section of the document pointed out that £500 million had been paid out in unemployment benefits between 1921 and 1929 – with absolutely no return. Had this sum, they argued, been paid in wages to construction workers then not only would ‘a million’ houses have been built, but many workers would have been saved from the indignity of the dole, profits would have accrued to the manufacturers of building materials, and increased tax revenue, both from wages and business profits, would have been returned to the Exchequer.³⁸⁵

At the end of May 1929 Hawtrey returned from his stint at Harvard and his colleagues at the Treasury were able to consult him directly rather than having to delve into their archives for his somewhat dated articles. On 13 June 1929 Hawtrey produced his memorandum on ‘The Liberal Unemployment Plan’.³⁸⁶ It concentrated upon, and developed, the section of his *Economica* article of 1925 relating to increasing home investment at the expense of foreign investment. The memorandum used a numerical example in which Hawtrey assumed certain values for economic output.

³⁸⁵ J.M.Keynes and H.Henderson, *Can Lloyd George Do It?* (London, 1929)

³⁸⁶ Treasury Papers, T.175/26. The Hopkins Papers. ‘The Liberal Employment Plan’ by R.G.Hawtrey, 13 June 1929.

Hawtrey's figures bore a fair approximation to Feinstein's retrospective estimates for 1929, and Feinstein's figures have been shown to be close to the one official estimate made for 1923-24.

The annual publication, *Reports of the Commissioners of Inland Revenue*, had been first published in 1857, and used by scholars (such as Bowley, Clarke and Feinstein) to estimate National Income. In 1904 Bowley had encouraged the Inland Revenue to use its vast resource of information to make its own estimate of National Income. It was reluctant to do this because it viewed its principal role as that of maximising its own income with a minimum of inconvenience. But in 1929 it undertook an experimental exercise in the estimation of not only the National Income, but also other key economic data.³⁸⁷

It took its definition of National Income from Marshall; a definition which excluded both earnings accruing to foreigners, and foreign earnings, by British nationals, from the totals. The exercise was to determine National Income for the financial year 1923-4. It also estimated National Production and the fluctuation in National saving (its estimate for saving was that in 1925-26 the nation was saving 14 per cent of income). It also made estimates for the distribution of income size and the distribution of production by different trade groups. Its estimates for National Income tended to be slightly lower than the unofficial estimates by Bowley and Stamp who had been working from more limited information.

³⁸⁷ J.R.N.Stone, *Inland Revenue Report on National Income* (Cambridge, University of Cambridge Department of Applied Economics, 1977).

Hawtrey approved of the exercise and suggested that it should become a permanent one. Unfortunately the importance of statistics as a means of guiding economic policy was not fully recognised at the time, and the exercise was not to be repeated until 1941; during which time reliance continued to be placed upon the unofficial statistics calculated by Bowley, Stamp and Colin Clark.

Scholarly estimates and the Inland Revenue exercise were directed towards calculating *National Income*, whereas Hawtrey's calculations were based upon assumptions of *National Output*. In a closed system, with no international considerations, National Output and National Income would be identical since the total money value of output would be equal to the sum of all incomes received through wages, rent, dividends, interest and profits (with the possibility of losses acting as a negative factor). This identity would be distorted by part of National Income being received from dividends from overseas production, and part of the profits from home production being transferred abroad. Customs and exercise figures for international earnings would have been able to accurately calculate the value of National Output from that of National Income.

With his assumptions for National Output in place, Hawtrey set out a numerical calculation which, as so often in his memoranda, saw him in the role of the pedagogue tutoring his generalist colleagues.³⁸⁸

³⁸⁸ At the root of Hawtrey's system was the belief that production and employment could only expand if credit could be expanded to both pay wages prior to the sale of products, and enable dealers to increase the levels of their stocks. The Liberal plan to finance public works through Government spending would normally have been interpreted as a fiscal measure. Hawtrey's response was to turn the plan into a device for creating an

Hawtrey's numerical example will be worked through at some length here, rather than merely its results being summarised. This is for illustrative purposes. It is given as an example of the way in which Hawtrey, in many of his memoranda, set up a hypothetical situation, using figures which approximated to the real situation, and then worked through the figures to a conclusion which supported his recommendations. This memorandum contained a number of terms which were peculiar to Hawtrey's economic analysis and will need explanation as the memorandum is broken down and its argument worked through. I have tried to shorten, simplify, and clarify Hawtrey's numerical example without in any way misrepresenting his argument. His numerical example contained at least one numerical slip, and a number of questionable assumptions.

Hawtrey commenced by assuming a total national income of £4,000 million – broken down as follows (to produce table A):

<u>A</u>	
From production of home trade products	£1,700 million
From production of foreign trade products	£2,000 million
From foreign investments	£ 300 million

extension of credit via potential changes in foreign exchanges. In this respect he can be seen to have been tutoring his generalist colleagues on the, to him, all important role of credit creation.

He also assumed the figure of £150 million as the amount of capital exported abroad per year and proceeded to give the following set of figures for what he simply called 'consumption'. He did not explain how he arrived at the figures in the following table, but it would seem that he assumed a state of equilibrium in the holding of gold reserves and the balance of payments. Income from foreign investments (£300 million) involved the import of gold, whilst the exportation of capital abroad for investment purposes (£150 million) involved export of gold. Thus if income from foreign investment earnings exceeding capital exported abroad by £150 million, then Hawtrey would have required, for the maintenance of equilibrium, a further annual loss of £150 million of gold. This could be accounted for by imports exceeding exports to the tune of this value – i.e. the national consumption of foreign-trade goods exceeded home production of foreign-trade goods by £150 million. Giving -

	<u>B</u>
Consumption of home trade products	£1,700 million
Consumption of foreign trade products	£2,150 million
Total consumption	£3,850 million

[When £150 million of net foreign investment income is added to this figure it sums to the National Income]

The idea of 'foreign trade products' is a concept used by Hawtrey in his economic analysis. It means the type of product which is exportable or

importable. As such its price will, to a large degree, be determined by world prices rather than local supply and demand. A cotton sheet would seem a suitable example. By contrast a haircut can not easily be exported or imported; its price will be set by local supply and demand and Hawtrey would regard this as one of his 'home trade products'. The distinction is not a simple division between manufactured goods and service goods, but it could well tend to run along these lines.

Hawtrey then rehearsed the two broad alternative ways of improving employment; firstly, by reducing prices and wages. Reducing prices would have enabled Britain's home-produced foreign trade products to be more competitive in world markets with resultant increase in output and employment. Lower wages were a necessary concomitant. The second way was by increasing the money value output of products for a given level of wages – with increased profits encouraging employers to take on additional labour.

Since there was no way of effecting an 'overnight' and simultaneous reduction of prices and wages, and the alternative ways of bringing this state of affairs about had been shown to be too unpalatable, then increasing the money value of output – implying an increase in demand – was the only realistic option.

Hawtrey then suggested that the Liberal plan, if it could successfully raise a loan of £125 million per year, might cause foreign investment to be reduced by an equal amount – from £150 million to £25 million. The consequences of that would be as follows:

i) The balance of payments would be disturbed and gold would be imported to the extent of £125 per year.

ii) To restore equilibrium, using the addition to the gold stocks, credit should be expanded sufficiently to attract additional imports of £125 million per year – thereby balancing the fall in external investment.

Extra imports of £125 million could only be absorbed if the national income rose. Hawtrey then addressed the question of the extent to which national income must rise to absorb an extra £125 to million imports.

He started by supposing that every £100 million added to the national income (an increase of 2.5 per cent. on £4,000 million) would be applied to purchases in proportions according to the figures in table B, i.e. each increase amounts to 2.5 per cent of each figure in that table -

	<u>C</u>
to home trade products	£42.5 million
to foreign trade products	£53 .75 million
to external investment	£ 3.75 million

At this point Hawtrey ran up against the problem of not knowing what proportion of any increased consumption of foreign trade products would be

satisfied by imports and what proportion by home-produced foreign trade products. As he pointed out:

Increased British consumption of importable agricultural products is likely to be satisfied almost entirely by additional imports. Increased British consumption of cotton goods is likely to be a negligible factor in the activity of Lancashire. On the other hand increased consumption of coal will take effect almost wholly in increased activity of the British mines. Increased consumption of iron and steel and engineering products . . . would go mainly to British production.³⁸⁹

Hawtrey then made an assumption, that one-fourth of the increased consumption of foreign trade products would be satisfied by increased British production, and therefore three-quarters of any increase in the consumption of foreign trade products was satisfied by increases in imports. Accordingly, his previous breakdown of the sources of the increase in national income was subdivided further:

Application of increased income:

D

to home trade products

£42.5 million

³⁸⁹ *Ibid.*

to foreign trade products produced at home	£13.5 million
to foreign trade products produced abroad	£40.25 million
to external investment	£3.75 million

Taking the increase in 'imports' together with 'external investment' as the 'gold exporting items' on this list, Hawtrey thus calculated that an increase in national income of £100 million per year would lead to increased annual exportation of gold amounting to £44 million. This proposition could be reversed to say that in order to increase gold exports by £44 million then an increase in national income of £100 million was required. But, the Liberal plan envisaged transferring £125 million from external to internal investment, producing an equal net importation of gold, and requiring, by way of equilibrating compensation, increased imports of £125 million. This would require an increase in national income (in £m.) of $100 \times 125/44$, or £284 million.

Allowing for the fact that diversion of £125 million from foreign investment would, in itself, increase national income by that amount, a further increase in national income of £159 million would be needed to balance the external payments. This would have to be from the production of home trade products and foreign trade products produced at home. Using the figures in table C, which are based upon an increased national income of £100 million, the corresponding figures for an increase of £159 million from trade would be £121

million from home trade products and £38 million from foreign trade products produced at home.³⁹⁰

The conclusion to be derived from this numerical example was that if a loan for £125 million could be successfully launched, then it might induce sufficient extension of credit to increase the national income by £159 million (this figure is roughly £4 per person in Britain). More importantly, by far the greatest boost to trade activity would be to that to home trade products, and not to the foreign trade products of the depressed regions.

Acknowledging the fact that that he had attempted to simplify his calculations by basing them on the assumption that the whole of the £125 millions of capital raised would be by diversion of *investible* savings (i.e. the diversion of monies already earmarked for investment in other ways) , Hawtrey admitted that they might need to be modified in two respects: firstly that part of the funds could be diverted from money previously spent on unemployment benefit, and secondly that investment schemes might entice holders of cash, cash which might otherwise have been held idle, to invest that cash.

As regards the first consideration:

³⁹⁰ Hawtrey did not explain it in this way in his memorandum, but it is the only way I can make sense of the figures he produced. Additionally, it appears that he made an arithmetical slip at this stage in his calculations, resulting in him calculating the increase required from home manufactured foreign trade products to be only £35 million. For further notes on the slip see Peden, *Keynes and his Critics*, p. 91.

. . . the figures . . . may be put at 30 millions. That means . . . the amount of employment given is greater by the employing power of 30 millions, but on the other hand, the effect on the balance of payments is 30 millions *less*. In fact . . . (given the diminished need to increase national income as a means of drawing in compensating imports) . . . net effect may be small.³⁹¹

As regards drawing 'idle' money into investment schemes, Hawtrey regarded the support of Keynes and Henderson for the Liberal scheme as 'extremely obscure' and confusing. In particular, he regarded the mobilisation of idle balances as an increase in the velocity of circulation of money which would have inflationary consequences leading to loss of gold and the restriction of credit.

Given that Hawtrey saw neither diversion of unemployment benefit nor mobilisation of idle savings as means of reducing the export of capital and enhancing the nation's gold, he dismissed these as a sources of finance.

It is in fact a blunder to advocate, as Messrs. Keynes and Henderson do, the provision of funds for the scheme in any other way than by drawing on the investible savings of the community out of income. Its foundation is the diversion of capital resources from external to internal investment. . . . the one and only obstacle to remedying unemployment by an expansion of credit is the loss of gold that would ensue. Were

³⁹¹ Treasury Papers, T.175/26. The Hopkins Papers. 'The Liberal Employment Plan' by R.G.Hawtrey, 13 June 1929.

this loss of gold made good by borrowing abroad and taking the proceeds either in gold or in foreign exchange, the threat to the gold standard would be avoided.³⁹²

Thus Hawtrey saw the Liberal unemployment plan as a means of boosting the gold reserves by diverting foreign investment to home investment, but he thought that an even better solution would be to borrow directly from abroad. The enhanced gold reserves would permit the monetary authorities to expand credit and increase employment and the national income. The amount by which the increase in the national income could be permitted was calculable by the extra imports which would be required to restore the country's balance of payments – in short it was 'nothing more than a very elaborate and roundabout alternative to raising loans abroad for the strengthening of our gold reserves'.³⁹³

If the loss of gold were made good by borrowing from abroad then it would, Hawtrey acknowledged, lead to a burden of external indebtedness, but set against this there would be no need to reign back on investment abroad and the benefits, in terms of foreign earnings and enhanced export opportunities, brought about by that activity. The borrowing from abroad could be more easily controlled and limited to that which was strictly necessary, whereas an elaborate programme of development works involved heavy commitments which could not be easily or quickly curtailed. Finally, as Hawtrey pointed out, as part of the

³⁹² *Ibid.*

³⁹³ *Ibid.*

Liberal plan, Keynes advocated *dear* money in London as a means of attracting investment which would otherwise have gone abroad. This would have tended to suppress trade whereas, by borrowing:

. . . we *start* with a credit expansion through a reduction in bank rate and a general tendency to activity all over that world, and so far as international markets are concerned the greatest share of this activity will be secured by those producers who are most seriously under-employed.³⁹⁴

Having indicated, in his memorandum on the Liberal unemployment plan, that he regarded it as merely a 'roundabout' way of raising loans from abroad in order to bolster the gold reserves, in which case, in his opinion, the matter would be better done directly, some two weeks later, on 29 June 1929, Hawtrey produced an alternative scheme which did not involve foreign borrowing.³⁹⁵

By way of introduction Hawtrey explained how the act of borrowing from abroad would have the same effect as the borrowing during the Great War which enabled Britain to nominally remain on the Gold Standard. The adverse trade balance was countered by the device of making good the gap in the balance of payments by the proceeds of loans raised in America. But under the conditions of 1929 he felt the Americans, who were best placed to make the loan, might

³⁹⁴ *Ibid.*

³⁹⁵ Treasury Papers, T175/26. 'Debt Policy and Unemployment' by R.G.Hawtrey, 29 June 1929.

oppose a scheme embarked upon for the purpose of relaxing credit in Europe. Hawtrey was concerned America might fear that easy money in Europe 'would tend to infect the American money market and encourage the stock market speculation which (had) been causing them so much uneasiness'.³⁹⁶ There were other concerns regarding the respective levels of interest rates and the existing British policy on taxation of foreign loans which reduced the attraction of this particular option.

Hawtrey began to outline his strategy, explaining that it would involve diverting some of the £149 million of capital exported abroad to home investment.

If a portion . . . (of capital currently being invested abroad) . . . were drawn from the market by the issue of a sterling loan in London and applied in some other way than external investment, the effect on the balance of payments would be just the same as if the export of capital had gone on unabated, and the same sum had been borrowed abroad.³⁹⁷

In the margin of the memorandum there are a number of queries pencilled in by Hopkins. The word 'if' has been doubly underlined by him. However, Hawtrey then went on to explain how the development plans of Keynes and the Liberals were devices for preventing the proceeds of such loans from being used abroad.

³⁹⁶ *Ibid.*

³⁹⁷ *Ibid.*

But Hawtrey felt that there was another, possibly more effective, way of achieving the same result.

Suppose that the British Government issues a loan on the London market and applies the proceeds to paying off Treasury Bills. The loan will presumably absorb investible savings, and since the export of capital practically represents the surplus of savings after meeting the requirements for capital outlay at home, the savings subscribed for the loan may be regarded as diverted from external investment.³⁹⁸

The paragraph above was heavily marked, underlined and question-marked by Hopkins. Hawtrey went on to explain his reasoning behind a move which senior Treasury officials, judging by the copious marginal pencil markings, must have seemed somewhat bizarre. His principal point was that the issue and paying off of Treasury Bills was a transaction within the sphere of banking rather than within the sphere of investment.³⁹⁹ The rate of issue of Treasury Bills had been increasing and providing significant profits for the commercial banks. If, he suggested, the supply of these bills were mopped up – creating a ‘bill famine’ – the banks would have to seek alternative short term investments for their profits

³⁹⁸ *Ibid.*

³⁹⁹ Treasury Bills are instruments by which the government covers temporary short-term deficiencies in its funds. They are promissory notes with the government promising to pay the bearer a fixed sum 91 days from the date of issue. The banks are invited to tender for these on a weekly basis. The tenders will be below the face value of the bills by an amount dependent upon prevailing rates of interest.

in the form of advances to traders. Presumably, Hawtrey thought that the banks would have to lower their interest rates in order to encourage traders to take on loans. By this process the government would have applied the resources diverted from external investment, through bank loans to traders, to increased orders to manufacturers - thus providing additional working capital for trade and industry.

Adjacent to the paragraph in which Hawtrey suggested that the banks, in search of profit, would have to transfer funds to loans to traders, Leith Ross has pencilled the comment 'or loans abroad?'. Hawtrey did then go on to concede that some advances would inevitably be made 'to merchants (British or Foreign) engaged in international trade, and will be used by them to buy goods from producers abroad'.⁴⁰⁰ However, he did not regard this as a deficiency in the scheme. Quite the reverse, in fact; since loans at low interest rates were essential for reviving international as well as national trade.

By itself an expansion of the national income, through improving employment in the production of home trade products, can do little to stimulate British production of foreign trade products, whether exportable or importable. The trouble of the past four years has been a heavy fall in world prices in terms of gold. . . . London is the centre of the world credit market and conditions there affect trade everywhere else. The high bank rate which

⁴⁰⁰ Treasury Papers, T175/26. 'Debt Policy and Unemployment' by R.G.Hawtrey, 29 June 1929.

has prevailed since February 1925 has depressed our export industries because it has depressed world markets funding of Treasury bills stimulates short term lending to international traders . . .⁴⁰¹

Secondly, with regard to the refunding of Treasury bills leading to foreign investment, Hawtrey cast doubts on the wisdom of the Bank of England's 'unceasing endeavour to attract foreign balances for temporary investment in London', since this had been the 'one justification . . . for the high Bank rate'.⁴⁰² These short-term foreign balances, in that they could be withdrawn at short notice, were an embarrassment rather than an advantage, acting as *negative* hidden gold reserves, and causing the monetary authorities the problem of getting rid of them without their being withdrawn in gold. The paragraph pointing out this problem is endorsed with a tick and triple marking by Hopkins who nevertheless, like the writer of this thesis, seemed somewhat perplexed by Hawtrey's explanation of the mechanism by which this might be achieved:

In so far as a plan for funding Treasury bills fails to affect the balance of payments that will be because London is coming into the market as a short-term lender. The balances will be in effect to that extent got rid of without a loss of gold, and our

⁴⁰¹ *Ibid.*

⁴⁰² *Ibid.*

underlying reserve position will be strengthened by the dissipation of our “negative gold reserve”.⁴⁰³

Hawtrey suggested that measures should be taken, such as there being no due date of repayment, which would encourage the public, rather than the banks, to purchase the new stock, fearing the banks might use the new issue as substitute for Treasury bills. He concluded a lengthy memorandum by conceding that the main practical objection against such a scheme would be that, at the time, the gilt-edged market was not very favourable and would require ‘substantial price concessions’. Leith-Ross doubly marked, ticked, and wrote the word ‘Yes’ against this point. On 15 July 1929 Hawtrey distributed a second memorandum giving a more detailed strategy for the implementation of his scheme for withdrawing Treasury bills.⁴⁰⁴ The marginal comments continued to show the Treasury’s scepticism.

The Treasury passed Hawtrey’s scheme on to the Bank of England for comment. They hardly treated it with any sense of urgency for it was not until 2 October 1929 that Sir Otto Niemeyer replied on behalf of the Bank. Niemeyer was totally unsupportive. His principal concern regarding Hawtrey’s scheme was the high rate that might be needed to compete with the attractions of foreign

⁴⁰³ *Ibid.*

⁴⁰⁴ Treasury Papers T175/26. ‘Debt Policy and Unemployment II’ by R.G.Hawtrey, 15 July 1929.

investment. In making his point he took a sideswipe at the Keynesian alternative.

Hawtrey's plan assumes the existence of "genuine savings not created by Bank credit" which can be attracted to his funding loan to repay Treasury Bills. He does not indicate clearly where these savings are but they are presumably those now going into foreign issues. If so, they can only be diverted by a sufficiently high rate of interest to compete with foreign attractions. In other words, we must have (a) a high bank rate and (b) a high yielding Government issue, say 5.5 per cent. or 6 per cent. that will depress all existing Government municipal and commercial stocks and is a curious method of facilitating development works. Indeed Hawtrey's thesis is contrary to the whole development work plan (and may be in so far right).⁴⁰⁵

Niemeyer doubted whether the banks receipts from the funding of their bills would be used as advances to traders, 'many of them could not show prospective profits', with the New York stock exchange being the more likely destination for these funds. He went on to deplore the way in which the Treasury had allowed the issue of bills to expand and had allowed 'the sinking funds to be filched', suggesting that what the Treasury should really be doing was to increase the sinking fund out of taxation and so forcing 'an increase not

⁴⁰⁵ Treasury Papers, T175/26. Response by Sir Otto Niemeyer on behalf of the Bank of England to R.G.Hawtrey's 'Debt Policy and Unemployment Scheme', 2 October 1929.

in "consumers' income" but in "consumers' saving".⁴⁰⁶ He ended up with further swipes at Hawtrey:

He has some other very odd ideas, e.g.

(1) "With a gold standard . . . it is impossible . . . for increased consumption of imports . . . to occasion an adverse balance of payments"!

(2) "Export of capital practically represents the surplus of savings after meeting the requirements for capital outlay at home"!!

. . . he is on firmer ground in deploring the fall of world prices: but how he can believe that the Bank of England can control that, I cannot conceive.⁴⁰⁷

The essential point of Hawtrey's criticisms of monetary policy over the previous four years had been that the world-wide clamour for gold, which as extremely influential agent the Bank of England had taken part in, was entirely responsible for the collapse of world prices. However, lacking support from both the Bank and the Treasury, Hawtrey's scheme for Debt Repayment made no further progress.

⁴⁰⁶ *Ibid.*

⁴⁰⁷ *Ibid.*

Chapter 5

The Treasury before the Macmillan Committee

1930

Philip Snowden would 'no more have dreamt of budgeting for a deficit than of going into a public house'.⁴⁰⁸ ⁴⁰⁹ The words 'credit' and 'debt' would not have rested easily with his puritanical Keighley upbringing. Yet it was Chancellor Snowden who, at the end of his speech to the Labour Party's Brighton Conference of 1929, announced that he intended to institute a thorough investigation into 'all aspects of banking, financial and credit policy, particularly to find out what . . . are the effects of present policy upon industry, and to put forward suggestions for (improvement)'.⁴¹⁰

He almost certainly did so reluctantly, feeling it was unnecessary to go beyond the strict economic orthodoxy and probity of sound Victorian economics. But, on

⁴⁰⁸ Taylor, *English History 1914-45*, p. 33.

⁴⁰⁹ In the context of this quotation, Professor Keith Laybourn has reminded me that, in 1915, and motivated by his dislike of alcoholic drink, Snowden accepted Lloyd-George's offer of a seat on the Central Control Board (Liquor Traffic). The purpose of this body was to prevent alcohol consumption from impairing the war effort. He had previously been a member of the Samuelson Commission which had recommended state control of breweries and licensed premises. These recommendations were rejected, but licensed premises in Carlisle were controlled with the intention of curtailing the drinking of munitions workers who were resident in Carlisle but worked at Gretna. The curtailing regulations were no match for the ingenuity of the Carlisle workers.

⁴¹⁰ S.Howson and D.Winch, *The Economic Advisory Council 1930-39: A Study in Economic Advice During Depression and Recovery*, (Cambridge, C.U.P., 1977). P.26.

20 September 1929, Bank Rate had risen to six and a half per cent in order to stem an outflow of funds. Ernest Bevin used his platform at the Brighton Conference to denounce the move, maintaining that every 'one per cent on the Bank Rate means a quarter of a million increase in unemployment in six months'.⁴¹¹ Painted into a corner by Bevin, Snowden announced the formation of the committee of inquiry; probably hoping that the arguments for 'sound' finance would prevail. In a later memorandum he was to explain that he instituted the committee 'largely because of the impression made on public opinion by Mr. Keynes's proposals on these points as enumerated in the Liberal Yellow Book before the last election'.⁴¹² Generally, the authorities were nervous about the outcome of the committee of inquiry – 'Is there not some danger of giving the impression that the Governor is being put in the dock?' the Chancellor's Private Secretary, Grigg, confided to his master.⁴¹³

The Macmillan Committee, under the chairmanship of a barrister who specialized in public law, consisted of academic economists as well as representatives from the central bank, the clearing banks, trade unions, industry and commerce. The Treasury was represented in the form of Lord Bradbury, former Joint Permanent Secretary, whilst the Deputy Controller of Finance, Frederick Leith-Ross, attended all meetings on behalf of the Treasury as an

⁴¹¹ *Ibid.*

⁴¹² Treasury Papers, T 175/26. Snowden memorandum (drafted by Treasury Controller of Finance, Sir Richard Hopkins) 8 April 1930.

⁴¹³ Treasury Papers T 160/46. Letter from Grigg to Snowden, 11 October 1929.

observer. The three anti-establishment figures were Keynes, Ernest Bevin, and Asquith's one-time Chancellor, now serving as Chairman of the Midland Bank, Reginald McKenna. This trio was to form a powerful axis of discontent.

An early casualty of the hearings was the Governor of the Bank of England, Montagu Norman. Norman's evidence, on behalf of the Bank, had been penciled in for 28 November 1929. The prospect must have been too much for him. On 26 November 1929 he reported himself too unwell to attend the committee hearing, sending his deputy, Sir Ernest Harvey, while he went on a recuperative Mediterranean cruise. Over the next five days Harvey gave a competent account of the Bank of England's functions. He was not subjected to any searching questions; those awaited a recuperated Governor. In the intervening time Keynes took the opportunity to extend the economic education of the committee by a series of five private meetings of the members between 20 February 1930 and 7 March 1930.

Two weeks of the Macmillan Committee's time were taken by Keynes as he, in effect, explained his Treatise to the committee members. The two weeks were to change much of the tone of the remaining proceedings.

Keynes's argument was, that in a closed system, it was relatively easy for a single instrument, Bank Rate, to maintain equilibrium between savings and investment. Lowering of Bank Rate discouraged excessive savings whilst encouraging businesses to borrow for investment – and vice versa. But the same instrument, within an international context, had to also maintain the

equilibrium between foreign earnings and foreign investment: raising interest rates to keep money at home when the attraction of foreign investments was in danger of causing too large an outflow of funds. External and internal functions were often incompatible. Moreover, in the process of both returning to, and maintaining the gold standard, a high Bank Rate had been allotted the task of reducing British costs to competitive levels without sufficient understanding of the mechanism by which high rates would bring about lower wages.

By requiring Bank Rate to perform a multiplicity of tasks it had lost the ability to maintain savings and investment in equilibrium. In this way Keynes introduced his committee colleagues to the most distinctive feature of his *Treatise*, the distinction between savings and investment. Saving, or refraining from consumption, had been regarded as the first pre-requisite before investment could take place. Keynes was at pains to point out that saving and investment were different activities carried out by different sets of people and there could be a serious imbalance between the two. Under the conditions necessary to maintain the gold standard, high interest rates were attracting savings whilst discouraging entrepreneurs to invest.

With high rates discouraging investment – but, he believed, unavoidable if the Gold Standard were to be maintained - Keynes outlined seven measures which carried the potential for increasing investment and stimulating trade. Devaluation, simultaneous reduction of all domestic incomes, taxation to support exporting industries, rationalisation to increase efficiency, import tariffs to allow

domestic prices to rise, investment by the Government in public works, concerted action by central banks to bring down rates. To Keynes, each proposal had some merit, but he left his colleagues in no doubt that investment in public works was his favourite remedy.

Keynes's last 'tutorial' with the Macmillan Committee was on 7 March 1930. Just over a month later, on 10 and 11 April, 1930, Hawtrey appeared as a witness, not as the Treasury's Director of Financial Enquiries, but in a personal capacity as an economist. Nevertheless, it was an opportunity for the Committee to scrutinize the source of the economic justification for the 'Treasury View'. Speaking to Alec Cairncross, in 1966, Hawtrey referred to his status before the committee as an independent economist rather than a Treasury employee and said that he 'felt on safe grounds talking about economic theory, but not policy'.⁴¹⁴ Hawtrey also submitted three documents to the committee: 'Mr. Keynes's Treatise on Money', 'International Short Term Investment', and 'Remedies for Unemployment'.⁴¹⁵ In addition, after being invited to appear before the committee, Hawtrey was sent a transcript of Keynes's testimony from which he prepared a memorandum for Treasury consumption, 'Mr. Keynes's Theory of Bank Rate'. He sent a copy of this memorandum to Keynes on 1 April 1930.

⁴¹⁴ Hawtrey Papers, HTRY 13/5. Interview with Sir Alec Cairncross, 1966.

⁴¹⁵ These three documents subsequently appeared as chapters in Hawtrey's book *The Art of Central Banking* (London, Longmans Green, 1932). References to the documents will be to the versions in which appear in this publication.

At the beginning of 1930 differences in theory between Hawtrey and Keynes were slight. Differences regarding policy were somewhat greater. Hawtrey believed that Britain was still economically strong enough, given London's worldwide influence, to unilaterally reduce interest rates and then influence world rates downwards. Keynes believed that such a policy would endanger the Gold Standard – hence his advocacy of alternative measures such as public works. There was a close affinity between the two men. Between 1925 and 1929 Hawtrey and Keynes would have met regularly at the gatherings of both the Royal Economic Society and the Royal Statistical Society. It was at a meeting of the Royal Statistical Society, as late as 17 December 1929, at which Hawtrey presented his paper 'Money and Index Numbers', that Keynes, responding to the presentation, began by making the meeting clear about his attitude towards Hawtrey:

There are very few writers on monetary subjects from whom one receives more stimulus and useful suggestion. . . and I think there are few writers on these subjects with whom I personally feel more fundamental sympathy and agreement. The paradox is that in spite of that, I nearly always disagree in detail with what he says! Yet truly and sincerely he is one of the writers who seems to me to be most nearly on the right track!⁴¹⁶

⁴¹⁶ Deutscher, *R.G.Hawtrey and the Development of Macroeconomics*, p.79.

The verbatim recordings of the Minutes of Evidence of the Macmillan Enquiry seem to indicate that Hawtrey was ill-at-ease; discussion and debate within the settings of a formal committee were not his milieu.⁴¹⁷ In contrast to his writings, where his arguments are developed at length with painstaking care, his answers to the committee were often terse and abrupt. In contrast Keynes, the consummate debater (who always made Bertrand Russell feel 'stupid' in discussion), was perfectly at home within this setting.

Hawtrey had submitted a prepared paper, 'Future Monetary Policy', with members quizzing him on it. If Keynes was the principal inquisitor then there were others, who took a keen professional interest: Reginald McKenna, former Chancellor of the Exchequer; Theodore Gregory, Professor of Banking at the London School of Economics; Ernest Bevin, General Secretary of the Transport and General Workers Union; Cecil Lubbock, director of the Bank of England; R.H.Brand, merchant banker from Lazard Brothers.

Hawtrey's written submission was a distillation of his economic analysis and its application to the trade depression. It began, unsurprisingly for Hawtrey, with a statement which carried the weight of an article of faith – that the greatest service that the credit system could render to industry was to maintain the value of the currency unit stable. Having pointed out that a stable currency avoids injustice between debtor and creditor, and also avoids distortion of the relationship between prices and wages and between wages and fixed costs,

⁴¹⁷ Macmillan Committee on Finance and Industry. Minutes of Evidence. (London, H.M.S.O., 1931), pp. 273-294.

Hawtrey then asserted that a stable currency avoids the 'evil of . . . fluctuations in business activity . . . the most serious of all the injurious consequences of monetary instability. For, here is to be found the cause of the unemployment problem.⁴¹⁸

means of payment can . . . be controlled if the creation and extinction of bank credit can be regulated. Credit is created when people borrow from banks, and extinguished when they repay. Regulation of credit is effected by encouraging or discouraging borrowers.⁴¹⁹

This was the central message of Hawtrey's written submission – that Bank Rate changes, usually enacted in order to control external flows of gold, have significant effects on the all-important consumers' outlay, with important consequences for economic activity.

Turning to the problems of the gold standard, Hawtrey outlined its workings; a credit contraction, in addition to leading to a fall in the price of home-based goods, led to a reduction of imported goods with the effect being a net inflow of gold. More importantly, for Hawtrey's analysis, the outflow of gold from foreign central banks would cause them to raise their interest rates in order to squeeze credit and restrict the increased inflow of goods from Britain.

The general principle is thus that under a gold standard the power of the Central Bank is used to impose on the country the same credit

⁴¹⁸ Macmillan Committee. Minutes of Evidence. P. 273.

⁴¹⁹ *Ibid.*

movements and the same changes of price level as occur in other gold standard countries. The fluctuations in the price level are therefore an international problem. To prevent them it is necessary to prevent fluctuations in the wealth value or purchasing power of gold in world markets.⁴²⁰

Since the wealth value of gold was largely determined by the demand for gold by central banks using it for the purpose of regulating credit, and given the tendency, under the gold standard, of international credit movements to synchronise, then, to Hawtrey, the international stabilisation of the level of credit was of paramount importance. He briefly recalled the Genoa Conference of 1922, and lamented that its recommendations to 'centralise and co-ordinate the demand for gold, and so to avoid . . . wide fluctuations in the purchasing power of gold' had never been acted on.⁴²¹

It cannot now be assumed that the generous international spirit of the Genoa conference can be revived. But we have reached a stage at which the most important countries may be regarded as having settled their gold policy for the time being. If that is so, an international agreement in regard to gold is not at present a matter of urgency. But the question of preventing cyclical or short period fluctuations of purchasing power has become more pressing than

⁴²⁰ *Ibid.*

⁴²¹ *Ibid.*, p.276.

ever. And in this respect I am inclined to suggest that no explicit international co-operation is really necessary at all.⁴²²

It was at this stage, towards the end of his formal presentation, that Hawtrey began to outline his view of how he believed credit, the purchasing power of gold, gold-related currencies and economic activity could be stabilised with lower levels of unemployment. Essentially he believed that London, acting alone, had sufficient power and influence to stabilise international finance and trade.

The position of London in the international credit system is so predominant that the Bank of England can take the lead and set the pace for all other countries. . . . if the Bank of England consistently pursued a policy of stabilising the purchasing power of the pound it would not encounter active opposition in any quarter. To . . . expand credit when the price level tends to fall will be quite in accordance with the past practice to which foreign banks have long been accustomed. The only innovation called for is that the appropriate action should be taken earlier than in pre-war days. . . . the Bank must be prepared to face some loss of gold when it is expanding credit.⁴²³

Expanding and contracting credit was to be effected, of course, by the Bank of England lowering and raising the Bank's discount rate. The remainder of

⁴²² *Ibid.*

⁴²³ *Ibid.*

Hawtrey's submission to the Macmillan Committee is a refinement of the criteria for changing Bank Rate.

It is customary to measure the price level by index numbers . . . but an index number is by no means a perfect measure, in that it may be affected by the scarcity or plenty of some important commodities . . . (for example) a scanty cotton crop in America, by raising the prices of cotton and cotton goods in the index number, might lead the Bank of England to initiate a contraction of credit so as to depress the prices of other commodities.⁴²⁴

Uprooted from 1930 to 2005, with oil substituted for cotton, this might well be wise advice for our own Monetary Policy Committee; as, also, could one of Hawtrey's final paragraphs –

The Bank of England should not confine itself narrowly to the guidance afforded by movements of the price level. Movements of price level are only symptoms of underlying movements of the consumers' . . . outlay. And other symptoms should be taken into account, particularly the state of unemployment. An unemployment percentage above normal itself affords a strong presumption in favour of relaxation of credit⁴²⁵

⁴²⁴ *Ibid.*, p.277.

⁴²⁵ *Ibid.*

Hawtrey's presentation probably caused some unease in both the Treasury and the Bank of England. They would regard as cavalier his view that the Bank, whilst waiting for world prices to rise, should watch with equanimity as its gold holdings ebbed away. As the Committee's examination of Hawtrey began, the Chairman was at pains to make it clear that Hawtrey was speaking in a personal capacity.

The excerpts of dialogue in this chapter have all been taken from *Minutes of Evidence taken before the Committee on Finance and Industry*. As indicated in the Introduction, the purpose of using this format is to attempt to re-create some of the drama, tension and sense of theatre which accompanied many of the Committee's proceedings – particularly when Keynes was operating with great effect. All the excerpts have been edited for purposes of brevity, but in such a way that neither the sense of the argument nor, hopefully, the drama of the occasion has been lost.

MACMILLAN. Just for the purpose of record, Mr. Hawtrey – you are an Assistant Secretary in the Treasury and Director of Financial Inquiries?

HAWTREY. Yes.

MACMILLAN. . . . you appear before us today in your personal capacity as an economist and an author of works dealing with

monetary questions. You wish it to be recorded that your evidence is given purely in that capacity?

HAWTREY. Yes.

The chairman, Macmillan then led the discussion towards eliciting Hawtrey's views upon the causes of the depression; the questioning being subsequently taken up by Bevin and Keynes.

MACMILLAN. We . . . have been appointed to investigate monetary problems . . . and the state of unemployment . . . do you think we are in the region of something which is quite different in kind as well as in degree?

HAWTREY. I do not think it is different in kind; I think that the causes are similar, but they have been intensified.

BEVIN. How?

HAWTREY. . . . the policy of cheap money has been abandoned . . .

KEYNES. Why was it abandoned?

HAWTREY. . . . the Bank Rate . . . which had till then been little, if at all, above 3 per cent., was forced up . . . in . . . March 1925 . . . to 5 per cent., and presumably that was all intended to prepare the way for the return to the gold standard.

KEYNES. Was that necessary?

HAWTREY. No I don't think it was. . . . the American price level was steadily rising . . . from 144.6 in June 1924, to 161 in March 1925 accompanied by . . . an improvement in the rate of exchange . . . from 4.32 in June to . . . 4.79 in March . . . that process might have continued . . . until we had reached par, without any strain at all.

The effect of dear money in England was to lower world price levels (by restricting the credit available for the purchase of goods) . . . due to the position of London as . . . the centre from which a great part of the international trade of the world is financed. [Thus] the effect of our 5 per cent Bank Rate has been to make the effort to put sterling at par . . . much greater than it would otherwise have been.

MACMILLAN. That is one of the exceptional causes that has been at work, in your view?

HAWTREY. Yes, I should say, so far as employment is concerned, it is the exceptional cause.⁴²⁶

After the chairman had given Hawtrey time and freedom to expand upon his theory of the instability of credit (described at length in an earlier chapter), and its responsibility for the trade cycle, Keynes returned to question Hawtrey on the dear money policy of the Bank of England and its relation to the return to the gold standard.

⁴²⁶ *Ibid.*, p.278.

KEYNES. You told us that the dear money which preceded the return to the gold standard was perhaps not necessary . . . [and] . . . things would have been very much better if we had enjoyed cheap money in subsequent years?

HAWTREY. Yes.

KEYNES. Do you hold that dear money in that period 1926-1929 was also unnecessary?

HAWTREY. . . . there certainly have been periods when it would have been quite easy to escape from dear money.

KEYNES. You mean . . . having got ourselves into a fix we had to have dear money, but if we had studiously pursued a cheap money policy all the way through we should probably have been able to overcome our difficulties?

HAWTREY . . . there has probably hardly been any time up to last year when we could not have escaped from dear money. . . . The price at certain times would have been . . . loss of gold.⁴²⁷

The prospect of loss of gold under Hawtrey's cheap money prescription was something which other members of the committee found disturbing, and Gregory (Professor of Banking; L.S.E.) was quick to take up this issue with Hawtrey.

⁴²⁷ *Ibid.* p.280

GREGORY. Would have been or might have been? [referring to the potential loss of gold].

HAWTREY. Would have been; but not so great as to have driven us off the gold standard.⁴²⁸

After a brief interruption from Mckenna, Hawtrey returned to complete his carefully reasoned answer to Gregory on what the consequences for Britain's gold reserves would have been if the Bank of England had pursued a cheap money policy in the period following the return to the gold standard. His lengthy response indicates he believed that his initial answer to Gregory might have been too pessimistic and that gold reserves need not have been depleted.

HAWTREY. [continuing his response to Gregory]. . . . if the gold had been allowed to form the basis of credit expansion in the United States that would have eased the situation here In 1925, 1926, 1927 . . . the United States was clearly aiming at a credit expansion, they had cheap money all through that period they would have been willing to expand credit if they had received additional gold Instead of that . . . gold was sent on an enormous scale from the United States to Europe . . . we got our share, and we used the opportunity not to expand credit here, but to increase our gold reserves . . .⁴²⁹

⁴²⁸ *Ibid.*

⁴²⁹ *Ibid.*

After brief exchanges involving Macmillan and Lubbock, in which Hawtrey acknowledged that credit expansion was no panacea for all Britain's economic ill – inefficiency in the staple industries would have reduced the growth of the British standard of living whatever credit policies had been pursued - Gregory returned to interrogate Hawtrey on the extent to which his cheap money recommendation in Britain might have stimulated world prices.

GREGORY. I wish you would explain more fully what I have always felt to be the difficulty of accepting your theory, how precisely cheap money in this country has an influence out of proportion to cheap money in New York and the rest of the world?

HAWTREY. Cheap money in London means a low rate of sterling bills. Sterling bills are the means of financing international trade. . . .a low rate on sterling bills is encouragement to the merchant who borrows to hold larger stocks . . . this leads to increased orders and therefore increased activity . . .

GREGORY. . . . but . . . during the years you have described . . . New York was very actively financing international trade?

HAWTREY. . . . it seems to me that the evidence of experience is decisive . . . for two years the Americans failed to make their cheap money policy effective . . . it is a point of great practical importance as to what is the power of London and New York over [the international price level]. I regard *that* experience as a very important piece of evidence, and insofar as the power of London *has* been impaired I

think it has largely been due to dear money, which has resulted in traders financing themselves by drawing bills on New York, Amsterdam or Switzerland in preference to London, because the discount rate has been cheaper.⁴³⁰

After an interchange with Brand (merchant banker from Lazard Bros.) concerning the extent of purchases of American securities in Europe, Keynes brought the questioning back to the main argument. During the times when Keynes was the interrogator, from the evidence provide by the verbatim record, Hawtrey seemed more cautious, less confident, and more hesitant in his responses.

KEYNES. . . . you regard the history of events from 1924 to 1930, and their effect on unemployment, as the tragedy of a series of avoidable errors in monetary policy?

HAWTREY. Well, yes.

KEYNES. And that is based on two assumptions. . . . the Bank of England could . . . have followed an easy money policy without losing too much gold . . . and . . . if it had . . . that would have cured unemployment?

HAWTREY. Yes

⁴³⁰ *Ibid.*, p. 281.

KEYNES. As regards the first, of course, you can only get a conclusive answer by trying?

HAWTREY. Yes

KEYNES. . . . as regards the other, do you consider that the level of money wages in this country was such that, in order to obtain full employment, the rise of prices in the outside world would have had to be quite substantial?

HAWTREY. No . . . Wages in America are 120 per cent above the pre-war level and prices are about 40 per cent above . . . no doubt [due] to technical improvements in production. . . . The Americans do not have a monopoly on technical improvements. I think it reasonable to assume that the enormous disparity . . . between prices and wages would have had its counterpart here. Wages here are [only] 70 per cent . . . above the pre-war level.⁴³¹

By this last statement Hawtrey seemed to be answering the implication in Keynes's question that British wages were unduly high in relation to world rates. Keynes continued to press Hawtrey, suggesting, with appropriate analogy, that whilst lower interest rates might have encouraged expansion of credit, this in itself was no guarantee of a healthy economy with low unemployment.

⁴³¹ *Ibid.*, pp.281-2.

KEYNES. It is an expression of opinion on your part. The argument to me is rather this. One wants a man to weight 12 stone to be healthy. He, in fact, weighs 10 stone; you say if he ate another biscuit every day he would weigh 12 stone. But all you have proved is that the tendency of the biscuit would be to increase his weight?

HAWTREY. I think you have statistical data which take you further than that. The American price level in 1925 was 161 . . . now it is 140. That disparity is . . . fully equivalent to the percentage of unemployment here.

KEYNES. . . . to assert that if the Bank of England had been brave it could have had sufficiently cheap money to prevent a fall of prices is, it seems to me, unwarranted?

HAWTREY. I have given you ground for supposing the . . . price change involved was sufficient. . . . that ought to wipe out all exceptional unemployment we are suffering from.⁴³²

There were further interjections by Brand and Mckenna on the theme of the relationship between British levels of interest and foreign price levels, which Hawtrey handled confidently with historical illustrations, before Keynes, once more, took up the interrogation.

KEYNES. Supposing in earlier years we had pursued an easier money policy, and that had led to loss of gold; if we had just let the gold go

⁴³² *Ibid.*, p.282.

to America, that might have led to the boom on Wall Street coming at an earlier date than it actually came in 1929, and the Federal Reserve system would have taken steps to sterilise the gold?

HAWTREY. That is to build hypothesis on hypothesis. It took them a long time to get worried about Wall Street speculation as it was.⁴³³

Brand and Gregory then attempted to clarify the extent to which Hawtrey believed London interest rates were capable of swaying the general level of world prices.

BRAND. Does your case involve the supposition that it is the Bank of England which determines the American price level?

HAWTREY. That would be carrying it too far. . . . if there is active opposition between the two credit operations, the tendency is for the London policy to prevail owing to its effect on international trade. I would not go beyond that.

GREGORY. Would you be prepared, at least, to accept this: that a cheap money policy initiated in London will fail . . . unless . . . the action of the Bank of England is accompanied by systematic action by the other Central Banks of the world?

⁴³³ *Ibid.*

HAWTREY. . . . if they do not actively take concerted measures I think there is a very strong presumption that the London policy will govern the situation.⁴³⁴

Here the day's proceedings drew to a close with Hawtrey facing a somewhat sceptical set of questioners. At the conclusion, Hawtrey was invited back to face a further day's questioning.

On Friday 11 April 1930, the twenty-third day of the committee's deliberations, Hawtrey was re-called and further examined. Macmillan, the Chairman, after summarising the view expressed by Hawtrey on the previous day, with Hawtrey agreeing that it was a fair summary, voiced the anxieties which most of the committee felt about Hawtrey's preferred option.

MACMILLAN. Suppose . . . without restricting credit . . . that gold had gone out to a very considerable extent, would that not have had very serious consequences on the international position of London?

HAWTREY. I do not think the credit of London depends on any particular figure of gold holding. . . . The harm began to be done in March and April of 1925 [when] the fall in American prices started. There was no reason why the bank of England should have taken any action at that time so far as the question of loss of gold is concerned. . . . I believed at the time and I still think that the right treatment would have been to restore the gold standard *de facto* before it was

⁴³⁴ *Ibid.*

restored *de jure*. That is what all the other countries have done. . . . I would have suggested that we should have adopted the practice of always selling gold to a sufficient extent to prevent the exchange depreciating. There would have been no legal obligation to continue convertibility into gold . . . if that course had been adopted, the Bank of England would never have been anxious about the gold holding, they would have been able to see it ebb away to quite a considerable extent with perfect equanimity, and might have continued with a 4 per cent Bank Rate.

MACMILLAN. . . . the course you suggest would not have been consistent with what one may call orthodox Central Banking, would it?

HAWTREY. I do not know what orthodox Central Banking is.

MACMILLAN. . . . when gold ebbs away you must restrict credit as a general principle?

HAWTREY. . . . that kind of orthodoxy is like conventions at bridge; you have to break them when the circumstances call for it. I think that a gold reserve exists to be used. . . . Perhaps once in a century the time comes when you can use your gold reserve for the governing purpose, provide you have the courage to use practically all of it. I think it is possible that the situation arose in the interval between the return to the gold standard . . . and the early part of 1927 . . . That was the period at which the greater part of the fall in the [international] price level took place.⁴³⁵

⁴³⁵ *Ibid.*, pp. 283-4.

For several minutes Hawtrey confidently fielded further questions on the Bank of England's policies from Keynes and Gregory, displaying a mastery of the history of exchange rates, price indices, interest rates and gold movements, and asserting at one point (note, in April 1930) that Britain had been 'heading all through last year straight for the abandonment of the gold standard'.⁴³⁶

Macmillan then decided to move the discussion on from criticism of the Bank's past failings to recommendations for the future, and Hawtrey was given the opportunity to make a general statement. This he divided into short and long-term recommendations. Inevitably his short-term recommendations were that everything should be done to bring the effective Bank Rate down to a level of two per cent. – a level which had been regarded as 'cheap money before the First World War.

. . . the Bank of England ought to carry the process of credit limitation to its limit. The more it does . . . the faster the revival of business will come. . . . I would attach importance to the buying of securities (by the Bank of England from the commercial banks, thereby increasing their cash deposits), . . . and the setting in motion of that tendency that the joint stock banks have, to increase their lending when they have more cash on their hands than they need. That is what I would rely on so far as the immediate future is concerned.⁴³⁷

⁴³⁶ *Ibid.*, p. 284.

⁴³⁷ *Ibid.*

Turning to the more distant future, Hawtrey's recommendations, once more, read uncannily like a handbook for the guidance of the Bank of England's Monetary Policy Committee of 2007. Much of his recommendations for the future had already been covered in his written submission. The greatest and overriding need was for a policy to 'stabilise the purchasing power of the pound'.⁴³⁸ To this end he regarded independent action to adjust interest rates on the part of the Bank of England to be the most effective means of procuring stability. His view was that there were wide limits within which the Bank of England could exercise freedom of action without endangering the gold standard. In setting interest rates the Bank of England should be guided by a number of indicators; principally an index number of prices. Hawtrey suggested that credit policy should be based on an international price index composed of the quotations of all the staple commodities which have an international market. He also believed there should be sensitivity to situations where prices of commodities were being forced up (or down) by non-monetary causes. Finally, Hawtrey regarded any rise in unemployment as an indicator that the consumers' outlay was being reduced and that an expansionist credit policy was being called for.

. . . if the Bank of England were guided in its credit policy primarily by these two considerations, the price index with its necessary

⁴³⁸ *Ibid.*

corrections, and the state of employment, then it would get as near an ideal credit policy as practicable.⁴³⁹

Following this statement there was an interlude of jousting between Hawtrey and Keynes on theoretical concerns. From the verbatim report of the encounter Keynes was the more confident and relaxed combatant. Misunderstandings abounded. Each of the two economists used different concepts in their analysis. Hawtrey insisted on using his concept of 'consumers' outlay'. Hawtrey regarded 'investment' as *part* of the consumers' outlay with the investment market being the intermediary agency for transferring it to business use; Keynes treated savings and investment as distinct entities enacted by different groups of people – saving being carried out by individuals, investment by businessmen. To Hawtrey 'investment' meant the purchase of investment goods – shares, government bonds, and so on by *individuals* – to Keynes's, the word meant the creation of real 'bricks and mortar' by industry. Keynes's *Treatise*, which he was, at that time, in the process of completing, put great store upon trade depression and unemployment being the result of savings exceeding investment. Hawtrey's theory of the trade cycle required that depressions began when consumers' outlay fell short of consumers' income. Keynes tried to get Hawtrey to restate his theory in terms of the difference between savings and investment, with depressions being caused by the level of investment falling short of the level of

⁴³⁹ *Ibid.*, p.285.

savings, but Hawtrey clung on desperately and refused to yield his ground. At one point, during a disagreement about the appropriate definitions for 'investment' and 'savings', Keynes felt sufficiently confident of his grounds to taunt Hawtrey – 'I am defining 'savings' as the excess of a man's income over his expenditure on consumption. If his income is less than what he spends on consumption then his savings are negative. You are sufficient of a mathematician to appreciate that.'⁴⁴⁰

After this interlude, which was probably only enjoyed by the two principal participants, Keynes returned to matters of economic policy.

KEYNES. . . . when we returned to the gold standard we tried to restore equilibrium by trying to lower prices here, whereas we could have used our influence much more effectively by trying to raise prices elsewhere?

HAWTREY. Yes.

KEYNES. . . . I should like to take the argument a little further. . . . the reason the method adopted has not been successful, as I understand you, is partly . . . the intrinsic difficulty of . . . [reducing] wages?

HAWTREY. Yes.

⁴⁴⁰ *Ibid.*, p.287.

KEYNES. . . . and partly the fact that the effort to reduce [prices] here causes a sympathetic movement abroad . . . ?

HAWTREY. Yes.

KEYNES. . . . you assume a low Bank Rate [here] would have raised prices elsewhere?

HAWTREY. Yes.

KEYNES. But it would also, presumably have raised [prices] here?

HAWTREY. . . . what I have been saying . . . is aimed primarily at avoiding the fall in prices both here and abroad. . . . it is possible there might have been an actual rise in prices here . . .

KEYNES. . . . one would have expected our Bank Rate to have more effect on our own price level than on the price level of the rest of the world?

HAWTREY. Yes.

KEYNES. So in that case . . . wouldn't *dear* money have been more efficacious . . . in restoring equilibrium between home and foreign prices . . . ?

HAWTREY. . . . the export of gold itself would have tended to produce equilibrium. It depends very much at what stage you suppose the process to be applied.

KEYNES. . . . so cheap money here affects the outside world more than it affects us, but dear money here affects us more than it affects the outside world?

HAWTREY. No. My suggestion is that through cheap money here, the export of gold encourages credit expansion elsewhere, but the loss of gold tends to have some restrictive effect on credit here.

KEYNES. But this can only happen if the loss of gold causes a reversal of the cheap money policy?

HAWTREY No, I think that the export of gold has some effect consistent with cheap money.⁴⁴¹

Here, the general scepticism of the committee seemed to be in the process of justification as, for the first time, cracks began to appear in what seemed to be the previously ruthless logic of Hawtrey's case. Why, without dearer money to stem credit should the loss of gold, in itself, act to restrict credit and prevent the rise in prices in Britain from being even greater than the rise in prices which the export of gold sought to stimulate abroad? The merchant banker, Brand, interrupted the dialogue between the two economists to try to obtain clarification upon this point.

BRAND. The effect is psychological?

⁴⁴¹ *Ibid.*

HAWTREY. Yes, it is psychological . . .

KEYNES. I suggest that the loss of gold here only has a restrictive effect if it leads the Bank of England to reverse the easy money policy?

HAWTREY. No . . . I think the loss of gold does have some restrictive effect.

KEYNES. The Bank of England could only continue to keep money easy . . . [by] replacing the gold with securities?

HAWTREY. . . . having regard to the very obvious bias of the Federal Reserve System to cheap money and credit relaxation in the whole period 1925 to 1928, I do not think that [this would have been necessary].

GREGORY. Is not the proper answer to Mr. Keynes that you might have kept wages steadier and let wholesale prices rise?

HAWTREY. It is difficult to say, . . . cheap money [might have produced] a material rise of prices relative to wages, which, of course, would almost certainly have been accompanied by some rise of wages.

KEYNES. . . . you are suggesting that . . . our loss of gold . . . spread [thinly] over a wide area, is going to have a larger effect on world prices than our . . . [substantial loss] . . . is going to have on ours. Is that a hypothesis on which you would risk very much?

HAWTREY. I do not think you risk very much, because all the time you are exporting gold the export of gold is itself a corrective of your balance of payments . . . and affords you shelter under which your industrial situation is being revived.

KEYNES. How much gold do you consider we could have lost with impunity in 1924, 1925 and 1926?

HAWTREY. . . . it would have been worth getting rid of one hundred million pounds of gold in order to cure unemployment.⁴⁴²

After a short discussion with Lubbock, the Bank of England representative, over the legality of this move – Hawtrey remained adamant that there was nothing illegal about such a manoeuvre. Keynes then moved on to quiz Hawtrey on how he felt releasing what amounted to only five per cent of the world's gold stocks might influence world prices to the extent of fifteen per cent.

KEYNES. . . . would [the loss of gold] have affected speculation against sterling?

HAWTREY. . . . the speculation against sterling would have created a situation in which inflation of credit would have cured unemployment very quickly. You will recollect that in the autumn of 1923 that very

⁴⁴² *Ibid.*, pp. 287-8.

thing began, a speculation against sterling, and there was a greater improvement in trade than at any other time since 1920.

KEYNES. I do not know that I agree with that. One hundred million pounds of gold would be 5 per cent. of [the world's gold supply] ?

HAWTREY. Yes.

KEYNES. The fall in international prices from the end of 1924 to the middle of 1927 was about 15 per cent?

HAWTREY. Yes.

KEYNES. You think . . . letting out . . . 5 per cent. additional gold would have prevented prices from falling?

HAWTREY. There is only one place to which the gold would have gone . . . the United States.

KEYNES. . . . [that would have] only affected the situation there, surely it would not have helped us . . .?

HAWTREY. Yes, there was very little of the world on the Gold Standard then . . .

KEYNES. . . . one is seeking to affect world priced?

HAWTREY. Yes.

KEYNES. World prices are . . . not simply determined by the demand of the United States. . . . you would not get a proportionate rise in world prices?

HAWTREY. In the conditions of 1925-1926 the relevance of the demand for gold was . . . practically confined to the United States. . . . all other countries . . . would have quite readily followed the lead of London and New York so far as the value of their currency was concerned.⁴⁴³

Keynes moved relentlessly onwards, dominating the inquiry. He asked Hawtrey how he saw a low interest policy would affect Britain's capital exports, and suggested that if, as a consequence of low interest rates, London became a more attractive place from which to borrow this might not exacerbate the outflow of gold. Hawtrey argued that such an effect would be insignificant, and produced a lengthy, reasoned argument as to why the effect of Bank Rate changes on capital flows was both small and short-lived. When Keynes disagreed with the outcome of his analysis and solicited the support of the various practical men of finance on the committee, Hawtrey was in no way submissive – 'I regard my arguments as very cogent. All I hear against them is that practical opinion is unanimously against them, but that does not dismay me unless practical opinion can give good grounds for its beliefs.'⁴⁴⁴

⁴⁴³ *Ibid.*, p.228.

⁴⁴⁴ *Ibid.*, p.291.

Two weeks after Hawtrey gave evidence to the Macmillan Committee Keynes sent Hawtrey the proofs of his *Treatise on Money* for comment, adding 'although we always seem to differ on these monetary questions in discussion, I feel that ultimately I am joined in common agreement with you as against most of the rest of the world'.⁴⁴⁵

With the benefit of the proofs of Keynes's *Treatise on Money* to hand Hawtrey prepared, in July 1930, his memorandum 'Remedies for Unemployment' for submission to the Macmillan Committee.⁴⁴⁶ It was, as ever, a meticulous, logically argued document, with numerical illustrations, within which he had given carefully consideration to the arguments within the Macmillan Committee, and also to Keynes's most recent published work.

Hawtrey began by clearly stating the parameters of his argument: to increase employment by, say, 10 per cent., the consumers' outlay must be increased by 10 per cent., or the amount of employment afforded by a given outlay must be increased – which, in effect, meant a reduction in wages. He ruled out the second alternative. With an inconvertible paper currency, i.e. no gold standard, he suggested that there would be no problem in expanding credit by 10 per cent. in order to provide the extra consumers' outlay to give the additional

⁴⁴⁵ Clarke, *The Keynesian Revolution in the Making*, p.148. Clarke is quoting from *The collected Writings of John Maynard Keynes*, vol. XX, p.131.

⁴⁴⁶ This memorandum was written in July, 1930, for the committee on Finance and Industry. It was printed with the Committee's Minutes of Evidence (vol. ii., pp. 315-21). It was reproduced in R.G.Hawtrey, *The Art of Central Banking* (London, Longman's Green and Co., 1932) pp. 427–448. Page reference numbers relate to the version in *The Art of Central Banking*.

employment. The same result could be secured under the gold standard with a reduction of its gold parity in the proportion 10 to 11.

With the gold standard in place and an unalterable parity there were inevitable problems associated with the policy of increasing the consumers' outlay by expansion of credit. Using carefully selected figures for the purpose of illustration, Hawtrey showed that where, previously, equilibrium had existed between the inflow and outflow of gold, and in the state of consumers' cash deposits, an increase in credit for the purpose of expanding consumers' outlay would result firstly, in depletions of the consumers' deposits and secondly, depletion of the nation's gold reserves. In the first case it would be because a portion of the extra outlay would be on imported goods, and consequently the total consumers' income would be less than increased level of outlay, causing consumers to have to draw on their cash reserves. In the case of the gold flows, Hawtrey reasoned that foreign investment (which involved the export of gold) had only been maintained because the loss of gold entailed in the purchase of foreign investments had been covered by the net inflow of gold as a result of exports exceeding imports. If expanding credit sucked in extra imports then the excess of exports over imports would no longer be capable of compensating for this loss of gold; gold would be lost or foreign investment cut back – a course of action with potentially undesirable consequences for future exports.

Hawtrey then looked at some of the measures Keynes's had recommended for reducing unemployment in his *Treatise on Money*, starting with protective tariffs.

He started by making the obvious point that the effectiveness of tariffs as a means of reducing unemployment depended upon the extent to which the tariffs were capable of causing shrinkage of imports, and this, in turn, depended upon the capability of home producers to expand their output in order to fill the partial vacuum left by the fall in imports. The bulk of British imports, at that time, were agricultural products, or other raw materials where Britain had little scope to expand its own output. Hawtrey also pointed out that there would be a tendency for British prices to rise above world prices; this would have a deleterious effect on British exports, with further implications for employment. He also made three other points regarding the imposition of tariffs. First, the uncertainty with regards to the fluctuating level of tariffs would make business planning difficult, and thus, if any tariffs were imposed, they ought to be considered as virtually permanent measures. Secondly, the field of products favourable to protection by tariffs was very limited; there was little to be gained by imposing tariffs on agricultural products or raw materials, and where imports were officially classified as manufactured, this often meant little more (especially in the case of petroleum products), than that they were basic manufacturing materials which had been put through a preliminary preparation process. Thirdly, Hawtrey pointed out, effective tariff protection tended to disadvantage one country, or set of countries, to the benefit of another set, whereas in a trading nation such as Britain the imperative was for a general revival in world trade.

In the remainder of the memorandum Hawtrey dealt with the effects to be expected from government expenditure, discrimination against foreign investment, inflationary expenditure by Government, funding the floating debt and the open-market operations of the Central Banks. The entire document was heavily illustrated with numerical examples, with considerable mathematical facility being required to follow the various sets of figures thrown up by his postulated scenarios.

Sir Richard Hopkins, the Treasury Controller of Finance and Supply Services appeared as a witness on Friday 16 May 1930 and Thursday 22 May 1930. His evidence signaled the adoption of a more pragmatic, and less dogmatic, approach by the Treasury to the issue of public works. His interrogation by Keynes over public works yielded the most fascinating of confrontations – producing the temptation to dwell on it for longer than this particular thesis merits. Hopkins's views, as expressed within the Macmillan Committee, do have a bearing upon Hawtrey's position within the Treasury, and it is from this perspective that his appearance will be considered.

The first day of Sir Richard Hopkins's testimony dealt with technical matters over profits on the fiduciary issue of Treasury notes and policy objectives relating to the conversion of floating debt to long-term debt. At the beginning of his second day of evidence, Hopkins discussed the various forms of Government assistance which had been in operation since 1920, before the Committee moved on to the matter of how the Treasury viewed the possibility of a large

programme of public works, initiated by Government, with the express purpose of stimulating trade – establishing what really was 'The Treasury View'.

HOPKINS. I think the Treasury view has sometimes been rather compendiously and not very accurately stated.

MACMILLAN. Now is your chance, Sir Richard.

HOPKINS. If I may say so, officials, if their views are published, start a controversy, and they are not able to intervene in its progress, and sometimes the exact form of their view - - -

MACMILLAN. - - - is a little misunderstood?

HOPKINS. - - - is a little misunderstood.⁴⁴⁷

Hopkins proceeded to explain certain aspects of the 1929 White Paper, *Memoranda on Certain Proposals Relating to Unemployment* – making the point that it was not intended as a general statement of Treasury policy on development works but as response to the publication of a scheme by the Liberal Party and 'an exceedingly able and lively pamphlet under the names of Mr. Keynes and Mr. Henderson, in which Mr. Keynes rather severely, though not

⁴⁴⁷ Macmillan Committee on Finance and Industry. Minutes of Evidence. (London, H.M.S.O., 1931), paras. 5562-4.

unkindly, beat the Treasury about the head for views which he ascribed to them'.⁴⁴⁸

Hopkins drew the attention of the committee to paragraph 3 of the 1929 White Paper in which the Treasury acknowledged that the state accepted responsibility for such services as roads, telephones and housing 'to the fullest extent that can be justified by our economic needs without extravagance'.⁴⁴⁹ As regards the actual amount of expenditure, Hopkins drew the Committee's attention to the following passage:

The scale of State capital expenditure is therefore not a question of principle but of degree. The view hitherto followed has been that State expenditure should be framed with due regard to other competing calls on our national resources, and that, as the natural test of profit making capacity was absent, the economic justification of all schemes ought to be thoroughly examined before they are put in hand.⁴⁵⁰

The essence of the Liberal plan, to which the 1929 White Paper was addressed, was that schemes should be started 'swiftly'.⁴⁵¹ Taking road construction as an illustration, Hopkins pointed out that not only was 'swiftness' an objective

⁴⁴⁸ *Ibid.*, para. 5565.

⁴⁴⁹ *Ibid.*

⁴⁵⁰ *Ibid.*

⁴⁵¹ *Ibid.*

incapable of achievement – '[a road] cuts across people's gardens . . . cottages . . . beauty spots . . . time has to be spent by engineers familiar with the locality in making plans . . . on proper recruitment and proper accommodation for labour' - but that the process of planning, especially if 'swiftness' was regarded as essential, would arouse public hostility to the extent that it would be impossible to attract financial support. Hopkins continued to stress the importance of the inter-related factors of planning feasibility and public acceptance in deciding whether a proposed scheme was a 'good' scheme.

After some discussion Keynes returned the question of clarifying the nature of 'The Treasury View'.

KEYNES. . . . there is the proposition that schemes of capital development are of no use for reducing unemployment [and] the proposition that it is difficult to find good schemes?

HOPKINS. Yes

KEYNES. Would it be a misunderstanding of the Treasury view to say they hold to the first proposition?

HOPKINS. . . . [that] goes much too far. . . [it] would ascribe to us an absolute and rigid dogma, would it not?

KEYNES. . . . the Treasury view, I thought . . . was, that . . . any capital that could be found for those schemes would be diverted from other uses. That is a misunderstanding then?

HOPKINS. Yes. That is much too rigid an expression of any views that have come from us.

The proposition, in the form in which it was put by Keynes, came as close as possible to the conclusion of Hawtrey's *Economica* article of 1925 that the idea that public works, in the absence of credit creation, gave additional employment was 'fallacious'.⁴⁵² The Treasury might have once had a large degree of confidence in Hawtrey's ability, on theoretical grounds, to counter Keynes's claims on behalf of public works. Clearly, that confidence no longer held and Hopkins can be seen to be anxious to move as far away as possible from any basis to the 'Treasury View' within macroeconomic theory.

Keynes moved on to try to establish the grounds by which the Treasury might judge a proposed scheme to be 'good'.

KEYNES. So the issue between those who are in favour of these schemes and those who are against them is not whether they cure unemployment?

HOPKINS. Do you wish me to agree?

[MACMILLAN. I do not think you must take it that Sir Richard agrees.]

⁴⁵² Hawtrey, 'Public Expenditure and the Demand for Labour', p.48.

KEYNES. What is the point where we differ?

HOPKINS. The capital for these schemes has got to come from somewhere.

Hopkins had been at pains to make the point that speedy establishment of public works was undesirable since he regarded the careful nurturing of public support to be an essential part of any public works programme. Keynes's line of questioning offered Hopkins the chance to point out one particular reason why a scheme which did not command public sympathy might, despite its short-term creation of employment, be a 'bad' scheme.

KEYNES. [The need for capital] is equally true of 'good' and 'bad' schemes?

HOPKINS. . . . if . . . a . . . scheme . . . is not a dynamic force towards a great renewal of activity and prosperity . . . it does make a hole in the capital which is available for the purposes of the community.

KEYNES. But do 'bad' schemes make a larger hole than 'good' schemes?

HOPKINS. . . . they may in their consequences.

KEYNES. . . . I fail to see the logic of what you are saying.

HOPKINS. Well it may divert capital from more useful schemes.

KEYNES. That is equally true of 'good' and 'bad' schemes?

HOPKINS. . . . the general effect upon the public mind of what you are doing is very much going to influence the amount of capital which is going abroad. . . . It might lead people to think that this country was a much better place to invest, or it might lead them to think that it was a much worse place to invest. When you were speaking of 'bad' schemes I was thinking of the latter.

KEYNES. Our foreign investments cannot increase unless our exports increase.

HOPKINS. No, but the burden on the exchange can increase.

Here, in conceding that capital might be diverted from 'more useful' schemes, Hopkins had come dangerously close to admitting that the old Hawtreyan 'Treasury View' with its thesis of 'crowding out' still persisted. On this occasion he outsmarted Keynes by changing the nature of 'crowding out' from one of rival schemes competing for limited home investment funds, to one in which the necessary investment funds would only be forthcoming if the schemes themselves did not alienate public opinion – a 'psychological crowding out'.⁴⁵³

⁴⁵³ The copyright to the term 'psychological crowding out' could probably be claimed by Roger Middleton. See R.Middleton, *Towards the Managed Economy* (London, Methuen, 1985), pp.93, 149, 162-3, 171.

Keynes was forced to concede that he had been left in a position where he could not press home his advantage over Hopkins as an economist.

KEYNES. . . . Nearly all of what you have been saying today comes to this, that it is difficult to find good schemes?

HOPKINS. Yes.

KEYNES. That is quite different from what I previously thought to be the 'Treasury View'. It was not a view of that kind but a theoretical view, that the objection to these schemes was that they caused diversion on theoretical grounds. That was a misunderstanding on my part of what the Treasury intended, was it?

HOPKINS. Yes. . . . It is . . . the views we take as to the practical reactions of [a] scheme.

KEYNES. It bends so much that I find difficulty in getting hold of it.

Keynes certainly did not relent at this point, nor was there any relaxation in the drama of the confrontation. Keynes continued to press Hopkins on his criteria for a 'good' scheme; at one point progressively pushing Hopkins down from 5 per cent, then 4 per cent., and finally to 3 per cent., on the overall return which the Treasury might expect before deeming a scheme to be worthwhile. In the

end, the Chairman declared the discussion to have been a 'drawn battle'.⁴⁵⁴ Many subsequent commentators have viewed this verdict by Macmillan as being overly generous to Hopkins since there is no doubt that he underwent considerable discomfort under Keynes's relentless questioning.⁴⁵⁵ But if Keynes scored more debating points than Hopkins (as Keynes tended to do with everybody) then, in terms of overall strategy, Hopkins emerged as the clear winner. He (at least, for some time, until Keynes began to introduce the multiplier concept into his promotion of public works) successfully removed the question of public works out of the realm of macroeconomics and into that of microeconomics, where individual works were assessed on their merits in terms of the returns which they might generate and the extent to which each project might receive public support. In doing so he temporarily took the debate on public works away from the sphere of Keynes's special economic expertise. Within the Treasury, he took the public works debate away from the area of the expertise of Hawtrey.

Public works did not disappear as an issue. But, so far as the Treasury was concerned, they were divorced from the issue of unemployment. Instead of being part of a macroeconomic solution to the overall level of unemployment,

⁴⁵⁴ Macmillan Committee on Finance and Industry. Minutes of Evidence. (London, H.M.S.O., 1931), paragraph 5690.

⁴⁵⁵ D. Winch, *Economics and Policy: A Historical Study* (London, Hodder and Stoughton, 1969), p.113. Winch found it difficult to see 'how anyone reading the Keynes-Hopkins exchange today could agree with the Chairman's description of it as a "drawn battle".'

they were dependent upon feasibility and local acceptability, as judged by the Board of Trade and the members of various local Boards and Councils.

Chapter 6

Leaving the Gold Standard

1931- 32

The formal process of withdrawing from the gold standard began on Thursday 17 September 1931. On that day, the Cabinet Committee on the Financial Situation discussed the drain of gold. It was resolved at the meeting to make every effort to secure extended credit from abroad in order to avoid resorting to either of the two alternative courses of action: suspension of the gold standard, or import tariffs.⁴⁵⁶ However, on the same day, the Treasury began contingency preparations for suspending the gold standard when Frederick Phillips began to draft the Gold Standard (Amendment) Bill.⁴⁵⁷ On Friday evening, 18 September 1931, at 9.45 p.m., Ramsay MacDonald met with the Deputy Governor of the Bank of England, Sir Ernest Harvey, and Fisher, Leith-Ross and Phillips from the Treasury. Harvey announced that £17 million had been lost during the day and this had exhausted the dollar credit. The Federal Reserve Bank of America had indicated that a banking credit would be unlikely to be available to save the situation. With the following day being a Saturday, and thus a short day, it

⁴⁵⁶ Cab. 27/462, Committee on the Financial Situation, 17 September 1931.

⁴⁵⁷ Treasury Papers, T. 163/68/G 3788. Phillips memorandum, 17 September, 1931.

might be possible to get through it with the aid of a loan made available from France, but they would be forced to stop on the Monday.⁴⁵⁸ It was agreed that the suspension of the gold standard should be announced before trading commenced on Monday, and the necessary legislation should be rushed through parliament on Monday 21 September 1931. In the event, the public announcement of the suspension was made after a special Cabinet meeting on the evening of Sunday 20 September 1931 – provoking the *Daily Mail* headline of Monday 21 September: 'Six months' suspension of Gold Standard'.⁴⁵⁹ The Gold Standard (Amendment) Act was passed on Monday 21 September, and Bank rate was immediately raised to 6 per cent. for the purpose of preventing an immediate collapse of sterling. Now, at least for the time being, the currency needed to be managed.

The introduction of a managed currency was not quite the straightforward, 'commonplace' event that A.J.P.Taylor might have had us believe.⁴⁶⁰ The suspension of the gold standard on 21 September 1931 forced the issue of a managed currency on to the economic agenda, but neither the Chancellor, nor

⁴⁵⁸ S. Howson, *Domestic Monetary Management in Britain, 1919-38* (Cambridge, C.U.P., 1975), pp.77-8.

⁴⁵⁹ R.S.Sayers, *The Bank of England 1891-1944* (Vol. II) (Cambridge, C.U.P., 1976), p.413.

⁴⁶⁰ A.J.P.Taylor, *English History: 1914 -1945* (Oxford, O.U.P.,1965), p.297. In referring to the events surrounding 21 September 1931, Taylor comments that a 'few days before, a managed currency seemed as wicked as family planning. Now, like contraception, it became a commonplace'.

the Treasury nor the Bank of England had a policy regarding the future of sterling.

Prior to moving off the gold-standard the Bank of England had exercised the greater control over monetary policy and interest rates. Its discount rate, at which it was prepared to lend to the commercial banks, formed the basis of short-term interest rates, and its level was determined by the Bank in accordance with its need to preserve its gold reserves. The emergency legislation, the Gold Standard (Amendment) Act – drafted by Phillips within the Treasury - gave responsibility for, and power over, monetary policy to the Treasury. The Act represented a giant snatch of power, by the Treasury, away from the Bank of England. But, for the Treasury, these were uncharted waters and it had no firm idea of how it should use its enhanced powers - of the course upon which it should embark. There was little agreement between the Chancellor and senior Treasury officials as to the best way forward. Between 21 September 1931 and February 29 1932, when Sir Frederick Phillips presented the final draft of his policy memorandum to the Government, there had been wide divergences of opinion and much changing of minds. For Philip Snowden, the Chancellor of the Exchequer, the suspension of the gold standard was a temporary measure designed to deal with abnormal withdrawal of deposits – ‘I believe the countries will return to an improved Gold Standard’ he assured the nation.⁴⁶¹ Others were

⁴⁶¹ K.Laybourn, *Philip Snowden: a biography* (Aldershot, Temple Smith, 1988), p.143.

less sure. The steadiest mind throughout the entire period of deliberation was that of R. G. Hawtrey, and it was his view which was to eventually prevail.

The first contribution to the Treasury's debate on the future of sterling came, on 26 September 1931, from the direction of the Bank of England; from the Treasury's former Controller of Finance, Sir Otto Niemeyer. Niemeyer, it must be remembered, was the civil servant who, along with Montagu Norman, presented Churchill with the 'irrefutable' arguments for the restoration of the gold standard, and then proceeded to act as Churchill's 'minder' through the subsequent parliamentary debates. Time had not softened his views.

I start from the point of view that the suspension of gold payments, so far from being a welcome and glorious relief from unconscionable burdens, is alike for this country, for foreign countries and for the general restoration of world confidence, a very great disaster, the full dangers of which we are as yet far from realising.⁴⁶²

Niemeyer suggested that foreign countries were 'vacillating between following gold and following sterling' and that the 'first and urgent [Niemeyer's underlining] essential is to frighten the bears and reassure those people who would follow sterling if given a modicum of hope'. To this end he felt it necessary that there should be a 'definite official statement that there was going

⁴⁶² Treasury Papers, T188/48. The Leith-Ross Papers. Memorandum by Sir Otto Niemeyer, 26 September 1931.

to be no inflation of credit and that it should proposed not to allow an increase of the note circulation'. By making it clear that the authorities would take strong measures to support sterling he believed that it would be possible to form a considerable sterling block which would cause 'the position of the gold holding countries, i.e. France and America [to] become more and more unenviable'.⁴⁶³ Niemeyer's argument for fiscal and monetary rectitude as a means of establishing a strong sterling block did, to a large extent, presage the international currency situation throughout the 1930's and was very much in line with the arguments being put forward by Snowden as Chancellor of the Exchequer. But Niemeyer's (and Snowden's) ultimate purpose in establishing a strong sterling block was as a means of bringing about a re-distribution of the world's gold with the intention of restoring a more effective gold standard.

Likewise at the Treasury, Leith-Ross, formerly assistant to Niemeyer, representative of the old 'sound finance' regime and still, for another year, occupying the post of Deputy Controller of Finance at the Treasury, favoured an early return to the gold standard (maybe, at a slightly reduced sterling value). But Frederick Phillips, his successor-in-waiting, was unconvinced about the advantages of returning to gold. A week after departing from the gold standard Phillips responded to Leith-Ross. The exact date of the response is uncertain since the memorandum is undated, but the position of the memorandum in

⁴⁶³ *Ibid.*

Leith-Ross's well-ordered file indicates a date between 26 September and 28 September. Phillips pointed out to Leith-Ross that:

. . . since October 1929, the appreciation of gold has:

Lowered wholesale prices by 25%;

Lowered cost of living by about 10%;

While wages have been practically unchanged.

Now all these things were out of harmony already in 1929. By the beginning of this month the disharmony was becoming fantastic. Compared with pre-war:

Wholesale price level was about the same (100);

Cost of living was about 145;

Wages were about 175.

This is what was crushing our farmers and manufacturers for the benefit of the rentier, the distributive trades and the fixed income man, while the working classes were losing as much from unemployment as they were gaining from an increase in real wages.

Why go on with it?⁴⁶⁴

⁴⁶⁴ Treasury Papers, T 188/20. The Leith-Ross Papers. Memorandum by Sir Frederick Phillips, September 1931.

Phillips went on to argue against Leith-Ross's suggestion that the return to gold might be at a somewhat lower level; suggesting that if the value of gold went on rising at its present rate (and he saw no reason why it shouldn't) then, within a year, the country would be back in the same position from which it had just escaped – '... a poor set off to the blow our prestige has suffered from suspending gold payments'.⁴⁶⁵ Phillips favoured attempting to stabilise the pounds exchange rate with the dollar without recourse to the gold standard. He, nevertheless, favoured the rather high value of four dollars to the pound as a target.

Hawtrey echoed Phillips's rhetorical question of 'Why go on with it?'. He saw no advantage in rushing back to gold; moreover, to him, four dollars to the pound was far too high a target level for the stabilising of the pound. He recommended that policy on the exchange rate should aim at the maximum beneficial effect on trade and industry, and accordingly suggested that the monetary authorities should attempt to peg the pound at \$3.40. His advice regarding future exchange rate policy was laid out in a memorandum – 'Pegging the pound' - addressed to Sir Richard Hopkins on 28 September 1931.

Hawtrey began his memorandum by making it clear that the virtue of the gold standard was not the extent of the level at which it maintained the pound, but its use as an agent of stability.

⁴⁶⁵ *Ibid.*

It was, no doubt, desirable to maintain the gold standard in order to avoid the adverse effects of fluctuating exchanges with gold standard countries upon the credit business of London. But, the gold standard, once suspended, the effect on credit business is much the same whatever the value of the pound is, whether 50 per cent or 95 per cent or par. In either case there is uncertainty. The question of the rate of exchange to be maintained ought therefore to be settled with a view to securing the maximum beneficial effect upon trade and industry. The detrimental effect on finance hardly enters into it.⁴⁶⁶

The essence of Hawtrey's argument was as follows. British costs (predominantly wages) were too high in relation to world prices. British wages were paid in pounds whereas the rest of the world, predominantly, paid for British goods with gold. Where British goods were sold abroad, at world prices, the incoming gold did not convert to sufficient pounds to pay British wages; if the price of British goods for sale abroad were to cover British costs then they would be unsellable. Moving off the gold standard afforded the opportunity of adjusting the value of the pound in relation to gold in such a way as to bring British costs back into equilibrium with world prices (this did not necessarily imply moving back to the gold standard at a lower rate, with all the commitments of convertibility, but looking to manage the value of the pound to keep it in a close relationship to the world value of gold or, in effect, the value of the dollar). Looking back, for a

⁴⁶⁶ Treasury Papers, T 175/56. The Hopkins Papers. Memorandum by R.G.Hawtrey to Sir Richard Hopkins, 'Pegging the Pound I', 28 September 1931.

base year in which Britain's costs could be considered to be in equilibrium with world prices, he suggested 1925 as suitable for such a base year.

It is probable that the year 1925 would supply a tolerable standard of the equilibrium relation between wages and prices. Some people would argue that wages were substantially too high then, and Mr. Keynes sometimes estimates the discrepancy at the time of the Gold Standard Act at 10 per cent., but on the other hand something must be allowed for the effect of increased technical efficiency upon the price level. A slightly lower price level would be appropriate now to a given wage level, owing to the decrease in the real cost of production.⁴⁶⁷

Hawtrey continued to pursue this line of argument. His starting point for calculating an appropriate figure for the devaluation of the pound was that, at the time of writing, the wholesale index number of prices was 37.5 per cent. lower than in 1925. He conceded that this figure included the price of products from the primary producing countries which, of late, had fallen disproportionately, and therefore was an index number which overestimated the general fall in world prices of both primary products and manufactured goods. On the other hand, the 27 per cent. fall in the price of British exports, he suggested, probably underestimated the fall in world prices, since Britain's poor export performance had been, in part, due to Britain's prices remaining too high.

⁴⁶⁷ *Ibid.*

Taking these figures, together with appropriate allowances, Hawtrey felt that the pound could be allowed to fall by 30 per cent. to bring British costs into equilibrium with world prices – ‘that is to say, the exchange on New York ought to be 3.40’.⁴⁶⁸

Hawtrey saw no problem with the mechanism by which this rate could be achieved and maintained. Reducing the Bank rate would lower the demand for pounds on world markets and cause its price to fall. If necessary, the Bank of England could reinforce this process; increasing the quantity of pounds on world markets by buying bills or foreign currency. He did warn, however, against allowing the pound to fall below what he considered to be its equilibrium value:

It is undesirable to let the exchange fall below 3.40, or whatever the equilibrium point might be, because that would involve an actual rise in wages. (In any case wages will have to be raised in one or two of the unsheltered trades where they have been disproportionately depressed . . .).⁴⁶⁹

In the event of the pound falling below this equilibrium level Hawtrey foresaw no problem in the Bank of England supporting it by raising interest rates, selling bills and selling foreign exchange. Once equilibrium was established, he suggested that the monetary authorities should permit the pounds exchange rate

⁴⁶⁸ *Ibid.*

⁴⁶⁹ *Ibid.*

with gold to fluctuate with changing world prices. In the event of a large rise in world prices (which he predicted), he believed that it was quite possible to achieve 'in the end, a restoration of the old parity without any effort at all'.⁴⁷⁰ At that stage (realising the old parity) he believed that an Anglo-American agreement for stabilising world prices would be both 'practicable and desirable'.⁴⁷¹

The exchange rate of \$3.40 to the pound was considerably less than Phillips' original suggestion of \$4.00, but by the end of October 1931 Phillips had come down to the idea of an exchange rate of \$3.65 to the pound (he was, later, to lower his recommendation even further – to \$3.40).⁴⁷² Treasury Controller of Finance, Sir Richard Hopkins, must also have had reservations about the apparently low figure of \$3.40 recommended by Hawtrey. He wrote to Hubert Henderson, secretary of the Economic Advisory council, asking for his comments on Hawtrey's figure. Henderson replied with a long memorandum which criticised the basis for Hawtrey's recommendation of an exchange figure of \$3.40.

Henderson was a former Cambridge economics lecturer who had had a close, but sometimes strained, relationship with Keynes. Virginia Woolf described him

⁴⁷⁰ *Ibid.*

⁴⁷¹ *Ibid.*

⁴⁷² Howson, *Domestic Monetary Management in Britain*, p. 84.

as a 'small, testy, unheroic man'.⁴⁷³ Some seven years younger than Keynes, Keynes recognised his potential when he took him from Cambridge in 1923 and appointed him editor of the *Nation and Athenaeum*; the periodical of which Keynes was chairman, and which he regularly used as a vehicle for expressing his disapproval of government policy. Henderson remained editor of the *Nation and Athenaeum* until 1930. He worked closely with Keynes on sections of the Liberal Party's 'Yellow Book', *Britain's Industrial Future*, and was co-author with Keynes of the pamphlet *Can Lloyd George Do It?* - an endorsement of the Liberal Party's election prospectus of 1929. After this collaborative effort Henderson gradually began to distance himself from Keynesian ideas on public works, which he came to regard as having the nature of a 'quick fix', more likely to destroy business confidence than create permanent employment.⁴⁷⁴ In 1930 Henderson had moved from the *Nation and Athenaeum* to become secretary of the Economic Advisory Council. The E.A.C. (which included Keynes, Bevin, Balfour and Tawney amongst its members) was a kind of economic general staff - a body instituted partly in recognition of the growing importance of economic theory to policy decisions, and partly Ramsay MacDonald's counterweight to the influence of Snowden and the Treasury on economic policy - which met in Downing Street and reported directly to the Cabinet. Henderson was persuaded

⁴⁷³ P. Clarke, *The Keynesian Revolution in the Making, 1924-26* (Oxford, O.U.P., 1988), p.78. Clarke is quoting from A.O. Bell (ed.), *The Diary of Virginia Wolf*, ii (Harmondsworth, 1981), p.268.

⁴⁷⁴ *Ibid.*, p.159.

to take up the position of secretary of the E.A.C. after reassurance from Keynes that he 'really would be at the centre of things and not in a sort of Hawtrey backwater'.⁴⁷⁵ As a consequence of accepting the position Henderson turned down the Chair of Economics at the London School of Economics, resulting in the position being offered to Hayek.

On 6 October 1931 Henderson sent his memorandum, critical of Hawtrey, to Sir Richard Hopkins. Susan Howson has suggested that, like Hawtrey, Keynes was a '\$3.40 man', and therefore it seems that Henderson was writing to Hopkins in a personal capacity rather than expressing the collective view of the Economic Advisory Council.⁴⁷⁶

Henderson attacked, as over-simplistic, Hawtrey's notion that there was some definite exchange rate of the pound with the dollar which represented a state of equilibrium which presumed full employment - he instanced the problems posed by Indian tariffs and Japanese competition for the Lancashire cotton industry. No amount of exchange-rate adjustment according to the general level of world prices could realistically restore cotton exports to their former volume. Furthermore, he suggested, that the current low, 'unremunerative', level of world prices was a temporary phenomenon which could not possibly persist and, as such, was a poor basis for calculating a suitable gold-value for sterling.⁴⁷⁷

⁴⁷⁵ S.Howson and D.Winch, *The Economic Advisory Council 1930-1939: A Study of Economic Advice During Depression and Recovery* (Cambridge, C.U.P., 1977), p.25.

⁴⁷⁶ Howson, *Domestic Monetary Management in Britain*, p.84.

Henderson also believed that Hawtrey's analysis was simplistic in assuming that other variables such as world prices, world wage levels, British prices and British wage levels could be treated as independent of the gold-value of sterling. To illustrate this point, he suggested that if the value of sterling were adjusted downwards to \$3.40, then this would make imports from the United States more expensive, and thus reduce the volume of American exports – which in due course would lead to a fall in American wages and a fall in the general price level of world manufactured goods. According to Hawtrey's line of reasoning, he suggested, this would involve even further reduction in the gold value of the pound – with the reinforcing nature of the exercise pushing the pound's gold-value down to absurd levels.

Indeed, I may sum up my essential criticism of Mr. Hawtrey's reasoning as follows. His goal is an exchange level which would permit Great Britain to have normal trade activity and full employment at a time when trade in the outside world is more depressed than it has ever been before. It cannot be done. . . . It is just possible that employment might be made very active for some time by a continuous and unlimited depreciation, with the printing presses hard at work. That is another story. But the notion that a country with Great Britain's international ramifications could build up a domestic paradise of normal trade, profits and employment in the setting of an unprecedented world

⁴⁷⁷ Treasury Papers T.175/56. The Hopkins's Papers. 'Comments on Mr. Hawtrey's memorandum' by H.D.Henderson, 6 October 1931.

slump is a will o' the wisp, and it would be absurd to regulate our monetary policy by reference to it.⁴⁷⁸

Henderson then gave his own reasoning for limiting the scale of the fall of the value of the pound. First, Henderson argued, a 30 per cent. fall in the exchange rate would, in the first instance, lead to an adverse effect upon the balance of payments, since imports would immediately cost more, and it would take time before a new equilibrium in trading patterns could be established. Furthermore, pursuing the implications of this first point, Henderson pointed out that:

. . . a 30 per cent. fall in the exchange means, other things being equal, over 40 per cent. on the price of imported goods. I find that . . . represents 27 per cent. of the total national consumption . . . [which] might raise the cost of living by over 10 per cent. . . . That seems to me beyond the margin of safety, if a general process of rising wages, including the sheltered trades, is to be avoided.⁴⁷⁹

Secondly, Henderson questioned Hawtrey's assumption that there would be no difficulty in checking an undue fall in the exchange rate; experience, he claimed, showed that where there was a lack of confidence then no amount of monetary or fiscal tightening could be relied upon to stem the fall in the value of the

⁴⁷⁸ *Ibid.*

⁴⁷⁹ *Ibid.*

currency – if it could, then ‘we need never have been driven off the gold standard’.⁴⁸⁰

The general point of Henderson’s memorandum was that to reduce the gold value of sterling by as much as 30 per cent. would be too great a ‘shock’ to the international financial system with many ramifications; some predictable, such as the loss of earnings on Britain’s foreign investments; others less predictable, such as the likelihood of other countries abandoning the gold standard as part of a process of competitive devaluation. Overall he felt that ‘he would like to see the pound settle at a depreciation of 15 to 20 per cent.’⁴⁸¹ Henderson was a ‘\$3.90 man’.

Sir Richard Hopkins had much to occupy his mind at this time. Within Hopkins’s Treasury file, immediately following the Henderson memorandum, is a reply from Hawtrey, dated 2 October 1931 – ‘Pegging the Pound II’.⁴⁸² This was a new situation for Hawtrey who was unused to the Treasury soliciting advice from economists from outside the Treasury. We cannot be sure how rapid Hawtrey’s robust response was, since the hand-written date on it, 2 October, actually precedes the date of 6 October which is added to the Henderson

⁴⁸⁰ *Ibid.*

⁴⁸¹ *Ibid.*

⁴⁸² Treasury Papers. T 175/56. The Hopkins Papers. Memorandum by R.G.Hawtrey to Sir Richard Hopkins, ‘Pegging the Pound II’, (the memorandum is signed by Hawtrey and dated 2 October 1931, but either this or the date attached to Henderson’s memorandum – 6 October 1931 - must be wrong since this memorandum of Hawtrey refers to that of Henderson).

memorandum, yet it must have been penned with knowledge of the contents of the Henderson document. Hawtrey returned to his main point: that there was an exchange rate at which British costs and prices were in equilibrium with world prices and whilst there was room for differences of opinion on what the equilibrium exchange rate should be, 'the real question at issue is whether the exchange should be maintained at a rate above the equilibrium point, whatever that point may be'.⁴⁸³

He conceded that there were three arguments for maintaining the exchange at a higher rate than its equilibrium rate. First, lower economic activity meant less possibility of demands for wage increases. Secondly, with exports priced in sterling but paid for by the transfer of gold, a higher exchange rate would, for a given level of exports, earn a greater value of gold. Thirdly, allowing the exchange to sink to its equilibrium level could damage confidence in the pound to the extent that preventing a fall to even lower values would prove too difficult. Hawtrey dealt with each of these points in turn.

First, regarding wages, he pointed out that there was no precedent for fears about wage demands, since in the past, in periods of active trade, wages had always tended to lag behind the growth of prices and profits. Furthermore, some wage increases, especially in the unsheltered industries, were necessary to remove anomalies which had developed.

⁴⁸³ *Ibid.*

If we adopt a high exchange, we leave all the existing anomalies amongst wages in different industries undiminished. If, as a result of a low exchange we let industry in for an increase in wages, this has the advantage of permitting the inequalities to be in some degree addressed. The pressure for an increase will be mainly (and at first exclusively) in the unsheltered trades.⁴⁸⁴

Hawtrey dealt with the second point in favour of a high exchange – that a low exchange rate would reduce the country's gold earnings, and thus adversely affect its balance of payments – by providing figures which showed how the French balance of payments had moved from deficit to credit during a period of depreciation of the Franc between 1923 and 1927.

British manufacturers are bound to make some concessions in the price of exports in order to get the business which the sudden reduction of their costs brings within their reach. . . . to recreate the export trade fairly substantial price concessions must anyhow be given.⁴⁸⁵

As regards loss of confidence leading to the monetary authorities being unable to prevent a collapse of sterling, Hawtrey felt confident that the monetary authorities could well control any tendency for the exchange to fall below its equilibrium point:

⁴⁸⁴ *Ibid.*

⁴⁸⁵ *Ibid.*

For people to persist in selling sterling at a heavy sacrifice they must feel very certain that it is not going to recover. . . . experience has abundantly proved that every sudden fall of a currency is followed by a shortage of cash and a temporary recovery, which can easily be made permanent unless there is some serious underlying cause in inflation.⁴⁸⁶

There was a divergence of views within the Treasury on the level at which the monetary authorities ought to attempt to stabilise the exchange rate. Frederick Leith-Ross - Deputy Controller from the days of Niemeyer, but soon to leave the Treasury – saw the departure from gold as very temporary, and anticipated a rapid return at the old parity. He favoured stabilisation at \$4.00 - \$4.25. The Controller of Finance, Sir Richard Hopkins, favoured \$4.00 in September 1931 because he felt that a lower rate would reduce confidence, raise the cost of living unduly, and lower the value of investments abroad, but later he came down to the value of \$3.60 - \$3.70. Hawtrey's favoured value remained at \$3.40 throughout. Frederick Phillips – increasingly influential and soon to be promoted to Deputy Controller – started, like Hopkins, favouring an exchange value of \$4.00, but adjusted this downwards, a month later, to \$3.65, but from December 1931 to March 1932 he was arguing for a value of \$3.40. Outside the Treasury Keynes was giving the weight of his support to Hawtrey's figure of \$3.40.⁴⁸⁷

⁴⁸⁶ *Ibid.*

Aside from the most appropriate level at which the authorities ought to attempt to stabilize the pound there remained concern, in some quarters, over the past failure of the gold standard system, and steps which might be taken to reinstate the institution in a more effective way. As previously noted, Leith-Ross remained in favour of a return to the gold standard, and on 9 October 1931 he wrote to Hubert Henderson asking for his views on steps which might be taken to bring about its restoration. He posed the following question to Henderson:

It is frequently suggested that France and America do not understand the rules of the game, and that if these rules were properly observed the gold standard would work without any of the present dislocation or maldistribution of gold. . . . I would find it extremely valuable if some statement could be drawn up showing the practical measures which we consider that France and America and other countries should take and have not taken to operate the Gold Standard fairly. Do you think that you could get something like this prepared?⁴⁸⁸

It is quite likely that, at this stage, Leith-Ross felt that the argument in favour of an early restoration of the gold standard was drifting away from him with, in particular, Phillips and Hawtrey questioning the wisdom of returning to the gold standard, and that he needed some ammunition from Henderson to fight his

⁴⁸⁷ Howson, *Domestic Monetary Management in Britain*, p.84.

⁴⁸⁸ Treasury Papers, T188/28. The Leith-Ross Papers. Letter from Frederick Leith-Ross to H.D.Henderson, 9 October 1931.

particular corner in the Treasury. There is also a possibility that he was subjecting Hawtrey's analysis of the situation to scrutiny. Ever since the Genoa Convention of 1922 Hawtrey had continued to bemoan the lack of any international apparatus for attempting to stabilise the price of gold in relation to other commodities, and had put the blame for the failure of the gold standard on America and France for deflating the price of other commodities in relation to gold by their accumulation of the metal.

Henderson sent his reply to Leith-Ross on 16 October 1931. In his opinion there was 'no substantial foundation for the common complaint that our present troubles are largely attributable to failure on the part of France and the United States to observe the rules of the game in the working of the gold standard'.⁴⁸⁹ Henderson attributed the tendency of gold to pile up in France and America as being due to the fact that the balance of payments had been heavily in their favour. He attributed their advantageous balances to, on the whole, France's early stabilisation of her exchange rate on the gold standard at a value lower than its pre-war rate, and to American tariffs. He saw nothing to substantiate the charge (implicit in Hawtrey's criticisms) that either France or America had embarked upon a policy of gold hoarding. He feared that serious damage had been done to the *de facto* operation of a gold-exchange system, whereby many foreign central banks had kept their reserves, as sterling, on deposit in London. They had been operating under the belief that sterling was 'as good as gold', and

⁴⁸⁹ Treasury Papers, T188/28. The Leith-Ross Papers. Memorandum by H.D.Henderson 'International co-operation and the Gold Standard', 16 October 1931.

their faith had been severely shaken and that was a factor which was likely to intensify the scramble for gold.⁴⁹⁰ Given the sudden fall in the value of sterling, Henderson argued, foreign investors were reluctant to remove their money from London in case there were to be a rebound in its value. Any premature attempt to stabilise its value, particularly at a low rate, might convince foreign investors that there was little to play for in keeping their deposits in London, and cause them to withdraw them – giving further concern to the Bank of England over the level of its deposits. He suggested an interim policy. The Bank of England, he suggested, should announce 'a definite buying and selling price for gold which should hold good until further notice', the period of notice being, perhaps, as short as one week.⁴⁹¹ The reason for Henderson suggesting a temporary value was that, by frequent movements, it could be adjusted according to the flow of gold in, or out, of the country (although off the gold standard, Britain still required deposits of gold with which to conduct international trade). If gold were being lost then the Bank of England could raise the price it was prepared to pay for gold (in effect, by giving more pounds per unit weight of gold it would be reducing its exchange value with the dollar and other gold standard countries); if gold were flowing into the country then the Bank should reduce the price of gold. If stability could be achieved under the operation of such a system, Henderson

⁴⁹⁰ *Ibid.*

⁴⁹¹ *Ibid.*

suggested that it might, only then, be an opportune moment to convene an international conference to achieve exchange stability.

On the following day, 17 October 1931, Hawtrey produced a memorandum covering similar ground to that of Henderson. The proximity of Hawtrey's memorandum to that of Henderson suggests that it was in no way a response to Henderson's document, but that Hawtrey was working to the same brief as Henderson. Although Hawtrey attributed the failure of the gold standard to its escalation in price caused by the absorption of gold by France and America, he absolved these countries of failing to 'play by the rules of the game', since no rules for playing the game had been drawn up – it was impossible for Hawtrey to write a memorandum without reminding the Treasury and the Bank of England that they had failed, back in 1922, to carry out the procedures necessary to implement his Genoa Conference resolutions. He thought that gold still offered the best hope for stability of prices and exchanges, but that any early return to gold was out of the question. In the mean time it was desirable to draw up a new code along the lines of the Genoa resolutions, and that the best hope for bringing into effect such a code would be through bilateral Anglo-American talks.

There is not the slightest chance of getting the French to give a moments consideration to any such proposal. French economists do not recognise that a problem exists French bankers and

politicians are equally immovable. Probably European opinion would be predominantly the same.⁴⁹²

The Americans, Hawtrey believed, could be persuaded to co-operate in attempts to stabilise the value of gold, but not so long as Britain remained on a paper standard with no policy regarding the future value of the pound. He recommended a three-stage programme by which Britain might return to a restored, stable gold standard. First, the regulation of credit, by changes in Bank rate, to stabilise the purchasing power of the pound. Secondly, negotiations with America to secure a policy for the stabilisation of the value of gold. Thirdly, settling an appropriate gold parity of the pound in order that there should be no new disturbances of the price level.

Hawtrey's basic scheme for stabilising the value of gold was a bilateral agreement along the lines of part of the Genoa Resolutions of 1922:

The Bank of England and the Federal Reserve System should agree that whenever the world price level showed signs of falling and trade of becoming depressed, they should adopt measures of credit relaxation (low Bank rate and purchases of securities) and that whenever the world price level showed signs of rising and trade becoming excessively active, they should adopt restrictive measures (high Bank rate and sales of securities). It should be understood that they would both persist in the former measures despite losses of gold,

⁴⁹² Treasury Papers, T188/28, The Leith-Ross Papers. Memorandum by R.G.Hawtrey, 'The Gold Standard and the Rules of the Game', 17 October 1931.

and that each would support the others gold reserve if circumstances so required.⁴⁹³

Whilst it might be desirable to secure the agreement of other countries, Hawtrey felt that it would be much better to be content with a two-party agreement 'than to complicate credit policy by the ostensible addition of a number of monetary authorities who neither believe in stabilisation nor understand it'.⁴⁹⁴ Hawtrey followed up this memorandum, on 26 October 1931, by commenting on Henderson's paper. Apart from some detailed qualification of Henderson's ideas – for instance, he suggested that the course of trade, rather than the inflow or outflow of gold, should be the basis of Henderson's proposal that the Bank of England should, as an interim measure, frequently revise the price at which it was prepared to buy gold - Hawtrey agreed that their two sets of ideas were not incompatible.

When, on 3 August 1928, three years prior to these discussions, Leith-Ross had responded to Keynes's article 'How to organise a wave of prosperity' which Keynes had written for the *Evening Standard* on 31 July 1928, he had prefaced his note with the words: 'I am sorry to see that Keynes is renewing the press propaganda which has done him little credit as a politician and considerable harm as an economist.'⁴⁹⁵ Leith-Ross had been an admirer of the hard-line

⁴⁹³ *Ibid.*

⁴⁹⁴ *Ibid.*

Niemeyer, a man whom he regarded as the great model public servant.⁴⁹⁶ In the intervening three years Leith-Ross had been the Treasury observer within the deliberations of the Macmillan Committee on Finance and Industry, where, along with the others, he would have admired Keynes's intellectual showmanship. By general consent, Keynes had dominated the proceedings of this committee. The experience had been sufficient to thaw the relationship between Leith-Ross and Keynes, and toward the end of November 1931 there was a cordial interchange of letters between the two men in which Keynes forwarded to Leith-Ross a personal copy of his memorandum on the currency question which he had prepared for Ramsay MacDonald's Economic Advisory Council. Keynes's document is dated 16 November 1931, but from his acknowledgement of receipt, Leith-Ross received it on 20 November 1931.⁴⁹⁷

Along with Hawtrey, and to a lesser extent Henderson, Keynes believed there was no need to hurry back to gold, nor to convene an International Currency Conference – it would 'merely be an occasion for France to endeavour to exercise pressure to induce us to return to gold at too high a figure and at a premature date'.⁴⁹⁸ Rather than an International Currency Conference, which

⁴⁹⁵ Treasury Papers T175/26. The Hopkins Papers. Memorandum by F. Leith-Ross, 3 August 1928.

⁴⁹⁶ Clarke, *The Keynesian Revolution in the Making, 1924-26*, p.30.

⁴⁹⁷ Treasury Papers, T. 188/48. The Leith-Ross Papers. Correspondence between Leith-Ross and Keynes, 20 Nov. 1931 and 28 Nov. 1931.

⁴⁹⁸ Treasury Papers, T.188/48, The Leith-Ross Papers. 'Notes on the Currency Question' by J.M.Keynes, 16 October 1931.

was generally mooted, or an Anglo-American Conference, suggested by Hawtrey, Keynes put forward the idea of an Imperial Conference to create an Empire Sterling Standard, with the suggestion that South American, Scandinavian and Central European nations be invited to join such a standard (the sterling exchange question was creating some very strange bedfellows, since this idea of Keynes's came very close to that of Niemeyer, who had advocated such an alliance in order to 'frighten' the French and Americans). Keynes presented a number of ways in which sterling might be managed within such a sterling block, but his favoured method (his 'third' option) was to manage sterling, not in terms of some parity with respect to either gold or the dollar, but in terms of an index of commodity prices.

Keynes then turned to the most appropriate level at which to attempt to stabilise the pound, since even though he had suggested stabilising by means of a basket of tradeable commodities, any value would have implications for the current relationship of the pound with gold and the dollar. Here, he suggested that four criteria were available by which the most appropriate level might be arrived at. Firstly, he suggested, the prevention of inflation may be considered an important criterion. Those who considered this to be the most important criterion argued that a low exchange rate would raise the cost of imported goods and provoke demands for rises in wages. 'This school of thought generally has in mind some value for sterling in the neighbourhood of \$4.00 at the existing commodity value of gold. The second criterion was a level of the pound which

might reduce the national debt to a more manageable proportion. This criterion, he suggested, was 'at the opposite pole from the first'.⁴⁹⁹ Relief for the Treasury's debt burden would come from the increased tax revenue brought about by rising money wages. Rising money wages would only come about through the rising prices caused by a low pound; hence a value for the pound of around \$3.00 would satisfy this criterion.

Keynes's third criterion for assessing a suitable level for the pound was to maximise the benefit to the country from external trade.

Too high a rate of exchange will hinder the development of an adequate volume [Keynes's emphasis] of exports, whilst too low a volume may lead to our selling our exports too cheap in terms of gold Moreover if we give an excessive bounty to our exports, we run the risk of provoking reprisals of one kind or another; whilst too great a rise in the sterling price of imports might set in operation a premature movement towards wage increases.⁵⁰⁰

If the external trade balance were to be the sole criterion for establishing the pound's value, then this, to Keynes, suggested a figure between \$3.50 and \$3.75.

The fourth and final criterion by which Keynes thought the most suitable value of the pound might be judged was linked to his suggestion of the formation of a

⁴⁹⁹ *Ibid.*

⁵⁰⁰ *Ibid.*

sterling block. According to this criterion the appropriate level for the pound would be one which gave a satisfactory return to the primary producers (a return to a level approximating to that of 1929 according to Keynes). This would not only stimulate trade with the Empire but give adequate returns on many British investments held abroad. (This criterion must have been in Keynes's mind when suggesting that the value of the pound be managed according to the value of a basket of commodities). If this were the overriding criterion then a value for the pound of \$3.40 to \$3.50 would be appropriate.

The contrast between the contributions of Keynes and Hawtrey to this debate reflected the contrast in their personalities and modes of working as economists. Hawtrey's advice came from an allegiance to his own theoretical model and his understanding of the possibilities within the real world. His basic model of the working of the economy had evolved only slowly from its first fashioning during the first decade of the twentieth century. He was capable of fitting the world's economic problems into his working model, and seeing, with great clarity, how economic problems related to his model. Within this model, it was clear to him that British costs and prices were not in equilibrium with world prices and that restoration of equilibrium demanded a parity rate of \$3.40 for the pound. Recognising the problems of achieving international agreement, he knew that an Anglo-American agreement would be sufficiently powerful to be hegemonic. His advice was direct and contained within the limits of the implications of his economic model. Keynes, on the hand, worked intuitively; he usually 'sensed' a

problem, and its solution, long before he could marshal a rational justification for the solution. Because he worked intuitively, the formal presentation of Keynes's economics often fell short of satisfying his intuitions. In many ways this was because the formal tools of classical economics were inadequate to express the ideas of his fertile imagination - the rapid abandonment of his *Treatise on Money* was in part due to being forced to express many of his intuitive ideas in terms of the concepts of classical economics. Being unconstrained by a formal theory, Keynes's approach to problems was often highly imaginative, even if the result was that he might make himself open to criticism. He also ran a greater risk of being clearly wrong. Keynes's notion of a sterling trading block based on the Empire might have been wrong, but it was imaginative and in sympathy with many of the sentiments of the time.

Following Keynes's memorandum, within Leith-Ross's file, there is a note on the Keynes document, by Leith-Ross, which illustrates the way the currency problem was perceived by a financial administrator as opposed to an economist.

The whole of this document seems to be written on the assumption that we are sailing on an even keel in a smooth sea and that it rests with us to decide to what extent we will allow the pound to depreciate and where we are going to stop it. . . . £250 million to £300 million of sterling is held by foreign banks and Governments. This sterling was sent here for security and is not likely to remain here if our currency is likely to be unstable . . .⁵⁰¹

Leith-Ross remained in favour of an early return to gold, regarding it as 'impossible for a country so deeply committed to international trade to cut itself adrift from the staple basis of international commerce and sacrifice all its financial business in order to attempt to maintain internal prices stable in terms of commodities'.⁵⁰²

Keynes's memorandum had been sent to the Prime Minister, Ramsay MacDonald, who circulated it amongst Cabinet ministers. Treasury Controller of Finance, Sir Richard Hopkins, concerned about some sections of Keynes's memorandum, produced a lengthy document in response and sent it to the Chancellor, Neville Chamberlain, on 15 December 1931. The text of Hopkins's memorandum refers to that of Keynes being written some 16 days previously (Keynes's document is dated 16 November 1931), and must have been some time in preparation. It appears twice within Hopkins's papers; the first copy is within the file T175/56, the second is within T175/57. The second copy contains a large number of amendments by Phillips which are instructive of the direction in which Treasury thinking was changing. Phillips's amendments tended to gently modify the document away from the idea that it was inevitable that, at some time, Britain would return to a gold standard with a fixed exchange-rate, and also towards \$3.40 rather than \$4.00 being the rate at which the Treasury

⁵⁰¹ Treasury Papers, T.188/48, The Leith-Ross Papers. 'Note of Mr. Keynes Memorandum' by F. Leith-Ross, (undated).

⁵⁰² *Ibid.*

would prefer to attempt to stabilise the pound. There seems to be no record of the final draft of this document, but it is presumed that the amended version was forwarded to the Chancellor.

The Hopkins-Phillips paper was meant to be a commentary upon Keynes's memorandum; an aid to Ministers and intended to be read alongside the document of Keynes. On closer reading it turns out to be a savage demolition of Keynes's main arguments.

Hopkins, initially influenced by Leith-Ross, began his paper with Leith-Ross's suggestion that the Bank of England did not possess the means to control the exchange rate by purchasing and selling gold or foreign exchange. In doing this he incorporated, almost verbatim, Leith-Ross's naval imagery that 'Mr. Keynes seems to assume that we are sailing, or shall very shortly be sailing, on an even keel in a smooth sea'.⁵⁰³ He then went on to expand upon the problem which Leith-Ross had pointed out – the existence of large short-term deposits in London – and, in the process, make Keynes's advice seem totally unrealistic.

In sixteen days since from the date of Mr. Keynes' Memorandum the pound has sunk to \$3.30. Not only is there the German riddle [Keynes's term for the reparations problem]: not only is there the problem with the balance of trade: not only is there the problem of the immediate fate of other countries now precariously clinging to the

⁵⁰³ Treasury Papers, T 175/57. The Hopkins Papers. 'Note on Mr. Keynes' memorandum of 16th November: The Future of the Pound', by Sir Richard Hopkins, amendments by Sir Frederick Phillips, December 1931.

gold standard; not only are there the new exchange and other restrictions springing up in all quarters of the globe to impede the revival of the export trade. Beyond this the Bank of England and the Treasury are known to have short debts running to £100 million which have to be met within the year and this repayment will entail heavy purchases of foreign exchange or the export of all our present store of gold. Our income from investments abroad is gravely reduced by bad trade and by foreign default and there are doubts how far our exporters will repatriate the money proceeds from their sales abroad. Nor are these by any means the only clouds upon the horizon It is not true that in present conditions the Bank of England can effectively control the pound.⁵⁰⁴

Hopkins went on to condemn Keynes's preferred option: the tying of the pound to a basket of currencies since there was no mechanism within it to stem withdrawal of balances from London. Under the floating exchange system operating at that time the fall in sterling exchange resulting from any incipient movement towards the withdrawal of balances tended to be self-correcting with the lower value of the pound attracting money in anticipation of a rise. Under Keynes's scheme, Hopkins argued, the pound would have the worst of all worlds – lack of flexibility allied to lack of stability. If adopted, it would most likely break down very quickly.

In discussing the exchange rate which Keynes felt would be most appropriate for the commencement of his system Hopkins included the following extract:

⁵⁰⁴ *Ibid.*

He would begin his new system of course at some very low point, say with the pound at \$3.40. That level is so low that in all probability wages would increase at any rate in the unsheltered trades. He is asking us to commit ourselves to a system under which for a period the pound would be at \$3.40 and then, possibly within a short time, it might rise progressively as commodity prices improved to a figure as high as \$4.40 or more.⁵⁰⁵

Phillips, in his amendment, deleted this section and pencilled in the following:

He would begin his new system at a very low point, say with the pound at \$3.40. That is fairly in accordance with the Treasury view, but on the Treasury view the exchange should not be allowed to move upwards unless and until world prices have moved upwards quite substantially. On Mr. Keynes' plan the exchange must move upwards immediately the price of raw materials shows any recovery.⁵⁰⁶

Hopkins's initial effort hinted at some alarm at the idea of accepting an exchange rate as low as \$3.40. Phillips felt that such a rate could be accorded with 'Treasury Policy'. It is not known what discussions, and at what level, might have taken place within the Treasury, but the figure now being accorded the status of 'Treasury Policy' was the exact figure which Hawtrey had recommended

⁵⁰⁵ *Ibid.*

⁵⁰⁶ *Ibid.*

in his first submission on the matter in September 1931. Moreover if, as Hopkins had conceded, the Bank of England was incapable of controlling the exchange rate by the sale of gold or foreign currency, how was such a figure to be managed? It could only be by short-term adjustments to Bank rate supported by open-market sales and purchases of securities – exactly as originally recommended by Hawtrey

Hopkins went on to dismiss Keynes's idea of summoning an early Imperial Currency Conference since only Britain could formulate a sterling policy, and at that point it was not yet in a position to produce a plan. 'The conference could only end in either disappointment or in dangerous commitments'.⁵⁰⁷

The paper presented to MacDonald's National Government Cabinet was prepared by Phillips on 29 February 1932.⁵⁰⁸ He pointed out that stabilising the pound at a high value - \$3.90 or over - would give the advantage of low import prices and that Britain's fixed interest investments abroad, which were denominated in sterling but transferred back home in the form of gold, would bring in a greater value of gold at the higher exchange rate (reserves of gold still being necessary for trading with countries which were still on the gold standard). But he felt that the decisive arguments were in favour of a lower value of \$3.40. In adjudicating in favour of \$3.40 Phillips put emphasis on the need to raise wholesale prices by at least 25 per cent above their value of the previous

⁵⁰⁷ *Ibid.*

⁵⁰⁸ Treasury Papers. T175/57. The Hopkins Papers. Memorandum, 'The Present Position of the Pound' by Sir F. Phillips, 24 February 1932.

September in order to bring wholesale prices into line with British costs. He also emphasised that it might be necessary to resort to credit restriction – raising Bank rate by another name – if it was felt necessary to prevent the pound falling below this equilibrium value.⁵⁰⁹ Treasury policy had, very largely, returned to the advice first offered by Hawtrey in his memorandum of 28 September 1931.

Donald Moggridge, in his biography of Keynes, has suggested that Keynes influenced Hopkins and Phillips towards adopting a target rate of \$3.40 rather than the \$3.90 rate proposed by Henderson, or even higher rates which certain other high ranking officials felt to be appropriate.⁵¹⁰ George Peden has argued that Hawtrey's influence 'was no less important, and perhaps more so'.⁵¹¹ The Treasury may have taken cognisance of Keynes's thoughts, but the evidence of close examination of the Treasury files seems to indicate that Hopkins demolished the proposals of Keynes as those of an unrealistic, remote don who was completely out of touch with the realities of government finance (small wonder that the Chancellor's private secretary, Sir Thomas Padmore, should have remarked that 'Keynes would talk to anyone but he would listen to Hopkins').⁵¹² The ideas that eventually prevailed were those of the Treasury's own in-house economist, R.G.Hawtrey. Throughout the deliberations on

⁵⁰⁹ *Ibid.*

⁵¹⁰ D.E.Moggridge, *Maynard Keynes: an Economist's Biography* (London, Routledge, 1992), pp.537-8.

⁵¹¹ Peden, *The Treasury and British Public Policy 1906-59*, p.255.

⁵¹² L.Robbins, *Autobiography of an Economist* (London, Macmillan, 1971), p.187.

exchange-rate policy Hawtrey had steadfastly maintained that \$3.40 was the most suitable level for the pound. His argument was framed not in terms of the convenience, or status of the City of London, but in terms of the rate which would be most beneficial to industry. The steadfastness of his arguments gave Hawtrey a new prominence as the Treasury assumed control over discussions to stabilize worldwide exchange rates.

Chapter 7

Currency Chaos.

1931-1933

During the 1920s Hawtrey tended to be a lone voice within the Treasury as he appealed, first, for the export of gold to raise American prices, and later for the lowering of interest rates to raise demand through the extension of credit. After the relapse from the Gold Standard he became embroiled in disputes with other economists over matters of policy: the preferred way to stabilize currencies and the value of gold, and the appropriate measures needed to be taken to finance the rearmament programme and the prosecution of the war. Thus the form of chapters 7-9 differs slightly from that of earlier chapters. More space is allocated to the alternative views expressed by other economists, and to providing the background to the disputes. The Committee for Economic Information, with responsibility to the Cabinet, included Keynes, Henderson and Robertson among its membership. This was a powerful gathering of expertise which provided an alternative base for economic advice after 1930. The members of this group,

especially Henderson, were sometimes called upon for critical commentary on Hawtrey's memoranda.⁵¹³

One argument of this thesis is that the early 1930s saw an initial resurgence of Hawtrey's influence within the Treasury as a result of his persuasive arguments over the appropriate target level for the pound after going off the Gold Standard in 1931. Winch (1969), and Howson and Winch (1977) do not acknowledge Hawtrey's influence over this period, but subscribe to the view that Keynes's ideas gradually took over Treasury thinking during the 1930s. Winch (1969) worked without the benefit of access to the Treasury Papers of the period, but Howson and Winch (1977), despite having access to the Treasury Papers, did not see fit to substantially revise their view.⁵¹⁴ Middleton (1998) dismisses Hawtrey,

⁵¹³ Published primary material for the disputes between Keynes and Hawtrey over theory are to be found within the volumes of *The Collected Writings of John Maynard Keynes* [30 vols., ed. E. Johnson and D. Moggridge (1971-89)]. More useful for disputes over economic policy is George Peden's collection of Treasury documents in which Treasury personnel respond to Keynes's criticisms and suggestions [G. C. Peden, *Keynes and his Critics* (Oxford, O.U.P., 2004)]. For the period of this study it contains responses to Keynes from Hawtrey, Sir Otto Niemeyer, Sir Frederick Phillips, Sir Richard Hopkins, F. W. Leith-Ross, G. C. Upcott, P. J. Grigg, E. R. Forber, D. Fergusson and B. W. Gilbert.

⁵¹⁴ D. N. Winch, *Economics and Policy: an Historical Study* (London, Hodder and Stoughton, 1969).

S. K. Howson and D. Winch, *The Economic Advisory Council 1930-39: a Study in Economic Advice during Depression and Recovery* (Cambridge, C.U.P., 1977).

S. K. Howson, *Domestic Monetary Management in Britain 1919-38* (Cambridge, C.U.P., 1975)

S. K. Howson, 'Hawtrey and the Real World' in G.C.Harcourt's *Keynes and his Contemporaries* (Cambridge, C.U.P.,1985).

S.K.Howson, *Sterling's managed float: the Operation of the Exchange Equalisation Account* (Princeton, Princeton University Press, 1980).

suggesting that 'his major influence was, if anything, to convince his generalist colleagues that economic theory posed no great intellectual challenge nor had any real relevance to the administrative tasks facing the department'.⁵¹⁵ The evidence presented in this thesis will suggest that these views are very much overstated. It will suggest that Hawtrey robustly challenged economic opinions coming from outside the Treasury, and that his views tended to be supported by senior Treasury staff. It will argue that although Hawtrey's principal concern, the co-ordination of international interest rates through co-operation between the world's central banks, was never adopted as policy, the Treasury's attitude to public works continued to be shaped by Hawtrey's arguments. Finally, it will argue that inspection of Treasury documents suggests that it was Keynes's ability to put forward a mechanism for financing the Second World War without

E. T. Nevin, *The Mechanism of Cheap Money: a study of British Monetary Policy, 1931-1939* (Cardiff, University of Wales Press, 1955).

Susan Howson's *Domestic Monetary Management* is the published version of her Ph.D. thesis. It uses Treasury, Cabinet and Bank of England Papers, together with a huge amount of monetary data, to trace the effects of the monetary policy of the authorities between the two World Wars. Her principal conclusion is that cheap money after 1931 stimulated the housing boom, and that this was the foundation of economic recovery. The short essay 'Hawtrey and the Real World' is one overspill from Howson's extensive study of Treasury Papers. In this essay she still clings to the conclusion that Hawtrey lost influence in the 1930s.

Howson's volume, *Sterling's Managed Float*, is a study of the way in which the authorities, led by Phillips, managed the level of Sterling through a 'float' – the Exchange Equalisation Account. Howson's study of the mechanics by which this fund was operated complements her earlier study. It suggests that the float might have been 'dirty' in that it was designed to deliberately maintain sterling at below its equilibrium value in order to gain an advantage to British exports.

Nevin's *The Mechanism of Cheap Money* gives an account of how, largely through the Exchange Equalisation Account, Britain was able to maintain a permanent cheap money policy throughout the 1930s whilst still controlling the external value of the pound.

⁵¹⁵ R. Middleton, *Charlatan's or Saviours: Economists and the British Economy from Marshall to Meade* (Cheltenham, Edward Elgar, 1998), p.199.

recourse to high interest rates that eventually saw him displace Hawtrey within the Treasury.

The year 1932 was, eventually, to see the realisation of the low Bank rate for which Hawtrey had been pleading throughout the 1920s. It did not entirely please him since he regarded the move as having been too tardy to break the 'vicious circle' of depression.

On the outbreak of the financial crisis of 1931, on 23 July, as gold and foreign reserves drained away from London, Bank Rate was raised from 2.5 per cent to 3.5 per cent. On 30 July 1931 it was raised further to 4.5 per cent.⁵¹⁶ Immediately, on the day of departure from gold, 21 September 1931, Bank Rate was increased from 4.5 per cent to 6 per cent. This was a defensive measure to temper the expected fall in sterling. Thereafter, despite being maintained at the

⁵¹⁶ R.G.Hawtrey, *The Gold Standard in Theory and Practice* (London, Longman's, 1947), p.146.

R. G. Hawtrey, *A Century of Bank Rate* (London, Longman's 1938).

B. J. Eichengreen, *Golden Fetters: the Gold Standard and the Great Depression* (New York, O.U.P., 1992).

B. J. Eichengreen and A. K. Cairncross, *Sterling in Decline: the Devaluations of 1931, 1949 and 1967* (Oxford, Blackwell, 1983).

The Gold Standard in Theory and Practice was first published in 1927, but was revised with updates in 1931, 1933, 1939 and 1947. The edition which I have used is that of 1947, which covers the years 1931-1939 and discusses some of the implications of the Bretton Woods plans. *The Gold Standard in Theory and Practice* not only gives insight into Hawtrey's views on the period, but contains an excellent history of the currency turmoil which was partly triggered by Britain leaving the gold standard.

Most of the statistics on the Bank of England's rediscount rate, exchange rates with the dollar, and gold holdings, following withdrawal from the Gold Standard, are taken from the post Second World War edition of Hawtrey's *The Gold Standard in Theory and Practice* and his *A Century of Bank Rate* (1938). Where the text proved to be inadequate then the statistical tables at the back of these two volumes by Hawtrey could generally be relied upon to provide 75 per cent of the figures required.

Eichengreen's *Golden Fetters: the Gold Standard and the Great Depression* (1992), and his work with co-author Cairncross, *Sterling in Decline*, (1983) were sources of background information on the period after withdrawing from the Gold Standard.

high level of 6 per cent for the next 21 weeks, the pound moved down to a low of \$3.27 in November 1931; a value some way below the Treasury target value of \$3.40. This overly large fall could be attributed to Britain selling pounds in the market in order to acquire the foreign currency which it needed to repay the loans obtained from France and America at the height of the September 1931 crisis. However, after November 1931 the pound climbed back above its target value; hitting \$3.80 by March 1932. Breaking above \$3.40 enabled the Treasury, with its newly acquired powers, to force the Bank of England to commence lowering its discount rate, which by six stages reached 2 per cent in June 1932. The motive behind the Treasury pressure was less concern for the expansion of credit than as a means of paving the way for the purchase and re-issue of its expensive war-loan debt. By lowering short-term interest rates to 2 per cent and creating the expectation that interest rates would remain low, the Treasury were able to persuade the public to purchase its new issue of war loan at 3.5 per cent. The successful conversion of 5 per cent war-loan to 3.5 per cent war Loan in 1932 was an immense saving for the Treasury. It was also a significant step in enabling low interest rates to be maintained throughout the 1930s.

Having decided upon a target exchange rate of \$3.40 for the pound, the Treasury needed some means of overcoming fluctuations in the value of the pound; fluctuations which were often due to large short-term capital movements for speculative purposes. It could have attempted to continue to control the fluctuation in demand for sterling by equally rapid contrary movements in Bank

rate, but this would have negated its policy of encouraging an expectation of permanently low interest rates; an expectation necessary for encouraging the purchases of its own reduced-rate War Loan. Instead, the Finance Act of 1932 saw the establishment of the Exchange Equalisation Account (EEA); a fund intended to offset fluctuating market demand for sterling. The EEA was the brainchild of Sir Frederick Phillips, and he was the most senior Treasury official charged with supervising it.

The assets of the Exchange Equalisation Fund were supported by Government funding and included gold, foreign currency and pounds sterling. When international demand for sterling caused it to be in short supply and threatened to send it above the target value of \$3.40, then pounds were released into the market by the process of buying up foreign currency. If excess supply of sterling threatened to lower its value then the EEA would use its gold, or reserves of foreign currency, to mop up that excess. The beauty of the EEA lay in its ability to relieve Bank Rate of the burden of controlling the external exchanges. Politically, it even further emasculated the Bank of England. Being dependent on Government support, the EEA was under the control of the Treasury; the Bank finding itself reduced to the status of little more than that of errand boy as it performed the mechanical operation of buying or selling foreign currency at the behest of the Treasury. The fund was held by the Bank of England in the form of Treasury Bills. When the Bank required sterling for the purpose of purchasing foreign exchange it sold Treasury Bills to the market; when it released foreign

currency, it used the newly acquire sterling to purchase Treasury Bills. By this use of Treasury Bills it kept the domestic money supply steady whilst countering international fluctuations in the demand for sterling.⁵¹⁷

The strategic thinking of the senior Treasury officials – a strategy very much led by Phillips – was only partly along the lines which Hawtrey had recommended throughout the deliberations over the appropriate level for the pound. The policy of keeping sterling at \$3.40 and not permitting it to rise until sterling prices had risen at least 25 per cent above their level of September 1931 was certainly in keeping with Hawtrey's views.⁵¹⁸ However, Hawtrey had envisaged a greater role for the Bank of England, in the sale and purchase of open-market securities as a means of controlling the exchange rate. By purchasing securities the Bank of England would have widened the monetary base for the extension of credit; a process which Hawtrey regarded as an essential preliminary to any economic regeneration. Suitably controlled extension of credit, he argued, would have permitted an adjustment of demand and, by regulating imports, the adjustments to demand could have effectively varied the exchange value of the pound to any desired level. He regarded undue reliance on the Exchange Equalisation Account for maintaining the level of the pound as neglecting the importance of credit creation to economic recovery. In pursuing their strategy the Treasury officials were left quite remarkably free of interference from politicians; Neville

⁵¹⁷ G. C. Peden, *The Treasury and British Public Policy 1906 -59* (Oxford, O.U.P., 2000), p.254.

⁵¹⁸ *Ibid.*, p.255.

Chamberlain and the Cabinet of National Government were far more concerned with the strategically less important issues of import duties and Imperial Preference.⁵¹⁹

Britain's departure from gold had not been an isolated event. By September 1931 the strains of maintaining convertibility of currency with the ever appreciating value of gold had already forced Argentina, Brazil, Uruguay, Australia, New Zealand and Mexico off the gold standard. Following Britain's departure from the standard Canada, India, Egypt, Norway, Sweden, Denmark, Finland, Portugal and Japan left the gold standard before the end of 1931.⁵²⁰ Germany and Eastern Europe maintained a semblance of the gold standard by prohibiting both foreign exchange dealing and imports.⁵²¹ Only the United States of America, France, Switzerland, Holland and Belgium retained an effective gold standard after 1931. London's position as a centre for international credit meant that Britain's departure was by far the most significant of the withdrawals, a withdrawal which inevitably accelerated the worldwide process, but it was but one of many such events. The effect of such wide-scale withdrawal from gold

⁵¹⁹ M. M. M. Luthje, *The Politics of Monetary Policy in Britain from the First World War to the World Economic Conference of 1933*. Unpublished Ph. D. thesis, University of Cambridge, 2002. Pp. 133-165. Luthje gives an interesting account of the power struggle between the Treasury and the Bank of England over this period. Luthje's thesis presents Phillips and Hawtrey as the twin driving forces of Treasury policy over this period. I think that this is probably an overestimation of Hawtrey's authority.

⁵²⁰ R.G.Hawtrey, *The Gold Standard in Theory and Practice* (London, Longman's, 1947), p.142.

⁵²¹ *Ibid.*

was to diminish any competitive advantage Britain might have gained from devaluation and to encourage discussion of the formation of a 'sterling block'.

Despite Hawtrey's recommendation that Britain should not return to gold until measures had been taken to stabilise the wealth value of gold, he nevertheless regarded the effects of Britain's suspension of gold payments as 'far-reaching and catastrophic'.⁵²² The German prohibition against foreign exchange dealing was but one of the moves which gave rise to general fears for balances held in foreign capitals and an early effect of this fear was a withdrawal of balances by the French, Swiss, Dutch and Belgian banks from the United States. The situation with regard to the United States was both complicated and exacerbated by multiple banking failures following the Wall Street Crash, but as a result of European countries withdrawing their American holdings in the form of gold, the United States lost \$703 million of gold in September-October 1931.⁵²³ If this figure is added to that lost by Japan, Germany and Argentina, a total of \$858 million of gold was lost from the central banks of these countries. The total gain in gold of the central banks of the acquisitive European central banks was only \$653. The difference of \$205 million could only be attributed to hoarding by individuals and commercial concerns – a process which was sending up the price of gold and further deflating the price of other commodities in relation to gold. Bank failures in America produced a wave of currency hoarding in that country

⁵²² *Ibid.*

⁵²³ *Ibid.*, pp. 144-5.

which, alongside its loss of gold, forced the Federal Reserve sharply to raise its rediscount rate from 1.5 per cent to 3.5 per cent in October 1931 – a move which further deterred any expansion of credit. Overall, the initial effect of Britain's withdrawal from the gold standard was to exacerbate world deflationary pressures, but particularly in those countries which attempted to maintain the gold standard.

Britain, however, was given a degree of freedom. Whilst being unable to escape some of the consequences of the deteriorating world depression, the freedom to vary the value of the pound promised a reduction, in terms of gold, of the costs of British manufacturers. According to Hawtrey, this afforded the possibility of breaking the 'vicious circle' of trade depression. It held out the possibility of profits for industries.

At the prices prevailing in world markets they could see their way to business which, if not remunerative by the standards of normal times, would at any rate keep their works going, preserve their goodwill, and cover prime costs with some margin by way of contribution to overhead expenses. . . . There were seen in some industries an activity and an optimism such as had hardly been known since 1920. The flow of credit, which in conjunction with productive activity, generates incomes, was set in motion.⁵²⁴

⁵²⁴ *Ibid.*, p.147.

Unfortunately Hawtrey regarded this initial burst of optimism as premature since he viewed the policies adopted (largely by the Treasury) in the fields of credit and currency as too timid and tardy to decisively break the cycle of depression. He was critical of the long period of almost 22 weeks, between 21 September 1931 and 18 February 1932, when the authorities held Bank rate at 6 per cent, and although he did not voice them at the time, he had reservations about the 30 per cent depreciation of the pound being sufficiently adequate.

Hawtrey regarded the depreciation of the pound to a level where industry, with its rigid wage costs, could once again become profitable as one of the essential conditions for the continuation of the revival.⁵²⁵ Throughout the deliberations on the appropriate level for the pound (discussed in the previous chapter) Hawtrey had consistently argued for a 30 per cent depreciation leading to a value of \$3.40 (based on a 37.5 per cent fall in world wholesale prices and a 27 per cent fall in British export prices between 1925 and 1931, with some allowance for increased productivity). Reviewing his recommendations, in later writings, he considered that the price levels of 'the raw materials and farm products which do not meet a shrinkage of demand' (rather than those of manufactured goods) would have been the best measures of the change in the purchasing power of the pound. Any tendency for the price of manufactured goods to fall would have been tempered by a decline in their output – a decline which, through increased scarcity, would have tended to hold up their price to a

⁵²⁵ *Ibid.*

level which did not truly reflect the fall in world prices.⁵²⁶ Using the criterion of the price of 'raw materials and farm products' and two sets of data, first the fall in the American index of raw materials between 1925 and September 1931 of 41.2 per cent and secondly the fall of the American index of farm products over the same period of 44.9 per cent, Hawtrey suggested that to return the pound to its 1925 level should have demanded a depreciation of over 40 per cent below gold parity (which would have taken the pound to a value in the region of \$2.91). If Keynes's claim that the pound had been overvalued by 10 per cent in 1925 had been factored into these considerations it would have demanded an even lower value for sterling. Not only did the subsequent devaluation of the pound never reach anything like these levels, but the persistent appreciation in the value of gold after September 1931 (for reasons outlined above) meant that when a steady value of the pound (in terms of gold and the dollar) was eventually reached, the effective depreciation from the 1925 level was only 20 per cent.⁵²⁷ Thus, despite the depreciation of sterling, the sterling price level of British manufactured goods actually decreased slightly between September 1931 and June 1932.⁵²⁸

As well as the depreciation of sterling being inadequate to restore business profits, Hawtrey believed that the Treasury were guilty of allowing the Bank of

⁵²⁶ *Ibid.*, p.148. and pp. 137-8.

⁵²⁷ *Ibid.*, pp. 148-9.

⁵²⁸ *Ibid.*, p. 149.

England to maintain high interest rates for too long. Acknowledging that 'in the first week or two something of the kind was needed to prevent too precipitate a depreciation of the pound', Hawtrey believed that the authorities kept Bank rate at 6 per cent for too long. As a consequence he did not believe that the self-reinforcing cycle of depression had been effectively broken.

By the 18th February 1932, when Bank rate was reduced, the vicious circle of deflation had been once again joined, and it was as impossible as it had been a year before to induce traders to extend their borrowing by cheap money alone. The opportunity had been lost, deflation and falling prices prevailed in spite of the abandonment of gold, and the pound sterling had become a currency only one degree less intolerable than gold itself. . . . The transition to cheap money, when it came, was prompt. . . . But it was too late.⁵²⁹

Meanwhile, internationally, France continued to accumulate gold at the expense of its foreign currency reserves; in the first three months of 1932 the French central bank disposed of \$305 millions of foreign currency and increased its holding of gold by £313 millions.⁵³⁰ The rapid appreciation of the value of gold, and the heavy fall of world commodity prices (in terms of gold) continued to dog the economies of the remaining gold-standard countries. In an attempt to

⁵²⁹ *Ibid.*, p.152.

⁵³⁰ *Ibid.*, p.154.

'reflate', the Americans embarked upon a programme of 'open market purchases' – the Federal Reserve Bank releasing extra currency into the public domain by, itself, purchasing shares and Government bonds.⁵³¹ Given the amounts of gold which America had released to continental Europe, such intended injection of currency into the economy would have exceeded the limits imposed by the Federal Reserve's gold holdings. In February 1932 the American Senate passed legislation (the Glass-Steagall Act) which allowed the Federal Reserve to include Government securities, in addition to gold, as cover for its currency note issue. Thus there commenced the weakening of the rigid grip which the gold standard had held over the American economy. To Hawtrey, these were 'heroic measures', but they had little immediate effect on boosting American prices since the Federal Reserve's attempt to inject currency into the economy by purchasing securities in the open market was being offset by American's using currency to purchase, and hoard, gold.⁵³²

By the end of June 1932 France had effectively liquidated the whole of its foreign reserve holdings and its absorption of gold ceased. The American Federal Reserve's injection of currency into the economy, through purchase of securities, continued until August 1932. 'Faint stirrings' were felt as a few

⁵³¹ In his interview with Sir Alec Cairncross (HTRY 13/5) Hawtrey claimed that the word 'reflation' - the restoration of a previously higher price level – was one which he personally coined.

⁵³² R.G.Hawtrey, *The Gold Standard in Theory and Practice*, p.157.

commodity prices began to rise.⁵³³ But, according to Hawtrey, the American cycle of depression, like the British one, was never broken since:

[i]t proved only too easy to re-establish unrelieved pessimism. The fact is that the policy of reflation was placed at a serious disadvantage by the adherence of the United States to the gold standard. . . . the dollar could not depreciate in terms of wealth except in so far as the currencies of [France, Germany, Switzerland] depreciated.⁵³⁴

By the autumn, all indications of revival of American activity had faded. Renewed transatlantic depression caused such a fall in imports that America started to see a net inflow of gold. Their monetary authorities took the renewed accumulation of gold as an opportunity to reverse the policy of purchasing of securities in the open market; a move which had the effect of stemming the injection of liquidity into its sagging economy, continuing the fall in prices, and further increasing the grip of the depression on America. Borrowers from the American banks were obliged to repay the banks with currency which had a greater value than that with which they took out their initial loans. Many were unable to; there were a large number of defaulters and banks continued to collapse.

⁵³³ *Ibid.*, p.159.

⁵³⁴ *Ibid.*, pp. 159-60.

World depression, collapsing prices, French absorption of gold, American bank failures: this was the international background to the League of Nations World Economic and Monetary Conference, eventually planned for London in the summer of 1933. The countries remaining on the gold standard pointed an accusing finger at Britain; citing the uncertainties arising from her 1931 withdrawal from the gold-standard as the root-cause of the world's currency chaos. Prior to the London Conference there were monetary discussions in the League of Nations Conference at Lausanne, in the June and July of 1932, and preparatory discussions in Genoa and Geneva in October-November 1932 and January 1933. Throughout these meetings the senior British representative was the government's Economic Advisor, Sir Frederick Leith-Ross, but his case was prepared by the Treasury, and he was guided, at all times, by Treasury officials.

With the emasculation of the Bank of England, and the Government being absorbed with matters of Imperial Preference (a theme which set the agenda for the Ottawa Conference of July and August 1932), there were few challenges to the Treasury's domination of monetary policy. MacDonald's Economic Advisory Committee, a body organised by Henderson but which came to be dominated by Keynes, was one attempt to set up a counterweight to Treasury dominance. It suffered from the inevitable disagreements between economists from different schools and eventually dwindled in effectiveness to that of one of its subcommittees, the Committee on Economic Information.

Howson and Winch give a generally sympathetic account of the work of the Committee on Economic Information, and also of its parent body, the Economic Advisory Council.⁵³⁵ Whilst acknowledging that the successes of the E.A.C. – a body composed of politicians, businessmen and economists - were limited, they claim greater success for its offshoot, the economist-dominated Committee on Economic Information. Two members of the C.E.I., Sir Frederick Leith-Ross (1932 – 1939) and Sir Frederick Phillips (1935 – 1939), were associated with the Treasury, although Leith-Ross left the Treasury very soon after the formation of the committee. Howson and Winch take the view that the presence of Treasury members during discussions at the C.E.I. assisted in diffusing Keynesian ideas into the Treasury's work. In particular, they feel that the 'airing of differences of viewpoint in front of the Treasury members may even have been beneficial in changing the theoretical basis of the Treasury's views'.⁵³⁶

This view was gainsaid by Sir Frederick Leith-Ross, who felt that the divergence of views within the committee prevented it from giving clear guidance regarding policy, adding that the secretary of the committee 'worked like a slave to secure agreement between the irreconcilable views of the members'.⁵³⁷ Likewise, there seems to have been no permanent conversion of the Treasury's Second Secretary, Sir Frederick Phillips, to Keynesian thinking, since as late as

⁵³⁵ S. Howson and D. Winch, *The Economic Advisory Council 1930-39: a Study in Economic Advice during Depression and Recovery* (Cambridge, C.U.P., 1977).

⁵³⁶ *Ibid.*, p.157.

⁵³⁷ F. Leith-Ross, *Money Talks*, p.147

1939 he was found to be in agreement with Hawtrey that it was on the basis of the extension of credit, not public works, that unemployment might be reduced.

From the somewhat limited perspective of a study of Hawtrey, the evidence seems to support Leith-Ross's view that Keynes's ideas made little inroad into the Treasury during most of the 1930s. First, whenever differences of opinion arose between Hawtrey and Keynes, as in the appropriate plan to present to the World Economic Conference, Treasury officials seemed generally more sympathetic to Hawtrey. Secondly, whenever Hopkins or Phillips sought a second opinion on a Hawtrey memorandum then it was not to Keynes, but to Henderson that they invariably turned (it is worth bearing in mind that Hopkins, Phillips and Henderson were all products of Emmanuel College, Cambridge). By the 1930s Henderson was markedly less sympathetic towards Keynes's ideas on public works, regarding them as something of a 'quick fix' which would undermine business confidence.

This committee gave Keynes and Henderson an elevated platform from which they were enabled to retain the status they acquired in the 1920s – thorns in the side of the Treasury. Out of the Committee on Economic Information, on 17 May 1932, came a memorandum for increasing global liquidity and halting the fall of world prices. The plan was intended for the Lausanne conference of 1932, bore the signature of Henderson, and came to be recognised as the 'Keynes-Henderson International Note-Issue Plan'.⁵³⁸

The 'Keynes-Henderson Proposal' was based upon a number of 'International Certificates' being issued by the Bank for International Settlements, each certificate being fully equivalent to a fixed weight of gold. Every government which legislated to recognise the 'International Certificate' and fixed its currency in terms of gold would be entitled to receive an interest-free loan of the certificates up to a level determined by some economic criterion (Keynes-Henderson suggested 15 per cent of the gold value of its 1928 exports).⁵³⁹ It was intended that the extra liquidity afforded by this move would reverse the fall in world commodity prices. In the event of world prices being successfully forced up, then the Bank for International Settlements would have the authority to order governments to return an appropriate proportion of their certificates, a proportion which would rise to 100 per cent at the point where prices were restored to their 1928 level. Any government unable to meet the request for repayments would be charged interest of 5 per cent on outstanding loans.⁵⁴⁰

In addition to their proposal, Keynes and Henderson produced a four-page 'Argument' to back up their plan. They started from the proposition that world economic recovery required a recovery of commodity prices in terms of gold, and

⁵³⁸ Treasury Papers, T208/158. The Hawtrey Papers; 'A Monetary Proposal for Lausanne', H.Henderson, 17 May 1932.

⁵³⁹ In their book *The Economic Advisory Council 1930-39* Susan Howson and Donald Winch have the figure of '50 per cent of . . . of the country's exports' (p.115). This is almost certainly the result of an initial typing error. In the Treasury's version of the document the typewritten '50' is crossed out and '15' has been hand-written in its place. The figure of 15 per cent is also referred to, in subsequent memoranda, by Hawtrey

⁵⁴⁰ *Ibid.*

that whilst the Federal Reserve was attempting to turn the tide of falling prices by large-scale purchase of securities in order to swell their banks' funds of cash, this was but an experiment, and it might yet fail since 'solvent people are reluctant to borrow and those anxious to borrow are insolvent'.⁵⁴¹ The requirement, as they saw it, was to secure increases in the international purchasing power of debtor countries and in the domestic purchasing-power of the consuming publics in the creditor countries. Keynes-Henderson considered public works as one means of meeting the latter objective, but pointed out the associated problems in a way which suggests that they had taken on board the new 'psychological crowding-out' dimension to the Treasury View:

Such schemes . . . run up against the difficulty of Governmental finance. The Governments must either tax or borrow to defray the cost. If they tax there is no gain to consumers' income: if they borrow, the growth of deficits disturbs confidence, keeps up the rate of interest, and may stimulate a tendency to hoard or a flight from the currency, even a strong currency like the dollar.⁵⁴²

They argued that their scheme would allow different countries, with different needs, to pursue the most appropriate policies, thus for example, obviating the requirement to persuade all countries to pursue common credit policies (a co-

⁵⁴¹ *Ibid.*

⁵⁴² *Ibid.*, 'The Argument', paragraph 6.

operative requirement of Hawtrey's Genoa proposals for stabilising the wealth value of gold). Keynes and Henderson believed that acceptance of their scheme would have the same effect as if 'in every country there were discovered on the same day a vast hidden treasure of gold'.⁵⁴³

At the Treasury, Phillips had reservations about the plans, regarding 'the extreme novelty of the proposals' as being against their acceptance.⁵⁴⁴ The Keynes-Henderson proposal was passed on to Hawtrey, for comment on their technical merit. He produced his first memorandum on the plan on 20 May 1932; he seemed to be not particularly impressed, but as with many of Hawtrey's critical memoranda, there was an element of nit-picking about his criticism. As regards the plan's ability to relieve debtor countries of their liabilities, Hawtrey thought the suggested resources would be insufficient – he calculated (on the basis of 15 per cent of 1928 exports) that Germany would receive \$415 million, and that this 'would not go far towards relieving' her.⁵⁴⁵ Relief for the debtor countries, he believed, would come through growing exports, which depended upon 'a sufficient degree of inflation in the creditor

⁵⁴³ *Ibid.*, 'The Argument', paragraph 10.

⁵⁴⁴ Treasury Paper, T 175/17 (Phillips Papers). 'The Keynes International Note Plan', F.Phillips, 13 April 1933.

⁵⁴⁵ Treasury Papers, T. 208/158. 'Mr. Henderson's Monetary Proposals', R.G.Hawtrey, 20 May 1932.

countries'.⁵⁴⁶ Therefore he believed that the fundamental question was how the new international currency would operate on the creditor countries.

Hawtrey saw it as inevitable that the 'International Certificates', like the remaining gold, would eventually find their way into the possession of the central banks of the creditor countries where they would simply serve as additional central bank assets enabling them to increase their supply of cash to the commercial banks. As such, they would be nothing more than a variant of the securities which permitted open-market operations. The real problem of persuading 'solvent people to borrow' would remain. It is at this point in the interchanges that a sense of mutual mellowing from long-held uncompromising positions can be faintly detected. If Keynes (albeit, in conjunction with Henderson) could concede that concerns about a form of 'crowding out' were legitimate (see above), then the merest hint of validation of public works can be detected in the following part of Hawtrey's reply:

It is true that a Government could use the money . . . on measures of relief or public works . . . and if so used it would make its first appearance in the form of income, giving rise to demand. Undoubtedly there is something to be said, at a time of extreme business stagnation, for a Government deliberately incurring a deficiency on its current expenditure and meeting the deficiency by inflationary devices.⁵⁴⁷

⁵⁴⁶ *Ibid.*

This was a concession rather than a conversion. Hawtrey remained sceptical about the potency of public works:

In reality the direct [Hawtrey's underlining] effect of inflationary expenditure supplementing incomes is small. Mr. Lloyd George in 1929 wanted to spend £250 million a year. It is hardly conceivable that an outlay of that amount would be sanctioned, and yet the deficiency in the national income to be made up to get our price level normal . . . might well be . . . £2000 million a year. To be effective, the inflation must [again, Hawtrey's underlining] work through an expansion of credit.⁵⁴⁸

In order to emphasise his view on the inadequacy, in terms of the existing position, of public works financed by deficit spending, Hawtrey instanced the situation in the United States. The American national income had fallen from \$90,000 million in 1929 to about \$50,000 million in 1932 – an annualised fall in the region of \$40,000 million. Its budget deficit was accruing at an annualised rate of only \$2,000 million and was negligible in terms of the deficiency of income to be made up.

In summary, Hawtrey regarded the Keynes-Henderson plan as having no technical advantage over other inflationary plans, being disadvantageous in re-establishing fixed parities at a time when conditions were very unstable, and

⁵⁴⁷ *Ibid.*

⁵⁴⁸ *Ibid.*

having the defect of requiring prolonged negotiations when other reflationary methods, such as open-market purchases of securities by the central banks could be instigated without delay.

Four days later, on 24 May 1932, Henderson wrote a reply to the criticisms. His first point was that Hawtrey had assumed too rigid an interpretation of the Henderson-Keynes criteria for determining the level of distribution of the 'International Certificates'. Henderson regarded the freedom to re-commence trading of debtor countries as of greater importance than the inflating of prices in the creditor countries, and would have been happy to see the issue of certificates to any level adequate to 'ensure the unfreezing of the international situation'.⁵⁴⁹ With regard to the creditor countries, Henderson was adamant that his plan was more than merely a variant of current open-market operations in that his certificates would provide additional strength to the resources of governments. Furthermore, he argued, any unilateral or uncoordinated execution of open-market purchases by a country, or group of countries was liable to lead to mistrust and speculative flight from particular currencies. His 'Currency Certificate' plan would remove mistrust because it would be international in character. It would have the effect of an internationally coordinated open-market policy to restore the original purchasing power of gold, and although he did not remind Hawtrey of the fact, this was not very far away from what Hawtrey had recommended to the Genoa Economic Conference back

⁵⁴⁹ Treasury Papers, T 208/52. 'Reply to Mr. Hawtrey', H. D. Henderson, 24 May 1932.

in 1922, where he had advocated international cooperation on credit policy to stabilise the value of gold. Henderson's final point was concerned with the idea that his plan might not be 'practical politics'. Phillips had used this phrase about the plan, but it was originally inserted, by Henderson himself, into the original proposition to suggest that no 'plan' would be internationally acceptable until disputes over war reparations had been settled. He and Keynes had floated the idea as something that would be needed to fill the inevitable void in international monetary policy once reparations were out of the way.

Hawtrey came back at Henderson on 30 May 1932 to create a series of exchanges reminiscent of those of the previous year when, like two exhausted heavyweights, they had pounded each other over an appropriate level for sterling.⁵⁵⁰ Hawtrey repeated his view that revival of world trade depended upon industry once more becoming profitable in the creditor countries, and the effect of any new currency issue depended upon its effect on the creditor countries. In this respect he questioned Henderson's assertion that the new currency units would strengthen the resources of individual governments since the advances from the Bank for International Settlements would be added to their national debt. Moreover, he pointed out, if the British *Government* were to be the recipients of the certificates then it would be enabled to make commercial loans using the certificates as reserve. The interest from these loans would accrue to the Government at the expense of the Bank of England.

⁵⁵⁰ Treasury Papers, T 208/52. 'Mr. Henderson's Monetary Proposal – Further Note', R.G.Hawtrey, 30 May 1932.

With regard to the international character of the proposal, which Henderson felt gave it a distinct advantage, Hawtrey had some reservations about linking up *all* currencies to that of the depressed United States, but he viewed the prospect of the flight from a *particular* currency with some equanimity:

[i]f only a flight from the pound or a flight from the dollar could be started, our difficulties would be at an end. In reality I do not think Mr. Henderson's plan would do anything at all to prevent either of them from occurring, and the plan is all the better for that.⁵⁵¹

The preceding paragraph calls for a moment's pause. Conventional wisdom was that a single country's depreciation of its currency was an unfriendly act, designed to gain immediate short-term advantage for its exports, but that the ultimate gain would be nothing since it would provoke competitors to depreciate by an equal, if not greater, amount. Hawtrey did not accept that. The benefit of depreciation was not competitive advantage but the rise of the price level in terms of the depreciated unit, thereby enabling manufacturers to make profits and stimulate economic activity. The increase of activity would bring about an expansion of credit – as ever, the key to economic expansion for Hawtrey. Subsequently, another country might devalue and receive the same stimulus to its economic activity. It could only work if, at any one time, a country acted in

⁵⁵¹ *Ibid.*

isolation so that the general world price level, in terms of gold, remained roughly constant. If all countries devalued in consort then any one country's devaluation would be accompanied by a corresponding fall in price and no expansion could ensue. Hawtrey applauded such devaluation, and believed that the process contained its own corrective mechanism which would prevent it being carried out to excess – eventually, unduly large profits would lead to excessive wage demands.⁵⁵²

Hawtrey conceded that if the Keynes-Henderson plan ever did become 'practical politics' then with 'careful handling' to avoid landing the world in a fresh series of monetary fluctuations it was one way of leading the world out of depression – but the careful handling would not be forthcoming. The plan would be rejected by the French who had deliberately built up their gold reserves as a buffer against currency collapses. They would be unwilling to participate in any scheme which diluted their holdings. Nor would the scheme commend itself to the United States since public opinion in that country was 'psychologically resistant' to a form of inflation which depended upon the creation of 'new' currency. Hawtrey felt that the necessary legislation could never get through Congress and even if it could, the inevitable delay would mitigate against the scheme.

Two weeks after Hawtrey's final reply to the Keynes-Henderson document, the League of Nations Conference opened at Lausanne on 16 July 1932. Sir

⁵⁵² R.G.Hawtrey, *The Gold standard in Theory and Practice*, pp. 204-5, 'Competitive depreciation'.

Frederick Phillips concurred with Hawtrey that under prevailing circumstances, especially with the stance likely to be adopted by the French, the Keynes-Henderson scheme stood no chance of acceptance and the plan was not therefore put to the Lausanne Conference. Immediately prior to the Conference, Hawtrey produced a memorandum suggesting that, because of the difficulty of securing agreement, it would be inappropriate at that stage to produce any specific plan for raising world prices. Nevertheless, he urged the British delegation to stress the importance of raising world gold prices, and suggested that it might point to a role which individual countries could play by their taking steps to prohibit the holding of gold by individuals.⁵⁵³ In the event, the discussions at the Lausanne Conference were dominated by the issue of the cancellation of war reparations and questions of currency stability hardly surfaced. The Lausanne Conference ended with an agreement to abolish reparations and, in the absence of progress on monetary stabilisation, a request that the League of Nations hold a World Conference 'to decide upon the measures to solve the other economic and financial difficulties which are responsible for, and may prolong, the present world crisis'.⁵⁵⁴ For the time being, the real issues had been shelved. The gold bloc blamed Britain's departure from gold for currency chaos; Britain required measures to reflate prices before returning to gold could be contemplated. Under these

⁵⁵³ Hawtrey Papers, HTRY 1/49. 'Monetary Discussions at Lausanne', R.G.Hawtrey, 7 June 1932.

⁵⁵⁴ S.Howson and D.Winch, *The Economic Advisory Council 1930-1939*, p.114.

circumstances the onus was on Britain to devise a reflationary policy which was internationally acceptable.

To prepare the ground for the 1933 World Economic Conference, a Preparatory Commission met in Genoa in October-November 1932. The apparently irreconcilable differences between Britain and the gold bloc emerged. The gold bloc rejected ideas of reflation and insisted that the onus was on non-gold countries to deflate.⁵⁵⁵ Deflation was diametrically opposed to the Treasury's policy, but it had no plan to offer which might have bridged the two camps. Prospects for the 1933 World Economic Conference were not good. Ramsay MacDonald had pressed for the conference to be in London with himself as its president; his prestige rested on its success and he was anxious that the British delegation should be well prepared for the conference. The Treasury were under rather more pressure than usual to produce some scheme to present to the gold bloc. MacDonald's own advisory group (in which Keynes was again prominent) prepared a revised version of the original Keynes-Henderson plan. Once more the Treasury rejected it as internationally unacceptable, but this put even more pressure on the Treasury to come up with its own plan.⁵⁵⁶ The Treasury's solution was the Kisch plan; a plan devised in early 1932 by Cecil Kisch, an official at the India Office, and later revised in conjunction with Phillips

⁵⁵⁵ M. M. M. Luthje, *The Politics of Monetary Policy in Britain from the First World War to the World Economic Conference of 1933*. Unpublished Ph. D. thesis, University of Cambridge, 2002. pp.175-177.

⁵⁵⁶ *Ibid.*, p.179.

and Hawtrey at the Treasury. Whilst Treasury officials may have had limited hopes for the plan, it did at the very least answer criticism that the Treasury had no policy for international monetary stabilisation.⁵⁵⁷

Kisch's revised memorandum clearly presented the problem that would be faced by the British delegation at the conference: Britain would insist on a rise in world price levels before its return to gold could be contemplated - and the gold-using countries would insist on Britain returning to gold as a prerequisite of monetary stabilisation.⁵⁵⁸ Therefore, Kisch argued, any plan must hold out the prospect, within a measurable period of time, of Britain returning to the gold standard – but under conditions which it regarded as satisfactory. His plan started from five basic propositions: appreciating gold values had unfairly advantaged creditor countries at the expense of the debtors since the 'real' value of what they had to repay had increased; the exhaustion of gold in certain central banks had prompted various regimes of import control and exchange restriction; the high levels of gold-holding in the central banks of the creditor countries were a symptom of 'something radically unsound'; the longer such disproportionate gold holdings were held, the more popular opinion would resist their reduction; the enlargement of the gold basis of credit would contribute to the restoration of world economy. The purpose of Kisch's plan was to enlarge

⁵⁵⁷ *Ibid.*, pp. 180-85.

⁵⁵⁸ Treasury Paper T 177/7 (Phillips Papers). 'The Gold Problem', C. Kisch, 25 November 1932.

and redistribute the gold basis of credit, and to safeguard, as far as possible, the recurrence of any mal-distribution of gold.

The achievement of these ends would be by the following procedures.⁵⁵⁹ First, central banks with excess gold would transfer gold to their *governments* in exchange for government bonds; gold earns no interest, so if the government paid some interest on the bond their central bank would be in profit. Secondly, *governments* thus endowed with gold would transfer it to the *governments* of debtor countries in exchange for a bond repayable, with interest and in the currency of the lender, over a long period (say 30 years). Thirdly, debtor governments, newly flush with gold, would transfer it to their central bank in exchange for a cancellation of the governments indebtedness to its central bank (or a deposit at the bank in favour of its government). There were provisions for the process to be carried out through a subsidiary of the Bank for International Settlements. In order to guard against further mal-distribution of gold Kisch, and his Treasury collaborators, included a provision that creditor countries should make deposits at the Bank of International Settlements (or its designated subsidiary) when its gold assets rose above a prescribed level.

The Kisch plan can be seen as a modest attempt to redistribute the world's gold supplies in favour of debtor countries without diluting the gold holdings (as the Keynes-Henderson plan would) of the creditor countries. Its provisions for enabling governments to procure gold from their central banks would have

⁵⁵⁹ *Ibid.*

further weakened the power and independence of central banks in the face of government, and the Bank of England pressed for an alternative plan (the Kindersley plan), but the Treasury disregarded it in favour of Kisch.⁵⁶⁰

After the lack of progress at the first Preparatory Commission at Genoa, a second Preparatory Commission for the 1933 World Economic Conference was arranged for Geneva in January 1933. The British Delegation of Leith-Ross and Phillips was strengthened, for the purpose of dealing with technical issues, by the addition of Hawtrey and Kisch. Hawtrey's inclusion annoyed Montagu Norman at the Bank of England.⁵⁶¹ For many years Hawtrey had been an irritant to the Bank: criticising its maintenance of high interest rates and its refusal to release gold prior to the return to the gold standard; demanding that the Treasury exercise its statutory powers over the Bank to force down interest rates in the late 1920s; influencing the Treasury to target a rate of exchange with the dollar in 1931 which the Bank believed to be dangerously low. After an initial 'honeymoon' between the two men in the early 1920s, when Hawtrey had given support to the Bank's high discount rate to fight post-war inflation, Norman had always regarded Hawtrey as a radically dangerous theorist. The rift between Hawtrey and Norman had, in fact, pre-dated the return to the Gold Standard. Although Norman and Hawtrey consulted over the Genoa resolutions in 1923,

⁵⁶⁰ M. M. M. Luthje, *The Politics of Monetary Policy in Britain from the First World War to the World Economic Conference of 1933*. Unpublished Ph. D. thesis, University of Cambridge, 2002, pp. 184-186.

⁵⁶¹ *Ibid.*, pp.186-7.

Hawtrey had already been pressing for lower interest rates and urging the Bank of England to export gold to America as a means of encouraging prices rises there. Norman regarded the former measure as an inflationary risk and the latter measure as futile in view of America's ability to 'sterilise' its excess gold holdings. In a letter, in 1922, to Benjamin Strong, Norman's counterpart at the New York Federal Reserve Bank, Norman criticised Hawtrey as someone 'who made it his particular business to quarrel with the policy of the Treasury and the Bank of England'.⁵⁶² At an even earlier date, in his diary entry of 7 July 1921, Norman had expressed his mistrust of Hawtrey's 'reliance on theory'.⁵⁶³

Writing after the Second World War, Hawtrey reported that in 1923, his proposal to accelerate American price rises by the shipment of gold was rejected by Norman, and even when the proposal was revived in 1925, by Churchill as Chancellor of the Exchequer, it was dropped in deference to Norman.⁵⁶⁴

Whilst Leith-Ross was to lead the British delegation, Norman knew that policy would be directed by the Treasury. Sir Frederick Phillips was the driving force within the Finance Division of the Treasury, but he tended to look to Hawtrey for

⁵⁶² Letter from Norman to Strong, 24 February 1922, quoted in *British Capitalism at the Crossroads, 1919-1932: a study in politics, economics and international relations* (Cambridge, CUP, 1987), p.41.

⁵⁶³ Bank of England, ADM34/10, 7 July 1921.

⁵⁶⁴ R. G. Hawtrey, 'Light on Montagu Norman's Policy', *The Bankers' Magazine* 188 (1957).

R. G. Hawtrey, 'The Return to Gold in 1925', *The Bankers' Magazine* 208 (1969).

theoretical and technical support, and Norman was therefore concerned at Hawtrey's inclusion in the official British delegation.

The progress made by the delegates at the second Geneva Preparatory Commission was sufficiently encouraging to give the green light to the World Conference, whose very existence had been in doubt after the first Genoa Preparatory Commission. Britain had tempered the demands of the gold bloc, which would have insisted that it return to gold, by forcing an acknowledgement of the deflationary problems which had caused the defaulting countries off the gold standard. The Kisch plan was not discussed by the Commission, but it remained open for discussion at the World Conference planned for June 1933.⁵⁶⁵

Whilst the monetary authorities waited for the World Conference, the world situation deteriorated. To Hawtrey, the growing banking crisis in America was yet one more consequence of failure to stabilise the value of gold.

The same deadly disease that had destroyed the German banking system was assailing that of the United States. It was the appreciation of gold, or, in other words, the fall in the price

⁵⁶⁵ P. Clavin, *The Failure of Economic Diplomacy. Britain, France, Germany, and the United States, 1931-1936* (London, Macmillan, 1996).

H. Samuel, 'The World Economic Conference', *International Affairs (Royal Institute of International Affairs 1931-39)*, Vol. 12, No.4 (Jul., 1933) pp. 439-459.

J.K.Galbraith, *Money* (Harmondsworth, Penguin, 1975), pp. 213-217.

The background to attempts to stabilise world currencies, including the World Economic Conference of 1933, are dealt with in Clavin (1996). An account of the World Economic Conference from the perspective of the serving Home Secretary is given in the text of an address by Sir Herbert Samuel to the Royal Institute of International Affairs on 23 May 1933. There was an element of circus attached to the proceedings of the World Economic Conference and Galbraith (1975) captures this well.

level that was steadily augmenting the burden of debts in terms of goods, and reducing those customers who had received advances from the banks to insolvency.⁵⁶⁶

Hawtrey was increasingly coming to see stabilisation of world prices and economic expansion as being realisable only through joint action between Britain and the United States. He regarded it as essential that agreement be reached between the world's two most powerful economies to permit easy credit and carry out open-market purchases of securities by their central banks. Any consequent loss of gold through their adverse balance of payments could be countered by a negotiated devaluation of their currencies against gold.⁵⁶⁷ When recommending a \$3.40 value for the pound, during the discussions of 1931, he had always emphasised open market operations, rather than the sale and purchase of foreign exchange through an equalisation account, as a means of both controlling the value of sterling and permitting expansion. In his diary entry of 8 April 1933, Leo Amery records a 'certain amount of interesting discussion' in which Hawtrey despaired of anything being 'done to set the economic situation right as long as the present people were in control at the Treasury and the Bank of England'.⁵⁶⁸

⁵⁶⁶ R. G. Hawtrey, *The Gold Standard in Theory and Practice* (London, Longman's 1947), p.161.

⁵⁶⁷ Hawtrey was to later give voice to this idea in a Treasury memorandum, T 208/168, 'Stabilization of Exchange; the best of both worlds', 8 July 1933.

On 20 April 1933 the United States authorities ceased the issue of licences to export gold, effectively withdrawing from the gold standard, and the dollar immediately began to depreciate. To Hawtrey the resulting 'relief to business was sensational, the transition to activity rapid'.⁵⁶⁹ The index of factory employment, which had fallen from 108.4 in August 1929 to 62.2 in March 1933, rose again to 77.4 by July 1933. Taken with the figure for the average weekly hours worked, which rose from 32.2 hours in March to 42.6 hours in July, these figures indicate an increase of over 60 per cent in the input of factory labour. This corresponds with the increase in the American index of industrial production, which rose from 60 to 100 over the same period.⁵⁷⁰ In his discussion of the Keynes-Henderson 'International Note' plan, Hawtrey had argued for the merit of serial devaluation and the American experience seemed to be confirming his argument. After the burst of activity between March and July the American revival was checked and industrial employment fell for the remainder of the year.⁵⁷¹ Hawtrey attributed this to the provisions of Roosevelt's National Industrial Recovery Act – part of his 'New Deal' – under which weekly wages were to be maintained whilst, to spread employment, hours were reduced.

⁵⁶⁸ J.Barnes and D.Nicholson (ed.), *The Empire at Bay: The Leo Amery Diaries 1929-1945* (London, Hutchinson, 1988), p. 292.

⁵⁶⁹ *Ibid.*, p. 163.

⁵⁷⁰ *Ibid.*

⁵⁷¹ *Ibid.*, p.165..

The increase in costs suddenly extinguished the prospect of profit that had been offered to industry by the growing depreciation of the dollar. With the prospect of profit there vanished the stimulus of activity The vicious circle of expansion was broken, and the impetus of recovery was lost.⁵⁷²

The Treasury had gone to great lengths during 1931-32 to establish a policy for sterling. The policy eventually established, of maintaining the pound at \$3.40, was based upon the assumption that the dollar would maintain a stable relationship with gold. The dollar's departure from gold left this policy in disarray since, in the three months subsequent to leaving gold, the dollar depreciated by 28 per cent and returned to very nearly its old parity with the pound.⁵⁷³

Prior to the United States going off the gold standard, a visit to Washington had been arranged for Ramsay MacDonald. He had been given an 'aide memoire' on monetary questions, prepared by Phillips and Hawtrey, and it had been agreed, in discussions with Neville Chamberlain, that the 'Kisch plan' for redistribution of the world's gold supply should be brought up.⁵⁷⁴ MacDonald's 'memoire', ruling out any return to gold until prices had risen to cover costs, bore the clear stamp and language of Hawtrey. It suggested that the principal

⁵⁷² *Ibid.*

⁵⁷³ *Ibid.*, p.163.

⁵⁷⁴ Treasury Papers, T 175/17 (Phillips Papers). Hopkins to Ferguson, an aide memoire for the Prime Minister, 13 April 1933.

requirements would be 'agreement between principal creditor countries . . . to maintain and extend the policy of cheap and plentiful credit with a view to a rise in wholesale prices (and). . . a combined aggressive expansionary policy by the Federal Reserve Board, the Bank of England and Bank of France'.⁵⁷⁵ It suggested that the Bank of France 'be empowered to undertake open market operations . . . to further credit expansion policy'. It cautioned that 'expansionary action by Governments [underlining in the memorandum] . . . depend for success on the cooperation of Central Banks', and if 'financed by ordinary methods . . . will result in a rising rate of long term interest and their effect on prices would be negligible and very slow'. The note went on to add, in best Hawtreyan fashion, that if 'the central bank in each country cooperated by expanding credit . . . the desired effects would be produced'.⁵⁷⁶ Susan Howson may have concluded that 'Hawtreys' influence waned during the 1930s',⁵⁷⁷ but in this short note written during 1933, for the Prime Minister's use on visiting the American President, the ideas, tone and language of Hawtreyan economics were still being conveyed to the highest offices in the world.

MacDonald's visit to Washington was unproductive. He was accompanied by the Government's Chief Economic Advisor, Sir Frederick Leith Ross, that erstwhile deputy to Niemeyer and Hopkins at the Treasury – a man whose personal

⁵⁷⁵ *Ibid.*

⁵⁷⁶ *Ibid.*

⁵⁷⁷ S. Howson, 'Hawtreys and the Real World', p.176.

preference and instinct was still for Britain's earliest possible return to an international gold standard. Leith-Ross relied, for guidance, on frequent telegram exchanges with Bank and Treasury. Roosevelt, guided by the merchant banker James P. Warburg, was willing to enter into an informal three-way arrangement by which separate exchange equalisation funds would operate in concert to stabilise the dollar, sterling and franc. The Bank of England cautioned Leith-Ross against this since it feared such an arrangement would delay its preferred option – the return to a gold standard; the Treasury, whose strategy still hung on the \$3.40 pound, found itself in the incongruous position of being unable, itself, to stabilise on gold, yet being reliant upon, and hoping for a return to the gold standard by the Americans. Leith-Ross received no clear message and the Washington talks made no progress towards currency stabilisation.⁵⁷⁸

J. K. Galbraith has described the World Economic Conference of 1933 as 'one of the truly bizarre international convocations of the century'.⁵⁷⁹ For Ramsay MacDonald, it may have been conceived as a means of allowing him, in his role as President, to act the part of the world statesman, but its success was increasingly being seen as a means by which the National Government might be seen to deliver upon its 'Doctor's Mandate'.⁵⁸⁰ A. J. P. Taylor describes the

⁵⁷⁸ M. M. M. Luthje, *The Politics of Monetary Policy in Britain from the First World War to the World Economic Conference of 1933*. Unpublished Ph. D. thesis, University of Cambridge, 2002, pp. 224-228.

⁵⁷⁹ J. K. Galbraith, *Money: whence it came, where it went* (Harmondsworth, Penguin, 1975), p. 213.

conference as MacDonald's 'last moment of aspiration', as he sought to end the world's economic problems through a great international meeting.⁵⁸¹

Sixty-six nations, 'not excluding Liberia', convened at the Geological Museum at South Kensington on 12 July 1933.⁵⁸² They ostensibly intended that international discussion might mitigate unstable currencies, beggar-my-neighbour tariffs, the dumping of surplus commodities, and in consequence, the world's economic depression. Each nation had its own agenda. France, as the leader of the gold bloc, hoped to shame the defecting nations into once more stabilising their currencies in terms of gold. The British Treasury, who had led the departure from gold and seen relief from the burden of high interest rates as a consequence, secretly hoped that the rest of the world would not respond to French promptings.⁵⁸³ The cynicism within the Treasury towards the World Economic Conference is wonderfully illustrated by a hand-written comment by its Permanent Secretary, Sir Warren Fisher, which he added to a short memorandum to the Chancellor by Sir Richard Hopkins, during the course of which Hopkins outlined the possibilities of agreement on currency with France. Fisher had few illusions about the conference:

⁵⁸⁰ M. M. M. Luthje, *The Politics of Monetary Policy in Britain from the First World War to the World Economic Conference of 1933*. Unpublished Ph. D. thesis, University of Cambridge, 2002, p.205.

⁵⁸¹ A. J. P. Taylor, *English History 1914-45* (Oxford, O.U.P., 1965), p.334.

⁵⁸² *Ibid.*, p.335.

⁵⁸³ *Ibid.*

It is that precursor of Utopia – the World Economic Conference – that forces upon the Chancellor’s attention this metaphysical, not to say mystical, topic.⁵⁸⁴

The shadow of unpaid war-time debts to the United States remained, and hung over the conference. It had been agreed in preparatory talks that any discussion of war debts would jeopardise the possibility of currency agreement - rendering such a topic taboo. Ramsay MacDonald launched the business proceedings by calling, in his opening address, for a reduction of war debts, leaving the British delegation to explain that this was an aberration brought on by his ‘advanced mental and physical deterioration’.⁵⁸⁵ France, predictably, made the stabilisation of currencies in terms of gold the first order of business. The American response to the French changed as the personnel of its delegation changed. Roosevelt’s letter to the conference on 2 July 1933, advising it that the United States intended to manage the dollar for the purposes of internal stability rather than external stability, was less of a ‘bombshell’ to the conference than a humane injection, finally putting it out of its misery. Keynes congratulated Roosevelt on his stand, declaring him to be ‘magnificently right’.⁵⁸⁶ The British Treasury, for the moment enjoying the relief of low interest payments on its debts, was, on

⁵⁸⁴ Treasury Papers, T 172/1810. Memorandum from Sir Richard Hopkins to the Chancellor of the Exchequer, 12 December 1932.

⁵⁸⁵ J.K.Galbraith, *Money*, p.215.

⁵⁸⁶ *Ibid.*, p.219.

the whole, probably equally appreciative of Roosevelt's announcement. It had experienced too many recent years of balancing internal price levels against the external value of the pound to want to return to that situation so soon.

If there was despondency from within the Treasury at Roosevelt's rejection of cooperation on currency exchange, then it was from Hawtrey.⁵⁸⁷ From the time of the 1922 Genoa Conference he had urged international cooperation between the world's central banks to both stabilise the exchanges and also stabilise the wealth value of gold in order to maintain steady world prices. These twin objectives represented 'the best of both worlds' to him. On 8 July he produced a short memorandum with this title, arguing that by stabilising the pound against both the newly valued dollar and gold, it would, indeed, be possible to have 'the best of both worlds'.⁵⁸⁸

Before Hawtrey produced the memorandum the dollar had been falling rapidly, and by the date of the memorandum it had fallen to a level where the pound corresponded to \$4.70. This was sufficiently close to the historic value of the pound for Hawtrey to propose that there was 'the prospect of linking the

⁵⁸⁷ Since moving off the gold standard, Hawtrey had wanted inter-bank co-operation on interest rates for the purpose of stabilising the value of gold and achieving exchange-rate stability. The Treasury were more concerned about the maintenance of permanently low interest rates whilst managing the exchange rate through the Exchange Equalisation Account. Hawtrey's absence from the World Economic Conference, whose objective was international agreement, further suggests that the Treasury was lukewarm towards the conference's aims.

⁵⁸⁸ Treasury Papers, T 208/168. 'The Best of Both Worlds', R.G.Hawtrey, 8 July 1933.

pound to the dollar without any serious risk of subsequent loss'.⁵⁸⁹ He suggested that it would be possible to stabilise the exchange at around \$4.70 'by buying all the dollars offered on the market', and that the risk of holding dollars would be 'much less than the risk of holding either gold or gold currencies, for it is almost certain that the purchasing power of gold must fall heavily in the next year or two'.⁵⁹⁰ His argument for stabilising the pound against the dollar was that it would encourage trade and enable Britain, and all sterling-linked countries, to participate in the rising prices and revival of business which, since it devalued its currency, were beginning to take place in the United States. He also suggested that there was a case for simultaneously, and independently, stabilising both the pound and the dollar in terms of gold.

For the past twelve months we have been buying gold and so helping to make it dearer. If we started pegging the pound and gold at a time when we are independently taking measures to reduce the purchasing powers of the pound, then we shall have to sell gold. . . . The appearance of a flood of gold pouring into the continent would tend to diminish the hoarding . . .⁵⁹¹

Hawtrey did not spell it out, but the 'measures to reduce the purchasing powers of the pound' would be open-market purchase by the Bank of England in order to

⁵⁸⁹ *Ibid.*

⁵⁹⁰ *Ibid.*

⁵⁹¹ *Ibid.*

stimulate credit creation. Such credit creation would have drawn in imports and forced the Bank of England to release gold – gold which would have formed the basis for credit expansion and economic revival abroad. This argument for the exportation of gold as means of boosting business abroad and reviving international trade was little different from that which Hawtrey had been making through the late 1920s – the argument which Keynes had strongly queried during Hawtrey's interrogation before the Macmillan Committee in 1931.

In producing these proposals Hawtrey severely misjudged the mood of the Treasury. Apart from MacDonald, whose personal prestige had suffered from the conference's collapse, few people in Britain were sorry at the outcome of the World Economic and Monetary Conference. The Chancellor and the Treasury were relieved; they had little interest in international monetary arrangements as means to economic recovery. For the moment, low interest rates at home meant low debt costs and relief for the Budget. The Exchange Equalisation Account was successfully serving the purpose of managing the external value of the pound. The Treasury was happy to focus on those domestic variables which it could control, without jeopardising them to the vagaries of international arrangements. 'The Best of Both World's' was Hawtrey's last attempt to persuade his colleagues of the possibility of action on an international scale to reflate the world's economy, and probably marked the peak of his influence over the Treasury's monetary policy.

Postscript to Chapter 7

Hawtrey and 'Competitive Devaluation'

Throughout the depression and the relentless appreciation of the value of gold, Hawtrey argued that whilst simultaneous devaluation of all currencies in terms of gold would not bring about recovery, a *staggered* devaluation of all currencies would, nevertheless, be effective. He gained little support for this argument from his fellow economists.⁵⁹²

In the process of reviewing Hawtrey's book *Trade Depression and the Way Out* in June 1934, Roy Harrod had this to say, and his view may be taken as a typical criticism:

The sections of [Hawtrey's] argument which seem least convincing are those concerned with competitive exchange depreciation. That is an absurd bogey we may well agree. But to the view that each country can by depreciating its currency send up its own price level without damaging the external price level is less easy to subscribe. Imagine the world divided into two areas, A and B. The authorities of A arrange that the value of its currency in terms of B's is reduced. The necessary consequence is a realignment of prices, such that international goods have the same price in A and B, taking the new rate of exchange into account. [Why] is it certain that it is the A prices that will move? Is it not equally likely that B prices will fall? [Or]

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that A prices will rise somewhat and B prices fall somewhat? While refusing to regard competitive exchange depreciation as a menace, we need not rush forward and hail it as a panacea.⁵⁹³

Harrod's argument was surely right on the basis of his assumption that the world was divided into only two trading zones. Hawtrey's theoretical argument was based upon a single country, in isolation, taking the step to depreciate its currency. This argument assumed that a single country's change in prices would not materially have affected world prices. In this assumption Hawtrey, too, may have been correct – but the wholesale departure of countries from gold after 1931, added to the formation of a large group of countries who attempted to maintain parity between their currencies and sterling, did in effect, gradually create a model somewhat closer to that of Harrod than that of Hawtrey's *isolated countries*.

On 25 April 1933 Hawtrey had read a paper 'Public Expenditure and Trade Depression' to the members of the Royal Statistical Society.⁵⁹⁴ He asserted that:

Currency depreciation is the most satisfactory measure of revival As our experience in the weeks following the suspension of the gold standard in 1931 demonstrated, a sudden depreciation of the currency unit of an order of 20 per cent is quite sufficient

⁵⁹³ R.F.Harrod, *The Economic Journal*/Vol. 44 No. 174 June 1934. Review of Hawtrey's book *Trade Depression and the Way Out*.

⁵⁹⁴ Printed and published as R.G.Hawtrey, 'Public Expenditure and Trade Depression', *Journal of the Royal Statistical Society*, Vol. 96, No. 3. (1933), pp.438-477.

to revive the spirit of enterprise here is a short cut to revival, which makes other and more doubtful expedients unnecessary. The world price level can be made remunerative to our producers . . .⁵⁹⁵

From the floor of the meeting Professor Jones raised a somewhat different point to that raised by Harrod when he questioned Hawtrey concerning the effect on exports arising from progressive currency depreciations:

. . . Mr. Hawtrey said . . . that by . . . depreciating the exchange it would be possible to increase employment more quickly and more permanently than in any other way, and then he went on to say that it did not make any difference if a similar policy were pursued by other countries at the same time. In other words, by depreciating the exchange it would be possible to increase exports, decrease imports and thereby secure an all-round improvement in the trade of the country, and then when other countries did the same, they could enjoy the same results.⁵⁹⁶

Professor Jones suggested that the effect on one country would be destroyed by extending it to all countries, and that as countries sought to progressively gain further advantage, 'the result would be serious'. He also suggested that if Hawtrey's analysis was correct, then this country need not fear the recent

⁵⁹⁵ *Ibid.*, pp. 456-7.

⁵⁹⁶ *Ibid.*, p.469.

departure from gold of the United States, but *he* feared the result would be an increase in American exports and a decrease in her imports – all to the detriment of Britain.

Hawtrey replied that Professor Jones's view of a depreciation of currency being for the purpose of 'increasing exports, decreasing imports and thereby securing an all-round improvement in the trade of the country' was a 'complete misconception'.⁵⁹⁷

I advocated depreciation as a device for starting a credit expansion and a rise of prices. If the rise of prices did not occur, then indeed, the depreciation would increase exports and decrease imports. But that merely means that a favourable balance of payments would counteract the depreciation, the currency would rise again and the plan would have been a failure.

If, on the other hand, the plan achieved its object, there would be an expansion of the consumers' income, which would attract additional imports, and would require a continuance of the depression of the currency to maintain equilibrium in the balance of payments. . . . therefore there is nothing inconsistent in supposing all countries to adopt the same policy.⁵⁹⁸

⁵⁹⁷ *Ibid.*, p.475.

⁵⁹⁸ *Ibid.*, pp. 475-6.

Hawtrey deplored the view that depreciation of the currency was in some way an unfriendly act; a device for assisting one's own exports by making them cheaper, and repelling the exports of others by making them more expensive. He saw benefits to exporters through the depreciation, but the main benefit was through the rise in price of exportable products on the home market.

His causal sequence ran as follows.⁵⁹⁹ The depreciation would cause imported goods to be dearer (in terms of sterling). It is at this stage of the argument that Hawtrey believed the critics of currency depreciation made a false assumption. The assumption that people would then reject imports and immediately turn to alternative home-produced goods, whose price would remain unchanged, was, he believed, a false one. Home-producers in competition with importers, had often been unable to make profits, and so had curtailed production. Alternative cheaper home produced goods were simply not available. However, the newly increased price of the imported goods afforded the domestic producers the opportunity of raising prices to a level where profits could, once again, be made. This would encourage them to expand production. To do so, required the availability of cheap credit to buy materials and pay extra wages until such times as goods could be sold. The newly created credit would be the source for the increase in the consumers' income and consumers' outlay which would provide the means for purchasing the increased output. Hawtrey conceded that the increase in price of imported goods could also have been

⁵⁹⁹ R.G.Hawtrey, *The Gold Standard in Theory and Practice* (London, Longman's, 1947), p.194.

achieved by import duties, and a similar sequence would have followed, but the imposition of import duties without currency depreciation would have handicapped the principal exporting industries; by keeping the price of exports restrictively high and also through retaliatory measures.

Writing in 1947, Hawtrey suggested that the process of staggered depreciation had, in fact, occurred during the early 1930s, and had in large measure been responsible for the climb out of the deep depression of 1929-32.

. . . the benefit is conditional on the action of the country being more or less *isolated*; there must be a sufficient inertia in the world price level in terms of other countries' currencies for it to pull against. . . . It is as if several men were in a pit too deep for any one of them to climb out alone, yet such that any one of them can climb out on the shoulders of the others, and once out, can help his comrades up. But at no time from the first suspension of the gold standard at the end of 1929 to the break up of the gold standard group in September, 1936, was there any question of general simultaneous depreciation. The countries acted one by one or occasionally in groups of two or three, but never so many at times as to fail to secure a sufficient leverage on the price level.⁶⁰⁰

Subsequent writers have questioned the extent to which devaluation – as opposed to the imposition of tariffs – was responsible for the industrial revival of the 1930s. To Hawtrey, the effect of an import tariff had similar effects to that

⁶⁰⁰ *Ibid.*, p.205.

of devaluation – both raised the price of imported goods, thus allowing domestic producers to raise the price of *their* goods. Higher prices enabled employers to make profits and thus encouraged them to expand production. Overall, he argued that devaluation was not as restrictive on trade as import tariffs.

The withdrawal from the Gold Standard saw both devaluation *and* import tariffs. Capie has concluded that 'since the two biggest sectors (construction and iron and steel) generally accredited with the principle contribution to economic recovery had very low effective rates of protection, the tariff played an insignificant part in the upturn out of depression'.⁶⁰¹ Eichengreen and Sachs have argued, in a similar way to Hawtrey, that currency depreciation in the 1930s was not a beggar-thy-neighbour policy designed to gain a competitive advantage for its exports over that of other countries. They have argued that had devaluation policies been adopted more widely then recovery from the depression of 1930 could have been achieved more rapidly.⁶⁰² The argument of Eichengreen and Sachs was essentially the same as that which Hawtrey was making in 1933, and yet despite very extensive referencing, Eichengreen and Sachs make no reference to Hawtrey's work.

⁶⁰¹ F. Capie, *Depression and Protectionism between the Wars* (London, George Allen, 1983), p.140.

⁶⁰² B. J. Eichengreen and J. Sachs, 'Exchange Rates and Economic Recovery in the 1930s', *Journal of Economic History*, 45 (4), pp. 909-13.

Foreman-Peck's studies have contradicted these findings and argued that tariffs made a greater contribution to recovery.⁶⁰³ His calculations suggest that 'there is as yet no good reason to abandon the view that the Iron and Steel Trades benefited greatly from protection'.⁶⁰⁴

Middleton has concluded that 'the balance of evidence at the macroeconomic level suggests that the case for a positive contribution of the tariff to recovery is unproven'.⁶⁰⁵

⁶⁰³ J. Foreman-Peck, 'The British Tariff and Industrial Protection in the 1930s: an alternative model', *The Economic History Review*, New Series, Vol. 34, no. 1 (Feb., 1981), pp. 132-9.

⁶⁰⁴ *Ibid.*, p.139.

⁶⁰⁵ R. Middleton, *Government versus the Market: the Growth of the Public Sector, Economic Management and British Economic Performance, c. 1890 – 1979* (Cheltenham, Edward Elgar, 1996), p.390.

Chapter 8

Rearmament and Preparation for War

1935-1939

In 1935, it could not be foretold that the country would have to commit its resources to war in four years' time, and this uncertainty was at the heart of the Treasury's problems. No time-scale could be given to the preparations. The cost of an extended period of rearmament might lead to financial exhaustion *before* the nation was called upon to fight a war; in which case victory would have been handed to an aggressor without it needing to actually *use* its arms.⁶⁰⁶

⁶⁰⁶ G.C.Peden, *British Rearmament and the Treasury* (Edinburgh, Scottish Academic Press, 1979).

R. Middleton, *Towards a Managed Economy: Keynes, the Treasury and the Fiscal Policy Debate of the 1930s* (Cheltenham, Edward Elgar, 1985).

S. K. Howson, *Domestic Monetary Management in Britain* (Cambridge, C.U.P., 1975).

M. Thomas, 'Rearmament and Economic Recovery in the late 1930s', *Economic History Review*, 36(4), pp.552-79.

Peden's *British Rearmament and the Treasury* examines the extent to which Britain's lack of readiness for war in 1939 could be attributed to Treasury parsimony. His findings are that Britain was walking a tightrope between military unpreparedness and allowing the demands of rearmament to destroy the economy. The Treasury, in his view, worked to prevent rearmament disrupting the economy by forcing the cabinet to establish defence priorities and then forcing the spending departments, over which it had control, to stick to these priorities. Peden's book is also an excellent study of the way in which a few strong officials dominated a very small Treasury staff.

Middleton (1985) discusses the Treasuries assessment of the 'balance of risks' as it walked the tightrope between inadequate preparation for war and damaging a fragile economy. Parker (1981) argues along similar lines to Peden, and also considers the response of the British Trade Unions to the reorganisation of labour demanded by the rearmament programme. Howson (1975) discusses monetary policy during

In 1919, following the end of the First World War, Lloyd-George's Cabinet had introduced the 'Ten-Year Rule' as a means of curbing the demands of the service chiefs. They were told that their spending allocations would be based upon the assumption that, with the existing state of international relations, they would not be called upon to fight a major war within the next ten years. By use of this measure the Treasury was able to reduce the annual estimates of the defence departments from £604 million in 1919 to £111 million in 1922.⁶⁰⁷ Thereafter, whenever the service chiefs agitated for increased armaments spending, the rule proved to be of immense convenience to the Treasury:

In 1925 the service chiefs asked again and were given the same answer: no major war within the next ten years. This answer was repeated in 1926 and 1927. Finally, in 1928, the service chiefs were told, on Churchill's prompting, that they need ask no more: the ten years freedom from major war began automatically each morning.⁶⁰⁸

With, in retrospect, admirable timing, the government succumbed to the pressure from the chiefs of staff and, in March 1932, they rescinded their guiding rule that no great war need be anticipated within the next ten years. The move

rearmament, and the Treasury's concern that borrowing for rearmament should not mark the end of its cheap money policy. Thomas (1983) has attempted to assess the effects of the rearmament programme on unemployment.

⁶⁰⁷ Peden, *British Rearmament and the Treasury*, p.3.

⁶⁰⁸ Taylor, *English History 1914-45*, p.228.

was not prompted by any fear of German aggression but by the Japanese invasion of Manchuria, which had taken place in September 1931.⁶⁰⁹ Despite this move, Neville Chamberlain failed to raise the defence estimates, and expenditure on defence reached its lowest inter-war value of just over £103 million in 1932/33.⁶¹⁰ The National Government had been elected as a means of restoring confidence after the economic crisis of 1931 and did not regard the abandonment of the ten-year rule as justification for the demands of the defence chiefs to overrule national economic recovery. If this might seem a frivolous attitude to national defence, the figure of £103 million represented roughly 3 per cent of Gross National Product whereas in the same year Germany was devoting only 1 per cent of its Gross National Product to defence.⁶¹¹ In the years 1932-36, German defence spending was to grow to 13 per cent of its G.D.P. whilst, in terms of G.D.P., that of Britain remained virtually stagnant (rising G.D.P. over the period meant that British defence spending rose from £103 million in 1932 to £186 million in 1936, an increase which can be seen to have justified the priority given to increasing national production in 1932).⁶¹²

⁶⁰⁹ *Ibid.*, p.363. Neither Taylor (1965), Shay (1977) nor Peden (1979) attach a proposed enemy or date to future military engagement. The consequence of the Japanese invasion of Manchuria seems to be to have changed world conditions such that it was deemed reasonable to expect Britain to have to engage in a war *sometime* within the next ten years.

⁶¹⁰ Howson, *Domestic Monetary Management in Britain: 1919-38*, p.120.

⁶¹¹ Peden, *British Rearmament and the Treasury*, p.8.

⁶¹² *Ibid.*

In November 1933 a Defence Requirements Committee (D.R.C.) was appointed within the Committee for Imperial Defence. It comprised the service chiefs of staff and three leading civil servants who included Sir Warren Fisher, the Permanent Secretary, as the Treasury's representative.⁶¹³ The Committee's first report, in February 1934, put the cost of making up the 'worst deficiencies' in the armed forces at a mere £93 million – a cost to be spread over five years.⁶¹⁴ It recommended that the forecast for the annual expenditure on all forces should rise from an actual expenditure of £103 million in 1932 to £119 million in 1934, with subsequent increases to £132 million in 1938.⁶¹⁵ The cabinet, mindful of the National Government's pledge to restore the 1931 pay cuts and pre-1931 rate of Income Tax, subsequently cut the figure of £93 million to £77 million in a meeting in July 1934.⁶¹⁶

In the autumn of 1934 the German Army began to equip itself with weapons that had been prohibited by the Treaty of Versailles and in 1935 the full extent of German military expenditure became apparent.⁶¹⁷ It was clear that British rearmament needed to be on a much greater scale than that envisaged by the Defence Requirements Committee in its first report of February 1934. The

⁶¹³ *Ibid.*, p.28.

⁶¹⁴ *Ibid.*

⁶¹⁵ *Ibid.*, p.205.

⁶¹⁶ *Ibid.*, p.68.

⁶¹⁷ *Ibid.*, p.71.

D.C.R., in July 1935, was asked to reconsider defence requirements in the light of the emerging international situation. Its brief still included the requirement to match defence spending against the country's general economic state, but it undertook its work with the understanding that a defence loan would be made available to augment money raised through taxation, and the Treasury Permanent Secretary, Warren Fisher, who was a member of the Committee, was of the view that a defence loan would be preferable since the public would resent the imposition of greater taxes for the purpose of armaments.⁶¹⁸ A report by the D.R.C. in November 1935 raised its recommendations regarding defence spending to figures which were generally about 70 per cent higher than those in its February 1934 recommendations (thus, for example, it raised its recommendation for 1938 from £132 million to £213 million – the *actual* defence expenditure in 1938 materialised at over £400 million, rising to over £700 million in 1939).⁶¹⁹

The Treasury's Controller of Finance, Sir Richard Hopkins, who had responsibility for public finances, was less enthusiastic about a loan than his Permanent Secretary. His memorandum to the Chancellor, Chamberlain, in October 1935, was in the tradition of the 'McKenna rule' of 1916, that borrowing for expenditure must never take place without provision through taxation for sufficient to cover both interest and sinking fund.

⁶¹⁸ *Ibid.*, p.74.

⁶¹⁹ *Ibid.*, p.205.

We should delude ourselves if we looked upon the expenditure facing us as capital in nature. . . . it is most of it ephemeral [sic.] and all of it unproductive of any money return, and all of it in nature revenue expenditure. . . . it would be unfortunate if the country began to think of a Defence Loan as a comfortable Lloyd-Georgian device for securing not only larger forces but also lower estimates, Budget surpluses and diminishing taxation.⁶²⁰

Accordingly, Hopkins believed that the re-armament programme should be financed from taxation. The general economic background against which Hopkins expressed this preference was one of stumbling economic recovery and growth during the period 1933-36. A major contributor to this fragile recovery had been relief from the strait-jacket of the gold standard in 1931. From 1932 to 1939 investment had been encouraged by holding Bank Rate down to 2 per cent. – half that of the average rate during the period 1925-1931.⁶²¹ There was concern that the Treasury would have to issue Bills at sufficiently high, attractive rates of interest to persuade the public to purchase them and that this would cause a general rise in interest rates; a rise which would stifle the halting recovery. The Chancellor of the Exchequer, Chamberlain, was also concerned that recovery would be halted if, even with a low Bank Rate, businesses did not

⁶²⁰ Treasury Papers, T172/1832. Chancellor of the Exchequer's Office: miscellaneous files. Memorandum by Sir Richard Hopkins to the Chancellor of the Exchequer, 7 October 1935.

⁶²¹ Peden, *British Rearmament and the Treasury*, p.62.

have confidence to invest. He regarded the greatest destroyer of confidence to be Governments failing to follow the precepts of 'sound' finance by not balanced their budgets. His 1936 budget raised the standard rate of income tax from 4s 6d to 4s 9d and also raised both tea duty and the Road Fund. This was to be his last 'nominally' balanced budget.⁶²² Over and above these considerations, the current balance of payments remained a problem. In peacetime, Britain's only balance of payment deficits prior to 1931 had been in 1919 and 1926; after leaving the gold standard there were deficits in 1931, 1932, 1934 and 1936 (these deficits were amplified dramatically in the years leading up to the war). The consequence of these deficits was that Britain's reserves of gold and foreign currency became depleted leading to concerns about her ability to purchase essential food and raw materials from abroad.⁶²³

The buoyancy of Chamberlain's tax revenues in 1936-37 obviated the requirement for borrowing for re-armament purposes in that year.⁶²⁴ By 1937, however, the estimated cost of the rearmament programme over the subsequent five years had risen to £1500 million, whereas the anticipated sum available for

⁶²² Howson, *Domestic Monetary Management in Britain*, p.121.

⁶²³ Peden, *British Rearmament and the Treasury*, p.63.

⁶²⁴ M. Thomas, 'Rearmament and economic recovery in the late 1930s', *Economic History Review*, 36 (4), pp.552-79.

Thomas examines the economic recovery of the late 1930s and attempts, using a matrix model, to separate the contribution of rearmament to recovery from that due to other factors. His conclusion is that roughly one million man-years of employment were created over the period 1935-38 (effectively reducing unemployment by around a quarter of a million during these years). The major beneficiaries of the rearmament programme were iron and steel, coal and engineering.

the purpose from taxation was only £1100 million.⁶²⁵ Phillips was charged with preparing a Defence Loans Bill with which to raise the £400 million balance over the five-year period 1937-1942, and this bill was enacted on 19 March 1937.

Under the authority of the Defence Loans Bill, and bearing in mind that the prevailing Bank Rate was 2 per cent., the Treasury issued £100 million of National Defence Bonds at 2.5 per cent interest in April 1937 followed by £81 million at 3 per cent. interest in June 1938.⁶²⁶ The Defence Loans Bill did not find universal favour, being criticised by the Governor of the Bank of England for its disturbing effects upon the markets for industrial finance, and by the Labour Party for being inflationary.⁶²⁷

As the international situation deteriorated, and after the Munich crisis of September 1938, defence estimates continued to rise, necessitating further borrowing. In February 1939 the government's borrowing powers under the Defence Loans Act were doubled to £800 million.⁶²⁸ Peden has suggested that this figure was 'a deliberate understatement to prevent too violent an adverse reaction on financial markets'.⁶²⁹ The Treasury was walking a tightrope. Heavy taxation for armaments had depressed general trade with the annual average of

⁶²⁵ Peden, *Keynes and his Critics: Treasury Responses to the Keynesian Revolution, 1925-1946*, p.179.

⁶²⁶ Howson, *Domestic Monetary Management in Britain*, p.124.

⁶²⁷ Peden, *Keynes and his Critics*, p.179.

⁶²⁸ *Ibid.*, p.180.

⁶²⁹ *Ibid.*

insured workers who were unemployed rising from 10.8 per cent in 1937 to 12.9 per cent in 1938. This had reduced the revenues which might be expected from taxation whilst increasing the burden of unemployment payments. Failure to raise sufficient revenues from taxation with the increased requirement to borrow had undermined international confidence in the pound. Fisher, Permanent Secretary to the Treasury, wanted large increases in taxation to reassure international markets that Britain was not about to abandon 'sound finance' in its quest to re-arm; his chief lieutenants, Hopkins and Phillips, who would be the architects of the budget, wanted to rely on borrowing from the people's savings, in the hope that merely token increases in taxation – token, in that their purpose would be to try to maintain confidence in sterling – would help stimulate the economy into a position where revenues would once again begin to rise.

On 17 April 1939 and 19 April 1939 Keynes wrote articles in *The Times* on his view of the policy options.⁶³⁰ They embodied thinking arising out of his *General Theory of Employment Interest and Money*. He began with a reassurance that the Chancellor could safely forget about the problem of unemployment; the estimated government expenditure of £350 million (an increase of £220 million over that for 1938-39) would assuredly, he claimed, consign the unemployment problem to recent history.

⁶³⁰ Treasury Papers, T208/201. Copies of these articles are pasted into Treasury File T208/201 alongside Hawtrey's commentary on the articles.

We have experience of peace finance and of war finance. But this is neither. And it needs fresh thinking to know how to act. . . . it is impossible for private enterprise to plan confidently for the future (therefore) we should feel in any other circumstances great anxiety concerning unemployment. But in the actual conditions of today it is safe to say that no such anxiety is necessary. . . . The Chancellor of the Exchequer should frame his Budget on the assumption that the problem of normal unemployment will cease to exist during the financial year 1939-40, and that all plans and special provisions for dealing with this problem should be dropped forthwith as being a waste of time and money.⁶³¹

As Keynes continued, he attempted to illustrate how the multiplier principle, an important element of the theoretical position worked out in his *General Theory*, would amplify the increased loan expenditure of £200 million to an increased income of around £400 million, and that this would reverse the economic priorities of the Government. In his estimation of an overall increase in income of £400 million from an injection of £200 million of extra public spending Keynes was assuming a propensity to save of 0.5 (the public would save one half of all increases in income) – the propensity to save being the reciprocal of the multiplier effect.

⁶³¹ *The Times*, 17 April 1939, 'Crisis Finance: an outline of policy' by J.M.Keynes.

. . . the increase in primary demand may be of the order of £200,000,000, which should mean an increase in total demand of perhaps twice this amount. Now, this is a very big figure. . . . in proportion, about twice the maximum public works expenditure in America. . . . the prospective increase in demand would require the services of about 1,500,000 men. . . . We have been so long in the notion – it is nearly 10 years now – that we have vast unused surplus capacity that we are being extraordinarily slow in facing the palpable fact that a complete reversal is in sight.⁶³²

Apart from the possibility of there being a shortage of suitable skilled labour, his first concern was that increased incomes would draw in greater imports and thus drain the country of its gold and foreign reserves. To this end he proposed an embargo upon foreign investment. Such an embargo would, he argued, have two beneficial effects. Firstly, it would conserve foreign reserves. Secondly, investing savings at home would provide the necessary funds for the governments public spending.

The time has come . . . to tighten up to the fullest extent the embargo on sending capital funds oversea by British nationals. . . . The whole of our liquid capital resources must be concentrated henceforward to meet the adverse balance of trade and to provide for political loans.⁶³³

⁶³² *Ibid.*

⁶³³ *Ibid.*

For one so long associated with the idea of saving being responsible for creating unemployment through reducing demand, there is an element of disbelief in reading Keynes now extolling the virtues of saving – ‘Virtue will come into its own. . . . private saving . . . will again serve a social purpose and private prudence will coincide with the public interest’.⁶³⁴

Pursuing the model of the economy derived from his *General Theory*, he was at pains to emphasise that public expenditure would, of itself, generate the necessary savings for government lending *after* the expenditure has taken place. Any attempt to acquire funds *before* expenditure would result in the Treasury siphoning off funds which would be used for investment by private industry.

Loans must be raised after the expenditure has been incurred and not before. . . . If an attempt has been made to borrow them before they exist, as the Treasury has done once or twice lately, a stringency in the money market must result, since, pending the expenditure, the liquid resources acquired by the Treasury must be at the expense of the normal liquid resources of the banks and of the public.⁶³⁵

Keynes’s final plea was that, to avoid handicapping private manufacture, the borrowing process should be undertaken without any increase in interest rates. Essentially, he felt, this could be done if that Treasury pandered to the public’s preference for short-dated debt.

⁶³⁴ *The Times*, 19 April 1939, ‘Crisis Finance: an outline of policy’ by J.M.Keynes.

⁶³⁵ *Ibid.*

If the public prefer short-dated debt, nothing can be gained and much will be lost in terms of interest . . . by attempting to force long-dated loans on them. . . . It would be well for the Chancellor of the Exchequer to announce that in no circumstances will he offer loans carrying a rate of interest in excess of 2.5 per cent. In the first instance a large addition to the volume of Treasury (six month) bills will be right and probably inevitable.⁶³⁶

Whenever Keynes's opinions appeared in the press it was customary for Hawtrey to prepare a critical commentary for the benefit of Treasury colleagues, and on 20 April 1939 he produced his reply to the article.⁶³⁷ It was robust in its criticism.

Hawtrey first questioned Keynes's assumption that government spending would automatically enhance economic activity and employment, noting that the early stages of rearmament had actually been accompanied by an increase in unemployment.

. . . half [of Keynes's presumed increase in national income as a result of his multiplier argument] will be lent to the government . . . half will pay for additional production by the consumption industries,

⁶³⁶ *Ibid.*

⁶³⁷ T208/201. Hawtrey File, 'Mr. Keynes on Crisis Finance' by R.G.Hawtrey, 20 April 1939.

That is a *possible* calculation. But . . . if the whole of the Government's loan expenditure were met from (1) additional savings, (2) reduced capital outlay by private enterprise, (3) sales of securities, gold or other capital assets abroad, there would not necessarily be any increase in activity, employment or national income at all.⁶³⁸

As ever, just as he had done after the publication of Keynes's major works, Hawtrey was ready to pick holes in the structure of Keynes's theoretical arguments. In seeking to reassure the public that savings would be forthcoming as a result of government expenditure and that the process need not be inflationary, Keynes had argued that 'the income of the community will be equal to what the Government spends plus what individuals spend. What is one man's expenditure is another man's income. Thus the excess of the community's aggregate income over what individuals spend, which is left over and available to pay taxes and loans to the Government must be exactly equal to what the Government spends'.⁶³⁹ Hawtrey took exception to this, arguing that the 'true principle is that the excess of what individuals and the Government spend over the community's aggregate income *must be met out of stocks of goods* (Hawtrey's italics)'.⁶⁴⁰ This, according to Hawtrey, was the beginning of the inflationary process. Dwindling stocks would cause their prices to rise, whilst at

⁶³⁸ *Ibid.*

⁶³⁹ *The Times*, 19 April 1939, 'Crisis Finance: an Outline of Policy' by J.M.Keynes.

⁶⁴⁰ T208/201, Hawtrey File, 'Mr. Keynes on Crisis Finance'.

the same time encouraging manufacturers to invest in further plant to increase capacity. The additional incomes paid to producers of capital goods would bid up still further the prices of continually dwindling stock.

If there were specific measures to limit capital outlay by private enterprise, inflation might be prevented. But it would be quite impossible to decide the extent of such measures.⁶⁴¹

In pressing the monetary authorities to avoid raising interest rates, Keynes had regarded the form of Government borrowing as irrelevant – it could equally have been ‘balances at the Bank of England, in Treasury Bills and Bonds, or in longer dated Government debt’.⁶⁴² Hawtrey regarded this as ‘very dangerous doctrine’, since if ‘the Government borrows from the banks, whether by bills or bonds, so that it creates new incomes while leaving the existing incomes undiminished, the effect will be . . . inflationary’.⁶⁴³ On the other hand he viewed the issuing of long-term bonds as non-inflationary since they would encourage extra income into savings rather than pushing up prices by creating excessive demand.

⁶⁴¹ *Ibid.*

⁶⁴² *The Times*, 19 April 1939, ‘Crisis Finance: an Outline of Policy’ by J.M.Keynes.

⁶⁴³ T208/201, ‘Hawtrey’ File, ‘Mr. Keynes on Crisis Finance’.

Hawtrey was contemptuous of Keynes's advice to the Treasury that 'loans must be raised after the expenditure has been incurred and not before'.⁶⁴⁴

. . . the idea that the Treasury can postpone borrowing . . . till after expenditure is incurred is an absurdity. Whenever the Treasury incurs expenditure in excess of current revenue, it has to borrow the excess in some form or other. . . . The reduction of the . . . debt tends to have a deflationary effect, and may well have contributed in the last two years to retard the revival of activity. . . . It might prevent even the swollen rearmament expenditure of the present time from restoring normal activity and full employment.⁶⁴⁵

Moving through Keynes's list of items of policy advice, Hawtrey then turned to the suggestion that the Treasury might obtain adequate loan advances without causing any rise in interest rates. He believed that this would be achievable only if 'an absolutely rigorous restraint were to be placed on all forms of investment, and if people believed that it would never be relaxed'.⁶⁴⁶ Noting that Keynes's proposals included the prohibition of investment abroad – a proposal which would restrict investment opportunities and accord with his desire to raise loan finance without incurring rising interest rates – Hawtrey also noted that Keynes had little to say about exchange rates. If the loan expenditure succeeded in increasing economic activity and employment then this would draw in extra

⁶⁴⁴ *The Times* 19 April 1939, 'Crisis Finance: an Outline of Policy' by J.M.Keynes.

⁶⁴⁵ T208/201, 'Hawtrey' File, 'Mr. Keynes on Crisis Finance'.

⁶⁴⁶ *Ibid.*

imports in addition to the additional imports necessary to fulfil the rearmament programme. Unless steps were taken to mitigate the effects of increased imports, the result would be the loss of gold and international purchasing power. He suggested that such a loss might be mitigated by a managed depreciation of the currency, by tariff or quota measures to restrict imports, or by raising capital from the sale of assets held abroad.⁶⁴⁷

By the late 1930's Keynes was no longer an outsider having, amongst other roles, served with distinction on the Macmillan Committee and the Economic Advisory Committee. Moreover he was gaining a substantial following amongst academic economists through his 1937 publication of his *General Theory*. By this time Keynes's censures of the Treasury should have been carrying greater weight with Treasury officials. As a means of evaluating the relative influences of Keynes and Hawtrey it is worthwhile examining Sir Frederick Phillips's reaction to Hawtrey's memorandum of 20 April 1939.

Frederick Phillips, by 1939, was Under-Secretary and Head of the Treasury's Finance Divisions.⁶⁴⁸ He had responsibility for the detailed construction of the budget. After reading Keynes's article and Hawtrey's comments, he sent a memorandum to Hopkins on the merits of the two economists' approaches.⁶⁴⁹

⁶⁴⁷ *Ibid.*

⁶⁴⁸ Peden, *British Rearmament and the Treasury*, p.203.

⁶⁴⁹ Treasury Papers, T177/47. The Phillips Papers. 'Keynes on Borrowing', memorandum by Sir Frederick Phillips to Sir Richard Hopkins, 24 April 1939.

In general, it belies the view that Keynesian thinking had taken hold of the Treasury before the outbreak of the Second World War.

Phillips began by gently mocking Keynes's journalistic efforts:

On the whole I am somewhat less critical than Mr. Hawtrey of Mr. Keynes's two articles in the 'Times', though to be sure these are marked by Mr. Keynes's customary optimism, over-emphasis and neglect of ulterior consequences. It is almost as though he sets himself out to instil distrust in his readers.⁶⁵⁰

Phillips acknowledged that armaments spending, on the scale contemplated, must reduce unemployment, but he felt that Keynes failed to recognise the potential effects of falling business confidence caused both by fear of impending war and concern at the necessary scale of government borrowing. He also felt that Keynes slipped too easily over historical experience whereby neither Roosevelt's expenditure on public works nor Britain's already substantial spending on armaments had, to date, been successful in preventing rises in unemployment.⁶⁵¹ Both Hawtrey and Phillips ignored Keynes's point that Britain's intended spending on armaments would be about twice the maximum expenditure in America on public works.

⁶⁵⁰ *Ibid.*

⁶⁵¹ *Ibid.*

He was more sympathetic than Hawtrey to Keynes's suggestion that public expenditure should take place *prior* to borrowing the money – following the Keynesian argument that enhanced incomes should generate the additional savings from which borrowing could take place.

. . . however unhappy his language, Mr. Keynes is really making a point. Spending first and borrowing afterwards is surely not too inaccurate a description of exactly the process by which Germany reached full employment. It is true that she adopted the worst possible methods, in particular that of paying armaments bills or part of them by I.O.U.'s and it is true that as a result she is now threatened with inflation. But our position is that we have not yet got out of the depression, and that to be frightened of inflation with unemployment as heavy as it is, is absurd.⁶⁵²

In the above extract Phillips referred to Keynes 'making a point' without spelling out precisely what that point was. It can only be inferred, from later in the document, that Phillips felt that Keynes had been making the important point that government borrowing in itself tends to be deflationary, since when individuals use existing savings for the purpose of purchasing government debt then the liquidity of the banks is correspondingly reduced and the banks attempted to regain their liquidity levels by reducing credit levels to their customers. Bemoaning the fact that the low level of Treasury Bills held by the

⁶⁵² *Ibid.*

banks - which the banks were able to readily sell back to the Bank of England for cash - had been a contributory cause of the existing depression he added the following footnote.

It ought not to have been. It is merely due to the folly of the Clearing Banks that they reduce the credit extended to customers when they experience a shortage of quick assets such as Bills, even though their cash position is amply secured. Still we must take the world as we find it and allow for the fact that banks are governed by rule of thumb methods.⁶⁵³

On the matter of Keynes's injunction that the government must under no circumstances borrow at interest rates greater than 2.5 per cent., Phillips was terse in his response:

I agree with Mr. Hawtrey that there is no basis for Mr. Keynes's belief that we shall be able to borrow at rates not worse than 2.5 percent. We shall be lucky if the rate can be kept down to 4 per cent.⁶⁵⁴

The strongest criticism of Keynes in Phillips's memorandum was related to Keynes's proposals for combating inflation, should it arise – 'Mr. Keynes is extremely vague as to what we ought to do if later on inflation threatens. He

⁶⁵³ *Ibid.*

⁶⁵⁴ *Ibid.*

seems to think that it is all a question of the physical control of industry. It is not easy to grasp his reasoning'.⁶⁵⁵ In his press article Keynes had spoken of 'rationing and a compulsory reduction of public consumption' as a means of curbing inflation.⁶⁵⁶ To Phillips this was unnecessary since 'if and when we reach a state of full employment and prices continue to rise without more labour being absorbed into work we must be ready to revert to all the usual controls, including heavier taxation, heavier customs duties, higher bank rate, a strong loan policy, reduction of floating debt and so on'.⁶⁵⁷ Furthermore 'once full employment has been reached, the country can very well stand increased financial pressures *without* going back to a state of unemployment . . . unless the monetary controllers are ignorant of their jobs'.⁶⁵⁸ The feeling throughout this Treasury criticism of Keynes is that it was rejecting the kind of direct government control which Keynes would have adopted in favour of using conventional monetary and fiscal levers – the kinds of levers which Hawtrey, as a long-standing advocate of the efficacy of Bank rate, would have preferred.

Towards the end of Hawtrey's comments on the Keynes articles he had raised the possibility of a depreciation of the currency as a means of preventing the loss of gold and foreign exchange (a depreciated pound would have enabled

⁶⁵⁵ *Ibid.*

⁶⁵⁶ *The Times*, 19 April 1939, 'Crisis Finance: an Outline of Policy' by J.M.Keynes.

⁶⁵⁷ Treasury Papers, T177/47. The Phillips papers. 'Keynes on Borrowing', 24 April 1939.

⁶⁵⁸ *Ibid.*

foreigners to obtain more sterling with which to purchase exports from Britain whilst, by a contrary argument, discouraging imports), adding the remark that if 'in the near future revival is resumed in the united States, this question will not arise'.⁶⁵⁹ Hawtrey's point being that an American revival would revive exports without need for sterling depreciation. Phillips latched on to this argument:

Mr. Hawtrey's memorandum is a cogent though concealed plea for *not* maintaining any fixed ratio between the pound and the dollar. If there is renewed recession in the United States, he argues, and if the £ is pegged to the dollar it may be that no amount of armaments expenditure will improve employment.⁶⁶⁰

Phillips went along with Keynes's advocacy of an embargo on foreign investment – 'there will no doubt have to be . . . a warning that in the event of war we intend to requisition British holdings of foreign securities'.⁶⁶¹ He concluded that:

Mr. Keynes is over optimistic in thinking unemployment will rapidly assume very small proportions, in particular he neglects the fact of the somewhat unsatisfactory conditions in the United States. . . . it is entirely in our own interests to avoid any measure likely to check . . . improvement. We should avoid further long or medium term borrowing until the market holdings of Treasury Bills have been

⁶⁵⁹ Treasury Papers, T208/201. The Hawtrey Papers. 'Mr. Keynes on Crisis Finance'.

⁶⁶⁰ Treasury Papers, T177/47. The Phillips Papers. 'Keynes on Borrowing', 24 April 1939.

⁶⁶¹ *Ibid.*

restored to normal . . . But [then] our borrowing needs will be gigantic. Thus we should now be preparing plans for a big war loan operation later this year . . .⁶⁶²

On 25 April 1939 Sir John Simon's second budget was balanced with a small number of additional taxes – on large estates, tobacco, imported sugar and surtax on high earners – designed to merely raise an extra £34 million in revenue.⁶⁶³ By balancing it, he hoped to retain the confidence of business and currency dealers. By leaving the standard rate of income tax at the same level he hoped to stimulate the economy with the hope of increasing future revenues through taxation. The great bulk of the estimated defence spending would have to be met at some future date by loans amounting to £385 million.

In the ensuing parliamentary debate Harold Macmillan, then a Conservative back-bencher representing Stockton-on-Tees, had warned that Keynes's *Times* articles had led people to assume that loan expenditure would automatically remove unemployment.⁶⁶⁴ Macmillan had warned that such a conclusion was facile since if armaments were to be the only expenditure they would only provide employment for a small minority of skilled workers who would, in all probability, have to be drawn from other employment.

⁶⁶² *Ibid.*

⁶⁶³ *The Times*, 26 April 1939.

⁶⁶⁴ *The Times*, 27 April 1939.

After the budget debate Simon asked the Treasury for clarification of certain points, and Hawtrey, to whom the task was assigned, responded. Hawtrey's memorandum reminded his readers that Keynes had in fact said, quite emphatically, that large numbers of people would be brought into employment as a consequence of the Government borrowing, Keynes's words being 'I repeat that nothing can prevent this forecast from coming true, except a failure to spend the money'.⁶⁶⁵ Hawtrey perceived Macmillan's case to be a revival of the plea for Government borrowing for public works, as opposed to re-armament, since public works would allow programmes to be selected which suited the available labour. Hawtrey's response to such an idea was a variant of the same argument which he had been making over the past two decades.

The real virtue lies neither in the public works nor the armaments themselves but in the resort to inflationary expedients to finance them.⁶⁶⁶

This is still the 'Treasury View' of the late 1920s – in essence, if the terms of credit are sufficiently attractive then borrowing by government for public works merely 'crowds out' borrowing by the more efficient private sector. Before returning the memorandum to the Chancellor, Phillips added his own comments which support the general thesis that throughout the 1930s, and up until the

⁶⁶⁵ *The Times*, 19 April 1939, 'Crisis Finance: an Outline of Policy' by J.M.Keynes.

⁶⁶⁶ Treasury Papers, T 208/201. The Hawtrey Papers, 'Borrowing and Inflation', 20 April 1939.

spring of 1939, Hawtrey had successfully prevented Treasury officials from being seduced by Keynesian finance.

I agree with Mr. Hawtrey that the real stimulus comes from reflationary finance. If there were no reflationary finance, the Government works would tend merely to replace private works without much effect on employment. But this is the famous or infamous 'Treasury View', still a most bitter subject of controversy which it would be a great mistake to raise.⁶⁶⁷

Meanwhile, the demands of the defence departments continued to increase. At a meeting in Cabinet, on 23 May 1939, Simon, whilst admitting that the country's annual savings could not be much in excess of £450 millions, conceded that the borrowing requirement would approach £400 millions.⁶⁶⁸ Whilst his view was that there was no action which the Government could take to increase the total volume of savings in the country, he drew the cabinet's attention to the argument currently being propagated by Keynes that spending on a sufficiently large scale would create the savings necessary to finance the expenditure.⁶⁶⁹

The arguments which Simon had referred to were those outlined by Keynes in his articles in the *Times* in April. Keynes took up his previous arguments and extended them to explain a mechanism by which the necessary borrowing might

⁶⁶⁷ Note added by Sir Frederick Phillips to T 208/201. Hawtrey Papers, 'Borrowing and Inflation', 20 April 1939.

⁶⁶⁸ Cabinet Papers. CAB 23/99, 23 May 1939.

⁶⁶⁹ *Ibid.*

be effected without provoking higher interest rates. He forwarded his arguments directly to the Chancellor of the Exchequer, and they were also published as two articles in the *Times* on 24, 25 July 1939.⁶⁷⁰

The argument that Government borrowing necessitated higher interest rates was, Keynes suggested, born of two separate propositions which were relics of the false thesis that saving was necessary before investment could be carried out. The first false proposition was that high interest rates were necessary to divert money away from consumption into savings. The second was that high interest rates were necessary to deter the private investors who would compete for the pool of savings.

Dealing with the second proposition first, Keynes argued that apart from foreign borrowers, the main competitors for savings would be local authorities and public boards responsible for major construction works. An investment authority, he suggested, should prioritise the allocation of funds between public bodies, whilst he viewed the engineering of steadily rising share and bond values at home as the best way of retaining savings. Since higher interest rates generally implied lower capital values for these assets, he suggested that they would discourage rather than encourage home investment.

Turning to the argument that high interest rates were necessary to build up a pool of savings, Keynes once more sought to apply the model of his *General Theory*. Increased savings would not be forthcoming as a result of higher

⁶⁷⁰ The *Times*, 24, 25 July 1939. 'Borrowing by the State' by J.M.Keynes.

interest rates, but as a result of the increased incomes resulting from Government expenditure. If the extra savings were not forthcoming as a result of the increased earnings, then it was in the Government's power to 'conscript' savings in the form of increased taxation.⁶⁷¹

The latter parts of Keynes's articles were devoted to the sequence of events by which a loan could be raised without prompting higher rates. They can, in part, be seen as a response to Hawtrey's caustic comment that 'the idea that the Treasury can postpone borrowing in any form till after the expenditure is incurred is an absurdity'.⁶⁷²

Initial expenditure, Keynes assumed, would be met by issuing Treasury bills (short-term loans repayable with interest after six months). The expenditure of these loans would generate incomes and additional savings alongside the repayment of the short-term loans. Keynes then saw the problem as 'inducing the holder to lend them to the Government in some more permanent form'.⁶⁷³ This inducement would necessarily have to be effective without raising the rate of interest. Keynes turned to the application of the idea of 'liquidity preference'. If the public could be, through the banking system, supplied with a level of liquidity in excess of that adequate for its needs, then it should be possible to induce it use the surplus liquidity to purchase interest-bearing bonds without the Treasury having to resort to higher interest rates to entice it to do so.

⁶⁷¹ *Ibid.*

⁶⁷² T 208/201. Hawtrey Papers, 'Borrowing and Inflation', 20 April 1939.

⁶⁷³ The *Times*, 25 July 1939. 'Borrowing by the State' by J.M.Keynes.

Timing was regarded as essential. Keynes argued that increasing the supply of Treasury bills and bankers' balances at the Bank of England would eventually work through to the public holding larger bank balances. A period of delay was then essential before a bond issue in order for a pent-up demand for interest-bearing securities to develop. On offering the bonds it was incumbent upon the Treasury to make it clear that it would not, in the future, be prepared to increase the interest rate on its securities.

Keynes scheme was passed back to the Treasury for a response, and Phillips passed it on to Hawtrey. Aware of Hawtrey's predilection for verbosity, Phillips requested that Hawtrey 'prepare a note, simple short comprehensive and conclusive'.⁶⁷⁴ On 20 June 1939 Hawtrey produced what Phillips had requested – a short note.⁶⁷⁵ But the note was accompanied by a lengthy memorandum of over four thousand words which demonstrated the rift that was developing between Keynes and Hawtrey.

In the short note Hawtrey made two critical comments. First, that measures to curb alternative demands for funds to public bodies would not be adequate since increased consumption would generate demands for funds for investment by private industry. Secondly, increased consumption would run down the stocks of traders who would be forced to bid up the prices of newly finished

⁶⁷⁴ T177/47, Phillips Papers. Hand-written note from Phillips to Hawtrey, undated, but ~ 10 June 1939 by its position in the file.

⁶⁷⁵ *Ibid.*, 'Government loan policy and the rate of interest: comments on Mr. Keynes's proposals' by R.G.Hawtrey, 20 June 1939.

goods in order to replenish their stocks. Keynes's policy for permanent low interest rates showed no means of curbing inflation.

In the longer memorandum Hawtrey queried the ability of Keynes's scheme to generate increased incomes without generating inflation. In the event of inflation he suggested that a higher rediscount rate would be necessary and this would negate Keynes's low interest rate plan.

Chapter 9

Reorganisation, War and Retirement

1937-1939

The years from 1919 to 1939 saw no change in the position of the Financial Enquiries Branch within the overall structure of the Treasury. The Treasury itself was divided into three broad sections. The 'Finance Divisions' handled the Budget and the preparation and presentation of public accounts, matters related to loans and the National Debt, and questions of banking, currency and foreign exchange. The other two sections were the 'Establishment Divisions' which dealt with the staffing and conditions of the Civil Service, and the 'Supply Divisions' which supervised public monies devoted to non-civil service bodies. The Finance Divisions were three in number: '1D', the 'Home Finance Division', '2D' the 'Foreign Finance Division', with the Financial Enquiries Branch, without code name, constituting the third of the three divisions.⁶⁷⁶

⁶⁷⁶ G. C. Peden, *The Treasury and British Public Policy 1906-1959* (Oxford, O.U.P., 2000).
H. Roseveare, *The Treasury; the Evolution of a British Institution* (London, Allen Lane, 1969).

G. C. Peden, *Keynes and his Critics* (Oxford, O.U.P., 2004).

F. Leith-Ross, *Money Talks* (London, Hutchinson, 1968).

G. C. Peden, 'Sir Richard Hopkins and the "Keynesian Revolution" in employment policy 1929-45' *Oxford Economic Papers* 32 (1980), 1-18.

K. Burk, *Britain, America and the Sinews of War 1914-18* (Boston, George Allen, 1985).

The authoritative secondary source on the internal structure of the Treasury in the twentieth century is Peden's *The Treasury and British Public Policy*. Henry Roseveare's

An Appendix to the Report of the Treasury Organisation Committee in February 1938 listed nine personnel in at, or above the level of 'Higher Grade Clerk' in '1D', five personnel at corresponding levels in '2D', but only Hawtrey and one assistant, a Mrs. Lucas at the level of Assistant Principal, in the Financial Enquiries Branch.⁶⁷⁷

From time to time questions were asked about the effectiveness of the work of the Financial Enquiries Branch. Responding to questioning by the Public Accounts Committee in 1936, Sir Warren Fisher, Permanent Secretary, explained to the Committee that:

[Hawtrey] works away on metaphysics and writes learned books and concerns himself primarily with the theory of higher finance .

The Treasury (1969) covers a longer period but deals only sketchily with the period 1919-1939. Peden's later work, *Keynes and his Critics*, contains portraits and pen-portraits of all the senior Treasury figures of the period. There is a dearth of biographies and diaries of the leading Treasury personalities of the inter-war period. In 1968 Sir Frederick Leith-Ross published his autobiography *Money Talks*, largely an exercise in self-justification. Peden has produced a sympathetic picture of Sir Richard Hopkins, the leading Treasury figure of the time. This tends to concentrate on the period after 1939 when Keynes was beginning to become more influential. A Cambridge Ph.D. thesis by E. O'Halpin, 'Sir Warren Fisher, head of the civil service' (1982), examines the way in which Fisher sought to make the treasury the co-ordinating ministry for all other ministries, but it has little to say about the politics of financial advice. Probably the most helpful source for obtaining a feel for the internal activities of the Treasury at this time is a series of three hour-long interviews of Hawtrey by Sir Alec Cairncross in 1966 which are held at Churchill College Cambridge (HTRY 13/5). Hawtrey, of course, was an old man at this time. His memory, to Cairncross's occasional frustration, sometimes fails him, and it becomes clear that he was very much a fringe figure in Treasury decision-making.

Kathleen Burk discusses how the Great War financially enfeebled Britain – with its consequential effects upon the importance attached to adequate financial preparation for the Second World War.

⁶⁷⁷ Treasury Papers, T 199/50 C, the report of The Treasury Organisation Committee, February 1938, p.43.

. . he is really continually examining into the theoretical side (at least as it seems to me the theoretical side), and we pull a stop out when we want something from him supposing some rather delicate exchange issue comes along to the Under-Secretary . . . he would get hold of Hawtrey and say "you ought to know all about this" and he would advise.⁶⁷⁸

In 1937-38 further re-organisation of the Treasury structure was contemplated, and a Treasury Organisation Committee took evidence throughout 1937 for its Report, presented in February 1938. The position of Hawtrey's department was once again subjected to scrutiny. On 15 January 1937 Sir Richard Hopkins, Second Secretary to the Treasury, gave evidence to the Treasury Organisation Committee and remarked that there was a good deal of duplication between various government departments – Treasury, Board of Trade, Department of Overseas Trade, Foreign Office – in the collection and study of statistical information.

It might be worth considering whether the branches concerned with this work (of which our Financial Enquiries Branch was one) might not be amalgamated into one general office for collecting and arranging statistical information for the use of all Departments.⁶⁷⁹

⁶⁷⁸ Minutes of Evidence taken before the Committee of Public Accounts, 30 April 1936; *House of Commons Papers 1935/36*, 131-48, p.399.

Hopkins went on to ask Mr. W. R. Fraser, Treasury Officer of Accounts and Principal Assistant Secretary in the Home Finance Division, if, on the assumption that the Treasury was to continue to have its own Statistical Branch, he would recommend that the Financial Enquiries Branch be disbanded and amalgamated either with 1D (Home Finance Division) or 2D (Foreign Finance Division). Fraser considered that the work of the Financial Enquiries Branch was closely concerned with that of the Foreign Finance Division and that amalgamation with that Division would be appropriate.⁶⁸⁰ He twisted the knife that was finding its way into the back of the Financial Enquiries Branch by adding that that when he was in need of statistics he often asked the Statistical Branch of the Bank of England for them. Hopkins continued that, in that case, it may be worth while to establish some formal mechanism by which the Bank's Statistical Branch supplied the Treasury with the most important statistical information which it collected.⁶⁸¹

On 27 January 1939 the Treasury Reorganisation Committee took evidence from Mr. S. D. Waley, Principal Assistant Secretary within the Treasury's Foreign Finance Division. Waley described the work of the Foreign Finance Division in collecting financial information from Foreign Missions and added that it needed 'someone familiar with the information available and ready to advise quickly on

⁶⁷⁹ Treasury Papers T 199/50 C. Treasury Organisation Committee, Minutes of Evidence, 15 January 1937.

⁶⁸⁰ *Ibid.*

⁶⁸¹ *Ibid.*

current affairs in any particular country'.⁶⁸² He suggested that an Assistant Direction of Financial Enquiries be appointed with the remit of collating information from foreign countries. The holder of his post should be a member of 2D (Foreign Finance Division). He suggested that if such a person kept in close touch with other departments he would be in a position to assess whether or not there was duplication of effort between departments and whether any measures of amalgamation might be possible. On the whole, Waley disagreed with Hopkins that there might be substantial savings to be made by creating an amalgamated statistical information office.⁶⁸³

On 9 March 1937 the Treasury Organisation Committee sought evidence from Sir Frederick Phillips, Under Secretary of the Finance Divisions. As regards the general level of staffing in 1D (Home Finance), Phillips conceded that the past few years had been unusually quiet and had not made great demands on current staffing levels. However, he felt that these quiet years were coming to an end, and he cited a number of areas where extra demands might be made on the Division in the near future. Two of these areas would involve increased need to call upon specialised economic expertise.

⁶⁸² Treasury Papers T 199/50 C. Treasury Organisation Committee, Minutes of Evidence, 27 January 1937.

⁶⁸³ *Ibid.*

. . . the Treasury would never now succeed in disinteresting itself from the study of currency and credit affairs generally: it might be expected perhaps to be more closely concerned

. . . the whole range of ideas connected with the control of capital expenditure and investment, and with the diversion of savings into particular channels might be expected to result in additional and important work for 1D.⁶⁸⁴

The first of these concerns was an acknowledgement of the shift of financial power away from the Bank of England and towards the Treasury as a result of leaving the Gold Standard. The second was an admission of the growing influence on government of Keynesian ideas on public investment and fiscal management.

Consistent with his theme of the increasing role of the Treasury in economic management, Phillips, in discussing the future of the Financial Enquiries Branch, said that 'he regarded the employment in the Treasury of a [sic] economist to advise on financial matters as a necessity'.⁶⁸⁵ He had concerns about the situation which might arise on the retirement of Hawtrey.

He [Phillips] had been wondering whether the post of Director of Financial Enquiries could be adequately filled, on the retirement of the present holder, from within the Civil Service; he had found

⁶⁸⁴ Treasury Papers T 199/50 C. Treasury Organisation Committee, Minutes of Evidence, 9 March 1937.

⁶⁸⁵ *Ibid.*

that field barren and thought that when the time came the Treasury would have to look outside for a competent young economist and pay him what was necessary; there were not more than a dozen men in the country fitted for the post.⁶⁸⁶

Phillips was concerned that if the task of economic advice was taken out of the Treasury (and dealt with, for instance, by the Economic Advisory Council's Committee of Economists) then Ministers might come to rely, and act, on economic advice of a diverse and conflicting nature coming directly from different groups of economists rather than on economic advice coming through the filter of senior Treasury officers⁶⁸⁷.⁶⁸⁸ In taking this view, Phillips seemed to be less happy than his immediate superior, Hopkins, about the disbanding of the Financial Enquiries Branch and amalgamating its work within a general statistical unit. Moreover Phillips gave his approval to much of the backroom work that Hawtrey had been doing by informing the committee that, in his opinion, whilst specific advice to senior offices was important, it was of greater importance to furnish the Treasury with a constant commentary on the financial and economic implications of its work.

Sir James Rae, Head of Establishments at the Treasury, and Sir Richard Hopkins were present as interrogating members of the Treasury Organisation

⁶⁸⁶ *Ibid.*

⁶⁸⁷ *Ibid.*

⁶⁸⁸ *Ibid.*

Committee. They continued to press Phillips on the importance of having expert economic advice available within the Treasury. Rae suggested that it might be difficult for an economist with an established reputation, and perhaps fearful of losing his reputation, to maintain the necessary silence and discretion. Phillips suggested that if there were a problem then the post need not necessarily be filled for more than a few years at a time. Hopkins anticipated the important work of the Treasury in the future to be management of the national debt by the issuing of suitable bonds, and management of currency and the exchange rate in co-operation with the Bank of England. In his opinion, the advice of an economist was hardly necessary for the debt management, and the problems of currency management would disappear 'if we should return to the gold standard'.⁶⁸⁹

Phillips did not accept that the future work of the Treasury could be simplified to such an extent. Again indicating that he was thinking in terms of an enlarged role for the Treasury in economic management, he suggested a third future role: that of finding a suitable use for the country's savings. In any case, the changing course of events would always throw up new situations where economic advice would be useful. As regards Waley's suggestion that an Assistant Director of Financial Enquiries be appointed, Phillips would say no more than there might be a case for appointing someone to the Branch responsible for collating and circulating financial statistics from other countries.

⁶⁸⁹ *Ibid.*

On 19 May 1937 Sir James Rae, Under Secretary for the Establishments Divisions, sent a note to Sir Thomas Padmore, Sir Richard Hopkins's private secretary, outlining certain recommendations which the Treasury Organisation Committee had a mind to implement.

[The Financial Enquiries Branch] caused us a good deal of thought. Various suggestions have been made Our conclusion is that the right course is to abolish, when an opportunity arises, the present post of Director of Financial Enquiries, and to make ad hoc arrangements for special reports on specific questions as and when they arise. For the purpose a confidential panel of advisers might be prepared there would be nothing to prevent on occasion a report being obtained on a specific question from more than one expert on the panel.⁶⁹⁰

Rae continued that 'advice on the more secret aspects of currency policy would, of course, continue to be given by the Bank', but this was pencilled out by Padmore. Rae also perhaps made an implied criticism of Hawtrey by pointing out that the disappearance of the post of Director of Financial Enquiries would throw more work, 'but not much', on 2D, the Foreign Finance Division.

The final report of the Treasury Organisation Committee appeared in February 1938 and included the suggestion that Rae had sent to Padmore that the post of

⁶⁹⁰ Treasury Papers T 199/50 C, Treasury Organisation Committee. Note from Sir John Rae to Sir Thomas Padmore, 19 May 1937.

Director of Financial Enquiries be abolished as soon as the opportunity arose and economic reports prepared by one or more members of an ad hoc panel.⁶⁹¹ The principal reason given for abolishing the post was that a difficulty existed in supplying a full-time advisor with sufficient work. It acknowledged that, because of questions of secrecy, it might not be able to supply an outside advisor with all the relevant information, but it re-inserted the clause that since the question of secrecy was most likely to arise in questions relating to currency, such questions could be referred to the Bank of England economic unit. One further possibility was mooted, but not with any great degree of seriousness. This was that an outside economist of standing be appointed for a limited period and without the offer of a permanent career as a Civil Servant. In this case it might be possible for conditions of secrecy to be imposed for a short time, after which the holder might return to full engagement in public discussion.

The 'opportunity' which the authors of the report awaited was, of course, the retirement of Hawtrey. Having been born on 22 November 1879, Hawtrey would have attained the age of sixty in November 1939. As was Civil service custom, on attaining the age of fifty-nine, Hawtrey received a letter from the Civil Service Establishments Division explaining that at this particular stage of a Civil Servants career it was practice for the extension of an employee's service beyond the age of sixty to be considered.⁶⁹² Hawtrey was asked if he wished to say anything

⁶⁹¹ Treasury Papers T 199/50 C. The Report of the Treasury Organisation Committee, February 1938.

before a decision was reached. Hawtrey replied immediately with a short note indicating that his 'personal preference would be to remain in the Treasury after reaching the age of 60 . . . up to the age of 65'.⁶⁹³

This preference of Hawtrey's did not accord with that of the Treasury. On 9 December 1938 Rae sent a note to the Permanent Secretary to the Treasury, Sir Warren Fisher, indicating how he proposed to respond to Hawtrey's request for extension of service.

Dear Hawtrey

Many thanks for your letter of the 7th. Instant [sic]. I am authorised to let you know that after very careful consideration Their Lordships feel that in order to facilitate a reorganisation of the work of "Financial enquiries" [sic] the date of your retirement must be fixed as the 31st. December 1939.

I am sorry that this does not coincide with your personal wishes but you will I am sure appreciate that official considerations must prevail.

Yours sincerely⁶⁹⁴

Hand-written on the note was a statement that Sir Richard Hopkins agreed with the decision that Hawtrey ought to go at 60. Also hand-written in the margin was a reminder that since Hawtrey attained the age of sixty on 22 November

⁶⁹² Treasury Papers, T176/5. Hawtrey's Personal File. Copy of letter sent from Sir James Rae to Ralph Hawtrey, 7 December 1938.

⁶⁹³ *Ibid.*, hand-written note from Ralph Hawtrey to Sir James Rae, 7 December 1938.

⁶⁹⁴ *Ibid.*, Note from Sir James Rae to Sir Warren Fisher, 9 December 1938.

1939, he was, in fact, being given an extension of 5 weeks, which was 'generous'.⁶⁹⁵

In the event, the Treasury's generosity to Hawtrey ended up being considerably more than five weeks. Hawtrey first of all pointed out that his time on secondment as Visiting Professor at Harvard had not counted for pension calculations and asked that, if there was 'no objection', he would prefer to continue in service until May 1940 since this would enable him to complete one more pensionable year.⁶⁹⁶ This request was immediately acceded to and Hawtrey's retirement date was moved on to 11 May 1940.

Returning to 1939; the year which saw the outbreak of war also saw the Treasury make the transition to a new pattern of working, calling upon the views of a variety of eminent economists. The new pattern begins to emerge in the way Sir Frederick Phillips sought advice on wartime exchange control policy. The economists which Phillips met with regularly on the Cabinet's Economic Advisory Committee were Keynes, Hubert Henderson and Denis Robertson. From now on it was from this trio that Phillips increasingly solicited views. Hawtrey, as he worked out his last months, continued to write his own commentary on events.

On September 1939 Phillips approached Keynes to ask him for his ideas about exchange control, an approach which seems to have taken Keynes by

⁶⁹⁵ *Ibid.*

⁶⁹⁶ *Ibid.*, Hand-written note from R.G.Hawtrey to Sir James Rae, Under-Secretary of Establishments, 15 December 1938.

surprise.⁶⁹⁷ Keynes spent a few days 'turning the thing over' in his mind before sending a note to Phillips on 24 September 1939, in which he 'reduced his thoughts to writing'.⁶⁹⁸ The attached note was anything but condensed since Keynes started with a long and uncharacteristic reminiscence.⁶⁹⁹ Keynes began by pointing out that apart from the need for import licenses and restriction on foreign investment, there had been no exchange control in the First World War – complete control being 'against the spirit of the age'.⁷⁰⁰ However, with the dollar-exchange rate being pegged for the duration of the war, and the authorities being unable, or unwilling, to devalue the pound in order to preserve dollar reserves, periodic heavy demand for dollars put the reserves in a precarious position. Apparently, according to Keynes, Chalmers and Bradbury of the Treasury were unwilling to reveal the extent of the position to Ministers, fearing what they regarded as the even more disastrous outcome of the abandonment of the 'peg'. After one particularly heavy run in 1916:

Chalmers went over to . . . report to the newly formed War Cabinet.

"Well Chalmers, what is the news" said the goat.

⁶⁹⁷ Treasury Papers, T 177/45, Phillips Papers. Letter from Keynes to Phillips, 24 September 1939.

⁶⁹⁸ *Ibid.*

⁶⁹⁹ *Ibid.*, 'Notes on Exchange Control' by J.M.Keynes, 24 September 1939.

⁷⁰⁰ *Ibid.*

“Splendid”, Chalmers replied in his high quavering voice, “two days ago we had to pay out \$20 million; the next day it was \$10 million; and yesterday only \$5 million.”

He did not add that a continuance at this rate for a week would clean us out completely . . . I waited nervously in his room until the old fox came back triumphant.⁷⁰¹

Ultimately, according to Keynes, the United States’ intervention in the First World War only took place to alleviate the British financial position and maintain America’s trade position.⁷⁰² The point of this reminiscence by Keynes [which he could not resist telling Phillips any more than I could resist leaving it out of this thesis] seems merely have been to point out that ‘we did get through after a fashion without blocking the exchanges; and this policy was not without considerable advantages of simplicity and efficiency’.⁷⁰³ In general, Keynes felt it would be counter-productive too try to impose over-rigid rules on currency exchange. He regarded the most important step being for being the requirement that British exporters should hand over their foreign currency earnings, followed in importance by the Treasury gaining as much foreign currency as possible from invisible exports. He felt that there was much to be lost by way of goodwill in attempting freeze sterling bank accounts in the Dominions and in neutral countries.

⁷⁰¹ *Ibid.*

⁷⁰² *Ibid.*

⁷⁰³ *Ibid.*

Just over a week later, on 3 October 1939, Hawtrey passed comment on the position of Sterling under war conditions.⁷⁰⁴ He believed that there was a place for exchange controls as a means of regulating the rate of exchange, whose value he regarded as of some importance. Moreover he believed that any effective rate of exchange could be achieved.

Any rate of exchange . . . becomes possible within very wide limits, provided the appropriate restriction of imports is imposed. If the value of the currency unit is fixed so high as to check exports, it can nevertheless be maintained by an equivalent restriction of imports.⁷⁰⁵

Hawtrey looked first at the case for a low rate of exchange, suggesting that one possible argument was that the maximum export potential needed to be achieved in order to import essential foodstuffs and the materials needed for prosecuting the war.

In comparing possible levels of the rate of exchange there will be found a rate which will secure the exporting industries full employment at a normal profit . . . If the foreign exchange value of the currency unit falls below this level, an abnormal profit is

⁷⁰⁴ *Ibid.*, 'Sterling under War Conditions', memorandum by R.G.Hawtrey, 3 October 1939.

⁷⁰⁵ *Ibid.*

offered to producers as an inducement to provide goods for export.⁷⁰⁶

Hawtrey thought that to adopt 'profiteering' might initially have favourable consequences, but the long term consequences would be adverse. Excess profits in the exporting industries would provoke demands for higher wages, which would then spread to the non-exporting industries. Higher wages in the exporting industries would eliminate the stimulus to export and provoke price rises which would reduce the competitiveness of the exported goods. There would be inflationary pressures which would be exacerbated by the low exchange rate causing the price of imported food to be high. Thus Hawtrey went back to the notion of finding a rate of exchange which would secure full employment in the exporting industries whilst offering 'normal' profits.

The actual rate of exchange of the pound had been \$4.68 in early 1939, but, without measures to protect it, it had fallen to \$4.03 after the commencement of hostilities. Hawtrey felt that \$4.68 had been an overvaluation at the time since the export industries were not operating at full capacity, but the recovery in the United States over the year was restoring this figure as an appropriate equilibrium exchange value – consistent with full employment at normal profits in the exporting industries. However, the dislocations of war, in particular the high freight and insurance charges, demanded a lower equilibrium value. Without committing himself to a figure, Hawtrey suggested that the exchange rate should

⁷⁰⁶ *Ibid.*

be closely monitored with respect to the export trade, and if 'it turns out that the existing rate of \$4.03 is too low, there would be great advantage to the price situation in raising it'.⁷⁰⁷

Sir Frederick Phillips seemed reasonably impressed by Hawtrey's point that maintaining a fairly high exchange rate might be necessary as a means of curbing war-time inflationary forces. Immediately on receipt of Hawtrey's memorandum he wrote to both Hubert Henderson and Denis Robertson enquiring if they had 'any observations on the rather important point raised in Mr. Hawtrey's memo'.⁷⁰⁸ Phillips added that he was contemplating a 'small hoist' of the exchange from \$4.03 to \$4.10 or \$4.15, but as no more than a symbolic gesture to potential holders of Treasury Bonds that the British monetary authorities would not permit the collapse of sterling. He acknowledged that a substantial exchange-rate rise would assist in keeping prices down, but he didn't feel that the export trades would be able to stand much of a rise.⁷⁰⁹

Both Robertson and Henderson replied within the next few days. Whilst neither economist sought to diverge strongly from Hawtrey's recommendation, neither of them seemed impressed by his analysis. In particular Robertson was 'not very much moved the argument that a low rate of exchange will generate excess profits and excess wages in the export trades, and thereby set the

⁷⁰⁷ *Ibid.*

⁷⁰⁸ *Ibid.*, hand-written note by Sir Frederick Phillips note circulated to D.H.Robertson and H.D.Henderson, 3 October 1939.

⁷⁰⁹ *Ibid.*

"vicious circle" in motion'.⁷¹⁰ Hawtrey had based his analysis upon the balance of payments on current account whilst ignoring movements of capital. Robertson thought it unsafe to ignore movements of capital since it would be very difficult to make control of such movements water-tight. He regarded it as possibly dangerous to set a too ambitiously high exchange rate for the pound, since the more dollars which speculators were able to obtain for their pound, the more they would find it attractive to convert their sterling holdings to dollars, which would stimulate ingenuity in exploiting holes in the control.

Despite the above reservation, Robertson, too, indicated that he would go for fairly high rates of exchange. His reasoning being that to aim for a high export volume by setting a low exchange rate would probably be futile, since under war-time conditions it was unlikely that the man-power and materials would be available in sufficient quantities to maintain a high volume of exports. Given this constraint, Robertson argued for a policy which sought to maximise the value of exports by maintaining a high price for them in relation to the price of imports. He felt that it would be more convenient to do this by maintaining a high rate of exchange than by allowing the pound to fall to a low rate of exchange whilst simultaneously attempting to force down the price of imported goods in terms of their local currencies.⁷¹¹

⁷¹⁰ *Ibid.*, 'Note on Hawtrey's memorandum on exchange policy' by D.H.Robertson, 5 October 1939.

⁷¹¹ *Ibid.*

Henderson endorsed Robertson's view regarding the importance of selling exports at a good price rather than at maximum volume, and agreed that, within limits, a high exchange rate was the simplest means of achieving this. But Henderson then went on to make the point that, given the protectionism of American tariffs, most British goods were not competitive with their American equivalents, and that those British goods which were able to make large-scale penetration of the American market were goods of a semi-monopoly character; he cited whiskey as the most obvious example, but also included raw materials such as tin, jute and rubber from the British Empire. Henderson thought that the prices of such goods should be individually and systematically considered from the point of view of maximising the country's foreign exchange resources.⁷¹²

As regards a suitable level for the pound, Henderson did not demur from Phillips's own instincts ('a small hoist . . . to \$4.10 or \$4.15') – 'a small increase at a well chosen moment seems to me exactly the right policy in the circumstances'.⁷¹³

The story of exchange and trade controls, the balance of payments and the exchange-rate during the Second World War is a fascinating one, but takes us outside the remit of this thesis, and outside the time when Hawtrey might have had any influence in the Treasury. However the stabilisation of the dollar-exchange rate at the relatively low value of \$4.03 proved more difficult than

⁷¹² *Ibid.*, 'Exchange Policy', a note from H.D.Henderson to Sir Frederick Phillips, 6 October 1939.

⁷¹³ *Ibid.*

Phillips and his advisors might have anticipated. Initially, controls over the ability to convert sterling into other currencies were only exerted over British residents; foreign holders of sterling were free to convert. There were other controls – and exemptions – but during this period of ‘weak’ exchange control the value of the pound fell to as low as \$3.44.⁷¹⁴ This heavy fall, to a large extent, reflected badly on the initial advice of Keynes, who felt that, as in the First World War, the country might ‘get through’ without taking exchange controls too seriously. Maybe it would have been wiser to heed the advice of Hawtrey who, from the start, wished to impose strict controls in order to aim for a high exchange-rate. After France had fallen to Germany and the Churchill coalition had been established in May 1940, controls were strengthened and the rate of \$4.03 was established and maintained throughout the war – ‘. . . the view that sterling must remain a free currency was finally put aside as a peace-time luxury . . .’.⁷¹⁵

Having already given him one extension as a means of completing a pensionable year, in early 1940 the Treasury approached Hawtrey and suggested that they would like to keep him ‘for the duration’.⁷¹⁶ The Treasury desired that a war-time history of its activities be written and Hawtrey seemed the ideal candidate for the job.⁷¹⁷ As with the First World War, the Treasury may have

⁷¹⁴ Tomlinson, *Public Policy and the Economy since 1900*, p.135.

⁷¹⁵ R. S. Sayers, *Financial Policy 1939-45* (London, HMSO/Longman, 1956), p.251.

⁷¹⁶ Treasury Papers, T 176/5. Hawtrey’s career file. A note from H. Brittain to Mr. Douglas recalling an informal conversation with Hawtrey, 7 October 1940.

hoped for a short war and envisaged Hawtrey's new role as a short-term contract. In November 1944, with Hawtrey coming up to retirement at the age of 65, the war still in progress, and the task of writing the Treasury's history an ongoing one, arrangements had to be made to further extend Hawtrey's Treasury career. Taking into account that he would be eligible for a pension of £1000 a year, and that Hawtrey had expressed a desire to 'be employed part-time on a basis of five days a week', it was agreed that he be re-employed within the Treasury 'at the rate of £500 per annum'.⁷¹⁸ The Treasury must have thought this was a bargain since it was of the opinion that 'in view of Mr. Hawtrey's acknowledged eminence in the sphere of currency matters, I should say that if he were not a Civil Service pensioner and we were employing him as a

⁷¹⁷ Although there is no evidence of a Treasury history of the Great War, and Hawtrey did not publish a Treasury history of the Second World War, it is not true to suggest that he might have 'got away with it twice'. He was assigned to write the history of the Second World War, and copies of an unpublished manuscript, 'Financial History of the 2nd. World War', are held in the Hawtrey archive at Churchill College, Cambridge (HTRY 2) and at the Public Records Office within the National Archives (T 208/204, T 208/205 and T 208/206). The National Archive catalogue records the manuscript as 'unfinished', but it runs to 23 chapters.

In 1956 Professor Richard Sayers published a financial history of the war [R. S. Sayers, *Financial Policy 1939-45* (London, HMSO/Longman, 1956)]. In his preface Sayers paid tribute to Hawtrey's assistance in the book's preparation.

Sir Ralph Hawtrey allowed me to draw freely on his massive chronicle, prepared for official purposes – I have used some of his phrases. Besides commenting on some early drafts, he read the whole book in draft and commented at length; even where I have not adopted his suggestions, his comments have been illuminating and have, I believe, helped me to expound my own point of view more effectively.

⁷¹⁸ *Ibid.*, a note to a Mr. Wilcox within Hawtrey's file, November 1944.

Narrator we should be lucky to get his services at anything less than the maximum of £900'.⁷¹⁹

Hawtrey's employment at the Treasury, still nominally Director of Financial Enquiries, continued until October 1947. There is some evidence in his career file that between June 1947 and October 1947 Hawtrey served as the United Kingdom Representative on the Fiscal Commission of the Economic and Social Council of the United Nations.⁷²⁰ The final irony is that almost eight years after the Treasury Establishments had indicated that he should retire, and at the age of 67, it was Hawtrey who offered his resignation in order to take up the position of Henry Price Professor of International Economics at the Royal Institute of International Affairs.⁷²¹

Hawtrey's retirement from active economic comment was long and productive. Of his 99 publications listed at the end of Collison Black's obituary, no less than 50 were published after the outbreak of the Second World War. In addition he was a frequent contributor to the correspondence pages of *The Times*. Sadly, for this historian, hardly any of his post-retirement writing looked backward at his career. Instead, he continued to comment on and criticise current policy. During, and immediately after the Second World War, whilst

⁷¹⁹ *Ibid.*

⁷²⁰ *Ibid.*, A note from the Foreign Office to the Treasury suggesting that Hawtrey's expenses in connection with the role should be borne by the Treasury rather than the Foreign Office.

⁷²¹ *Ibid.*, note from "G.P.H.D." to the Treasury accountant indicating that the payment of Hawtrey's salary should cease, 14 October 1947.

official policy was planning for full employment and the avoidance of deflation, Hawtrey was writing that the big danger facing the economy would be inflation. He gave a cautious welcome to the Bretton Woods agreement, but was scathing of the recommendations of the Radcliffe Committee. His last published article, in 1970 at the age of 91, was devoted to stopping inflation. Throughout this long period of comment and criticism he remained faithful to the same monetary model which he had developed prior to the First World War.

Conclusions

Six snapshots, taken from different times, give some justification for the view that the career of the Director of Financial Enquiries was one of disappointment and declining influence.

[April 1922 – the International Economic Conference called by the Supreme Council of Allies].

*In 1922, the Genoa International Conference adopted Hawtrey's proposals to stabilise the value of gold through international monetary co-operation.*⁷²²

[August 1928 – with Treasury officials anxious to counter Liberal demands for a Public Works programme].

*So far as the Treasury was concerned, Hawtrey was the one man who ought to know whether Keynes was talking nonsense. With Keynes's growing prominence in the economic debates of the 1920's Hawtrey found himself in a position where his advice was earnestly solicited.*⁷²³

[April, 1930 – before the Macmillan Committee enquiry into Finance and Industry].

Hawtrey's colleagues had some reason to suspect that their economic guru had jumped ship. . . . He called the dear money policy 'the exceptional cause' of recent unemployment . . . [and]

⁷²² Deutscher, *R.G. Hawtrey and the Development of Macroeconomics*, p.4.

⁷²³ Clarke, *The Keynesian Revolution in the Making. 1924-1936*, pp. 53-54.

*was much closer to Keynes than to the Bank, whose policy he criticised as timid in its refusal to make full use of the gold reserves in order to reduce interest rates.*⁷²⁴

[April, 1936 – Sir Warren Fisher, Permanent Secretary to the Treasury, before the Public Accounts Committee]

*. . . he felt that the Committee probably knew of Hawtrey, 'who works away on metaphysics and writes learned books and concerns himself with the theory of higher finance continually examining into the theoretical side (at least as it seems to me the theoretical side).*⁷²⁵

[January 1937 – Mr. Fraser of the Treasury Home Finance Division before the Treasury Reorganisation Committee]

*Mr. Fraser said that when in need of statistics he often asked the Statistical Branch of the Bank of England for them.*⁷²⁶

[August 1939 – Response from the Treasury to Hawtrey's request to continue in Treasury employment beyond the age of 60]

Dear Hawtrey

Many thanks for your letter of the 7th Instant. I am authorised to let you know that after very careful consideration Their Lordships feel that in order to facilitate a reorganisation of

⁷²⁴ *Ibid.*, pp. 142-146.

⁷²⁵ Minutes of evidence taken before the Committee of Public Accounts, 30 April 1936; *House of Commons Papers 1935/36*, 131-48, p.399,

⁷²⁶ Treasury Papers T 199/50C. Treasury Organisation Committee, Minutes of Evidence, 15 January 1937.

the work of "Financial enquiries [sic]" the date of your retirement must be fixed as the 31st December.

I am sorry that this does not coincide with your personal wishes but you will I am sure appreciate that official considerations must prevail.⁷²⁷

From being, in 1922 and shortly after his appointment, a man with bright, new ideas, and at the forefront of a British delegation to a leading conference called to establish a new world monetary order, Hawtrey was reduced to being regarded, in 1939, as redundant and surplus to Treasury requirements. These snapshots from his career would also suggest that, on the way, he forfeited the confidence of colleagues who had relied on his eminence as an economist to justify their policies, and that as his retirement approached, those colleagues found it increasingly difficult to justify his position. Thus, as we have already noted, Black has been led to conclude that the Financial Enquiries Branch under Hawtrey was 'something of a backwater' with his papers 'not often receiv[ing] much attention'.⁷²⁸ Similarly, Howson and Middleton have viewed Hawtrey's career as one of declining influence.⁷²⁹

⁷²⁷ Treasury Papers, T176/5. Hawtrey's Personal File. Copy sent to Sir Warren Fisher of a note sent to Ralph Hawtrey, 7 December 1938.

⁷²⁸ Black, 'Ralph George Hawtrey', p.379.

⁷²⁹ Howson, 'Hawtrey and the Real World', p.176. Middleton, *Charlatan's or Saviours*, p. 199.

Of other writers, Deutscher has largely neglected Hawtrey's Treasury career, but his brief assessment of that career is, I believe, perceptive – that while '[Hawtrey's] ideas were listened to and respected . . . they were discounted on account of his relatively strong concern for theory and his tendency to attribute outstanding importance to a narrow range of factors'.⁷³⁰ McDonald, too, makes a fairly apt summary of Hawtrey's role within the Treasury; adjudging him to have been 'unimportant in terms of policy making' and describing him as 'a marginal voice of dissent' whose 'approach was akin to that of a rebellious academic determined to speak his mind on the issues in which he chose to interest himself'.⁷³¹ In terms of Hawtrey's independence, apostasy and scholasticism, McDonald's brief pen-portrait is uncannily acute. In so far as McDonald's study is concerned with public expenditure policy-making, the comment on Hawtrey's importance is also fair. It would not be fair, I believe, to extend this judgement to the importance of Hawtrey's views on currency, credit policy and exchange-rates.

A recent study of the politics of monetary policy in Britain has been unusual in ascribing much importance to the influence of Hawtrey.⁷³² In the opinion of

⁷³⁰ Deutscher, *R.G.Hawtrey and the Development of Macroeconomics*, p.3.

⁷³¹ A. McDonald, 'The Formulation of British Public Expenditure Policy, 1919-1925'. Unpublished Ph.D. Thesis, University of Bristol, 1988, p.259.

⁷³² M.M.M.Luthje, 'The Politics of Monetary Policy in Britain from the First World War to the World Economic Conference', Unpublished Ph.D. Thesis, Cambridge University, 2002. I am grateful to my external assessor, Professor R.Middleton, for drawing the attention of my supervisor, Professor K. Laybourn, to this thesis.

Luthje there was in the Treasury, in the 1920s, 'an important development . . . driven by . . . Hawtrey' towards interpreting and solving the world slump through monetary measures.⁷³³ Luthje claims that this development was a movement towards achieving higher world prices, and stemmed from the memorandum, 'The Credit Situation', written by Hawtrey on 12 July 1928⁷³⁴. This memorandum, written shortly before Hawtrey left for America, was but one of many which he produced calling for concerted efforts to bring down interest rates in London and New York as a means of raising world prices. I am not convinced that this had such a major influence on Treasury attitudes. Certainly, not on the Deputy Controller of Finance, Leith-Ross, who later felt it necessary to caution the MacMillan Enquiry that 'Hawtrey holds views - not necessarily the Treasury's views'.⁷³⁵

Luthje goes on to quote Cassel's description of Hawtrey as the 'power behind the throne' in the Treasury. Such a view could only have been held by a fellow theoretical economist. In general, Luthje's is a fascinating account of the formulation of monetary policy, but one which tends to over-dramatise and over-personalise – possibly through reliance on the personal diaries of people who enjoyed dramatising their own roles. There is a fondness for dramatic hyperbole

⁷³³ *Ibid.*, pp. 9-10.

⁷³⁴ Treasury Papers, T 175/26. The Hopkins Papers. 'The Credit Situation' by R.G.Hawtrey, 12 July 1928.

⁷³⁵ Private session of the Enquiry. Quoted in Clarke, 'The Keynesian Revolution in the Making', p.146.

in Luthje's work which leads to dubious, sweeping statements such as 'Hopkins [Treasury Financial Controller from 1927] very quickly accumulated enough economic knowledge to hold his ground *vis-à-vis* such a formidable interrogator as John Maynard Keynes when he was questioned for the Macmillan Committee . . .'⁷³⁶ This is far from the truth. Hopkins, I believe, did outmanoeuvre Keynes – but not through economic knowledge. In fact, prior to his appearance, Hopkins specifically asked not to be questioned on matters of economic theory, and appealed to Macmillan, as Chairman, when he felt Keynes's questioning was drifting towards theoretical economics. Hopkins outmanoeuvred Keynes by taking the issue of public works away from Keynes's area of expertise – from the realm of economic theory to that of public confidence and acceptability. Nevertheless, I believe, that Luthje is correct in identifying a close rapport between Hawtrey and Phillips as the source of any influence which Hawtrey possessed in the early 1930s.

Hawtrey's influence outside the Treasury did not always correspond with his influence within the Treasury. It is almost certainly true to say that *outside* the Treasury Hawtrey's influence steadily declined throughout his tenure of office. Before 1922, and at the time of the Genoa negotiations Hawtrey enjoyed cordial relations with Montagu Norman at the Bank of England. In 1920-21 Hawtrey endorsed the Bank's high interest policy, and Montagu Norman warmed to him

⁷³⁶ Luthje, 'The Politics of Monetary Policy in Britain', pp. 41-2.

as an ally.⁷³⁷ After Genoa there was a cooling of relationships between Hawtrey and the Bank as Hawtrey persistently criticised its high interest rate policy. On subsequent occasions, whenever Hawtrey's work was referred to the Bank, as when he produced his 'Bill Famine' memorandum in 1929 as an alternative to Lloyd-George's Public Works schemes, his ideas received a frosty reception.

Similarly, as time progressed, his abilities received less recognition from politicians. This was, in all probability, not down to the *content* of his comment, but his lengthy, academic prose. In 1925, as Churchill contemplated returning to the Gold Standard, he specifically requested that Hawtrey take part in his 'exercise'. Additionally, he requested further information from Hawtrey regarding the effects on sterling of the return to the Gold Standard after the Napoleonic wars. Whilst later requests for comment from Chancellors might have been passed his way, it is difficult to find another example of where a Chancellor of the Exchequer went out of his way to specifically solicit the view of Hawtrey. There were subsequent occasions - occasions when Hawtrey's advice might have been solicited - where Churchill requested that younger non-economists in the Treasury such as Alfred Hurst or Bernard Gilbert be invited to respond to his queries, but not Hawtrey.

If, outside the walls of the Treasury, Hawtrey's stock faded during this period, it is more difficult to assess how his standing *within* the Treasury changed. His limitations as an administrator were obvious – apart from his tendency to

⁷³⁷ HTRY 13/5.

frustrate colleagues by losing files, and so on. These limitations remained throughout his career and were probably a large factor in him being appointed to the post of Director of Financial Enquiries in the first place.⁷³⁸ His influence depended upon the quality of his relationship with his superiors – and that relationship, in turn, depended upon the extent to which those superiors felt that economic theory could contribute to the effective discharge of the Treasury's duties. To crudely summarise this matter - Blackett, a fellow member of the Royal Statistical Society, fostered and encouraged Hawtrey; Niemeyer believed that the Treasury could continue to be run, without any advice from an economist, along the lines of strict, nineteenth century finance; Hopkins was sceptical about economic theory since it led to outcomes which were 'repugnant to common sense, although his deputy, Phillips, believed that high quality economic advice was vital to the work of the Treasury.

If indeed, Hawtrey's influence tended to be less than it might have been, then it is possible to put forward three reasons for that lack influence. First, his personality; secondly, prevailing attitudes towards the economic role of the state; thirdly, the special focus of Hawtrey's economics.

From the writings of people who knew Hawtrey, it seems that he could be charming, cultured, likeable, stubborn and frustrating. Some of the various facets of his personality were brought out in a letter which Keynes wrote to his wife,

⁷³⁸ Peden, *Keynes and his Critics*, p.17. I enquired of Professor Peden his sources for comments regarding Hawtrey's alleged incompetence. He replied that they were the result of his interviews with Treasury officials during the 1970s.

Lydia Lopokova, on 30 October 1933, whilst he was in Cambridge working on his *General Theory*. He wrote to Lydia confessing that he was 'weak as a rag – scribble, scribble, scribble for three and a half hours' – but that he had taken some time off from writing to visit Hawtrey, who was:

. . . very sweet to the last but quite mad. One can argue with him for a long time on a perfectly sane and interesting basis and then, suddenly one is in a madhouse. . . . His mind, though frightfully ingenious, seems to me to be maliciously perverse. Again it is like arguing with a madman.⁷³⁹

Shortly after embarking on this thesis I came across a letter in the *Times* from a 'Dr. Ralph Hawtrey of Cambridge'. On contacting him I found him to be a retired classics teacher whose father had been the cousin of R.G Hawtrey. He wrote to me in February 2004, confirming some of my impressions of Hawtrey's character.

. . . I used to see him from time to time as a child and a young man, the last being I think in 1964. He came for a drink in my room at Trinity in I think 1961, when he presented me an ancient and tiny edition of Horace, which he had inscribed "from an honorary fellow to a scholar of Trinity". He was a very charming old man I fear I am regrettably ignorant about his life.⁷⁴⁰

⁷³⁹ Skidelsky, *John Maynard Keynes: the Economist as Saviour 1920-1937*, p.495.

In an even later meeting, in November 1974, the Bank of England's historian Professor Richard Sayers called on Hawtrey on the occasion of his ninety-fifth birthday. He found him to be 'still the same charming and interesting man' that he had first met some forty-two years previously.⁷⁴¹

Hawtrey was held in affection by friends and colleagues not only for his charm but also for his loyalty and generosity. He remained loyal to the ethical precepts of Moore, frequently returning to Cambridge, even into his old age, to gatherings of Moore's adherents. Regarding his generosity, after his *Treatise on Money*, Keynes acknowledged that Hawtrey had taken 'enormous pains' over his book, and in the prefaces of books by Donald Moggridge and Susan Howson, relatively junior academics at the time, there can be found acknowledgements to the help and support of 'Sir Ralph Hawtrey'.⁷⁴² In contrast to these qualities, it should be noted that he was also known for a degree of stubbornness. Peden has related a story in which Hawtrey was chief British delegate at a League of Nations conference. A matter which could fairly easily have been resolved was allowed to drag on for a week because Hawtrey refused to make the smallest of concessions. He finally drove the French diplomat, a M. Massigli, to exclaim in

⁷⁴⁰ Letter from Dr. Ralph Hawtrey of Cambridge, a retired classics teacher, 7 February 2004.

⁷⁴¹ Black, 'Ralph Hawtrey', p.369.

⁷⁴² Moggridge, *British Monetary Policy, 1924-31*; Howson, *Domestic Monetary Management in Britain, 1919-38*. Both these works contain acknowledgements to the assistance of Hawtrey.

exasperation at Hawtrey's inflexibility, 'Monsieur Hawtrey, vous etes le logic meme!'⁷⁴³ In Hawtrey's taped interviews Sir Alec Cairncross, I was struck by a certain timidity of personality. Whilst allowance must be made for his age – he was in his eighties at the time – many of Hawtrey's replies were preceded by a rather silly, nervous giggle. This trait may have concealed an incisive mind, but did not suggest a strong and incisive personality. However, any reservations regarding Hawtrey's strength of personality should not detract from the fact that he could be a formidable debater who thrived on disagreements. His attitude to theoretical criticism was one of being happy to take on all-comers – even to the extent of publishing an entire book to defend his theory of interest-rate schedules against that of Keynes.⁷⁴⁴ Whilst it is generally conceded that he came off second-best to Keynes in their 'MacMillan' confrontations – even Bertrand Russell usually suffered that experience – Hawtrey could still instil fear in those who took issue with him. In the course of a question-and-answer session at the end of one meeting of the Royal Statistical Society, a certain Professor Jones confessed that it was 'with great diffidence', that he ventured to criticise Hawtrey's paper.⁷⁴⁵

⁷⁴³ G.C.Peden, *The Treasury and British Public Policy 1906-59*, pp. 235-6. The story was related to Peden by Lord Sherfield who was a junior member of the delegation.

⁷⁴⁴ Hawtrey's book *A Century of Bank Rate* was very largely devoted to showing, over a far longer period of time than Keynes had been prepared to consider, the relative independence of short and long term interest rates.

⁷⁴⁵ R.G.Hawtrey, 'Public Expenditure and Trade Depression', p.470.

Whilst the qualities of kindness, charm and gentleness – and disorganisation - which Hawtrey demonstrated, did not necessarily prevent him from being an effective policy advocate, they were qualities which lent themselves more readily to reflection than to strong persuasion or effective administration. His memoranda were invariably excessively long. Busy government ministers wanted memoranda which spelt out the essential issues in brief, clear fashion. Hawtrey could never be brief. His memoranda stand in stark contrast to those of his immediate superior during the 1930s, Sir Frederick Phillips. Phillips always seemed to be capable of going straight to the heart of a problem, clarifying the issues, and then assessing the advantages and disadvantages of alternative policy options. His short, clear memoranda gave ministers all the information they might want. The quality and conciseness of Phillips's work inevitably drew attention to the shortcomings of Hawtrey's, and pointed to another of the reasons why Hawtrey failed to advance to higher office in the Treasury. The same failing may partially account for his waning influence with colleagues. When, towards the end of the 1930s, the views of Robertson or Henderson were sought, their replies, although not necessarily offering better advice, were always more concisely expressed than those of Hawtrey.

Many of Hawtrey's memoranda had a pedagogic purpose beyond the advice they contained. As such, they often included lengthy, and extremely ingenious, numerical illustrative examples (see Chapter 4). It is in these memoranda that he seems to have revealed his real vocation. By temperament, he was not an

administrator but a teacher - he wanted to inculcate into his colleagues the ability to think as economists.

The intellectual climate within which he worked could also, partly, explain Hawtrey's lack of influence. Middleton has introduced a subsection of his book dealing with the inter-war relationship between economists and the British economy with the following health-warning.

All discussions of interwar economic policy should be prefaced by the statement that in 1918 governments did not think of themselves as having an economic policy, not at least in the sense that we would understand it today.⁷⁴⁶

Laissez-faire, the idea that implied that interference with industry by government agencies was disadvantageous to prosperity, was still overwhelmingly accepted by the financial authorities – a government economic *policy* must therefore imply interference. The Treasury and Bank may have been concerned to balance Budgets, maintain the external value of sterling, and preserve free trade, but these were regarded as essential institutions within which *laissez-faire* might effectively function rather than economic policies.⁷⁴⁷ Given such denial of the

⁷⁴⁶ Middleton, *Charlatans or Saviours: Economists and the British Economy from Marshall to Meade*, p.178.

⁷⁴⁷ The minimal balanced budget, the gold standard and free-trade were interlocking principles which served, true to the principles of Adam Smith, to be a self-acting system which minimised the states role in economic management. The largest responsibilities which state took upon itself were those for national security and order. The budget

validity of the concept of *economic policy* it is pertinent to enquire about the purpose of appointing a Director of Financial Enquiries in 1919. The role may have been envisaged as chiefly one of the gathering and collating of economic data rather than proffering economic advice, but the timing of the appointment reinforces the suspicion that it was made with a view to making the best possible use of a 'good chap' with limited administrative ability.

If, as Middleton suggests, the government would have denied the concept of *economic policy* in 1918 then by 1939 unemployment, deflation, and the enforced withdrawal from the gold standard had forced it into actively adopting measures to deal with economic problems – a retreat from *laissez-faire*. This retreat from *laissez-faire* did not necessarily imply that government officials gave a high value to theoretical economics as a necessary part of their work. Probably one of the most dismissive views of economists was made in the late 1930s - that, quoted above, of the Permanent Secretary to the Treasury, Warren Fisher, to the Public Accounts Committee in 1936 - when he suggested that they might have 'heard of Hawtrey who works away on metaphysics'. However dismissive

covered such necessary expenditure, but was intended to be fiscally neutral in not favouring or disadvantaging any part of the economy. Free-trade, too, allowed market forces to dictate patterns of production and expenditure. By maintaining free-trade the Government remained neutral from any area of industry. The Gold Standard, by maintaining the convertibility of sterling to gold at a fixed rate, guaranteed the soundness of the currency and imposed its discipline upon the spending of Government and citizens. Gold was the medium for international exchange. If the value of imported goods exceeded that of exported goods then the Bank of England lost gold. Its measure for stemming the net outflow of gold was the raising of interest rates – a measure which inhibited borrowing for purchasing imports and encouraged foreigners to send gold to acquire sterling. It was believed to be a beautiful self-correcting mechanism free from political corruption.

of the role of Hawtrey this might have been, it was also dismissive of the usefulness of economic theory to the functioning of government departments. In the same year, 1936, that Fisher was addressing the Public Accounts Committee, A.J.Ayer's *Language, Truth and Logic* appeared, in which he used the term 'metaphysics' pejoratively as a indication of the uselessness and meaninglessness of much traditional philosophy. Such sentiments about economic theory amongst senior officials were not restricted to Fisher. In the midst of the Macmillan enquiry, where he sat as the Treasury's observer, Frederick Leith-Ross took time out to pen his thoughts on 'the theory so attractively argued by Keynes'.⁷⁴⁸ He was convinced that Keynes was wrong in his approach to remedying unemployment since his approach was based on a number of assumptions which were not necessarily true. However, his final comments related to the lack of contact with reality of the economist's modelling process.

The fact is that Keynes, like other economists, lives in a world of abstractions. He speaks of "Industry" "Profits", "Losses", "Price Level" as if they were realities. In fact we have no such thing as "Industry". What we have is a series of different industries, - some prosperous, some depressed and a number carrying on normally. The position of each has to be examined separately.

⁷⁴⁸ T.Jones, *Whitehall Diary*, vol.II, 1926/1930, ed. Middlemas (1969), p. 250. Copies of Leith-Ross's notes were sent to the Deputy Secretary to the Cabinet, Tom Jones, and to Niemeyer at the Bank of England.

. . . the setting on foot of a gigantic programme of public works at short notice is impracticable without a great extension of bureaucratic power and considerable waste.⁷⁴⁹

In his ready dismissal of economists, 'living in a world of abstractions', Leith-Ross was doing no more than might be expected of someone widely regarded as the last remaining senior Treasury figure from the era of 'sound finance'. But Sir Richard Hopkins, a far more pragmatic Controller of Finance and less wedded to traditional dogma, was often equally sceptical about the value of professional economists. In the course of the sittings of the Macmillan Committee he shifted the 'Treasury View' away from a theoretical argument towards one of administrative feasibility. Considering the opposing views of Keynes and those of the economists of the London School of Economics on the effects of private saving, Hopkins wrote to the Chancellor of the Exchequer, Chamberlain, with words of damnation.

It seems useless to endeavour to follow professional economic teaching, for there is no criterion for determining the proper economists to follow, and whoever one chooses, one is apt to find oneself led into actions which are either repugnant to common sense or incapable of practical achievement.⁷⁵⁰

⁷⁴⁹ Treasury Papers, T175/26. The Hopkins Papers, 'The Assumptions of Mr. Keynes', memorandum by Frederick Leith-Ross, 28 March 1930.

⁷⁵⁰ Treasury Papers, T 175/70. The Hopkins Papers. Memorandum to the Chancellor of the Exchequer by Sir Richard Hopkins, 20 October 1932.

Hopkins's view on the value of professional economic advice seemed to change little in the next few years as, at the meeting of the Treasury Organisation Committee of 9 March 1937, he expressed the opinion that in view of the likely course of the Treasury's work over the coming years, debt management and currency management in co-operation with the Bank of England, 'the advice of an economist was hardly necessary and . . . it would not be easy to find full time work for an adviser'. Sir Frederick Phillips, Hopkins's deputy, made it clear to the same committee that he could not do without Hawtrey. Given Hawtrey's request to continue in his post beyond the age of sixty, it seems unlikely that Phillips would have demurred. In which case, it appears that Hopkins must have been instrumental in swinging that particular axe. In May 1939 Hopkins opposed the idea of an 'economic general staff' on the grounds that 'a lot of economists operating *in vacuo*' would not have sufficient practical experience of government.⁷⁵¹ It was not until after the war that such a body was created.

Given such institutional resistance to advice from theoretical economists throughout the period 1919-1939, it is probably not true, as Susan Howson has concluded, that after being influential throughout the 1920s (which was not entirely true), Hawtrey was supplanted by 'more influential' economists in the 1930s.

⁷⁵¹ Treasury Papers, T160/885/F17545. Memorandum, Sir Richard Hopkins to Sir Warren Fisher, 17 May 1939.

Hawtrey, who worked from an official base, had much more influence on academic thought than ever he had on Treasury policy. This is partly due, of course, to . . . personality and preference, Hawtrey being content for much of his life to remain a 'backroom boy' in the corridors of power. But Hawtrey's lack of influence on Treasury policy after 1925 cannot be explained solely by the fact that Hawtrey lacked Keynes's skills of propaganda and persuasion. . . . The reasons lie in the *content* of his . . . policy recommendations rather than in their style of presentation.⁷⁵²

Howson (alongside her sometime co-author Donald Winch) seems to believe that by the mid-1930s Treasury officials, by direct exposure to Keynes's arguments, had been re-educated away from outmoded economics.

. . . by 1937 the macroeconomic position which we associate with Keynes's *General Theory* had altered the thinking of the most important policy-making civil servants in the Treasury. These men were prepared to rethink the *theoretical* basis of the policies which they had so far pursued, and to adjust their policy recommendations accordingly.⁷⁵³

Keynes may, through his charismatic personality, have been able to dominate the proceedings of the Economic Advisory Council's Committee of Economists,

⁷⁵² Howson, 'Hawtrey and the Real World', p.177.

⁷⁵³ Howson and Winch, *The Economic Advisory Council 1930-39*, p.109.

but the Treasury representative, Sir Frederick Phillips, would have been aware of theoretical differences between Keynes and people such as Henderson, Stamp and Robertson, and would have been by no means convinced that Keynes had succeeded in peer group review.⁷⁵⁴ Certainly, there seems to have been no indication that Sir Richard Hopkins, during the 1930s, had revised his view on the 'uselessness' of following any one line of professional advice or that following that advice might lead to actions 'repugnant to commonsense'.⁷⁵⁵ Hopkins, as befits a former head of the Inland Revenue, placed a premium upon ideas and schemes which lent themselves to effective execution rather than upon whether they were consistent with any particular school of economics. Whatever influence Hawtrey may have had in the 1920s and early 1930s may have waned during the late 1930s, but there seems little evidence that the ideas of other economists took over the control of the Treasury.

If Sir Richard Hopkins 'quietly and without fuss transformed the Treasury during the 1930s',⁷⁵⁶ it was on the basis of highly competent generalist administrators (particularly Phillips) rather than through the use of economists or a movement towards any particular economic doctrine. Middleton, in one respect, overestimates Hawtrey's influence in describing him as someone whose

⁷⁵⁴ Booth, *British Economic Policy 1931-1949*, p.29.

⁷⁵⁵ Treasury Papers, T 175/70. the Hopkins Papers. Memorandum to the Chancellor of the Exchequer by Sir Richard Hopkins, 20 October 1932.

⁷⁵⁶ Middleton, *Charlatans or Saviours: Economists and the British Economy from Marshall to Meade*, p.199.

'major influence was *if anything* [again, my italics] to convince his generalist colleagues that economic theory posed no great intellectual challenge nor had any real relevance to the administrative tasks facing the department'.⁷⁵⁷ Hawtrey's generalist colleagues needed no such convincing. It was Sir Richard Hopkins himself, who fostered the cult of the layman and the practical administrator. In following this course he hardly needed *convincing* by his Director of Financial Enquiries.

Various studies, including those by Peden, Middleton, Tomlinson and Booth, have concluded that there was no conscious decision by policy makers to pursue a Keynesian schedule until the very late nineteen-thirties. My own reading of official memoranda is that any Treasury adoption of Keynes's ideas was done, not as part of any attempt to improve economic growth or reduce unemployment, but as a means of funding the war effort without burdening post-war governments with crippling debt charges. In pursuing these particular policies the Treasury, still wary and suspicious of Keynes, relied upon the reassurances of Denis Robertson that such debt management policies could be effective, before embarking upon its debt programme.

The third reason offered for Hawtrey's lack of influence in the Treasury relates to the kind of advice which he offered. In many ways, his position within the Treasury was an incongruous one. He believed that the trade cycle, and the unemployment which was a concomitant consequence of that cycle, had a

⁷⁵⁷ *Ibid.*

monetary cause. Its cause was the instability of credit, and he believed in the effectiveness of monetary measures as means of counteracting that instability and thus curing economic ills. His faith in the power of frequent adjustments to Bank Rate to control economic activity through adjustments in the levels of dealers' stocks remained undiminished throughout his career, as did his confidence in the superior power of short-term rates over long-term interest rates. He never ceased returning to the issue of dealers' stocks and their responses to movements in short-term interest rates. In short, he was a monetary economist, believing in monetary solutions to economic problems, but he worked in an organisation whose responsibilities were largely *fiscal*. He showed relatively little interest in the structuring of long-term debt, and even less in budgetary policy.

In 1966 Sir Alec Cairncross queried the many memoranda which Hawtrey had written on the subjects of Bank rate, credit, and the movement of gold; asking if the Treasury was 'on firm grounds putting forward arguments related to Bank rate'.⁷⁵⁸ Hawtrey's reply was that that Treasury had some concern over the level of interest rates since it affected the issue of Treasury Bills, and he *hoped* that 'Blackett or Bradbury' might have passed his memoranda on to the Chancellor of the Exchequer. He admitted that he got 'very little' feedback regarding any of his proposals. Probably few of Hawtrey's lengthy memoranda went beyond the confines of senior Treasury officials. [In his discussion with Cairncross, Hawtrey

⁷⁵⁸ HTRY 13/5. Interview with Sir Alec Cairncross.

frequently invoked the names of Blackett and Bradbury. Hawtrey was appointed Director of Financial Enquiries in 1919. In 1919 Bradbury was replaced by Fisher, and in 1922 Blackett was replaced by Niemeyer. These men were Hawtrey's superiors for only a very short time, and his frequent references to them suggest that he enjoyed better working relationships with them than with later Treasury officials.]

Implicit in Cairncross's writings is a further reason why Hawtrey's Treasury career was perhaps something of a disappointment. Hawtrey was too wedded to his own theoretical model, and perhaps believed that real-world problems could, all too easily, be related to idealised models. Cairncross has cautioned economists to be wary of the relevance of pure economic theory and to recognise that 'economics is by no means the whole story and that there are other studies of human behaviour with which economics has to make common cause'.⁷⁵⁹

Cairncross was enlisted in the British War Cabinet Secretariat in 1940. He never felt the need to make much use of the more refined parts of economic theory. Both during and after the war he found that he constantly had recourse to deploy the basic theory relating supply, demand and price when confronted with politicians whose instincts were to deal with economic problems by price-fixing.⁷⁶⁰

⁷⁵⁹ A. K. Cairncross, *Economics and Economic Policy* (London, Blackwell, 1986), p.28.

⁷⁶⁰ *Ibid.*, p.4.

Whilst respecting economic theory, Cairncross believed that economic theory was essentially a modelling process and involved abstractions. It took a limited number of variables and assumptions, and then worked through to their logical conclusion. The real world, he suggested, could never be quite so simple; the range of variables could never be restricted to those of the economist's model. Even the variables themselves, in the form of economic data, could never be located with such precision and confidence as economic modelling assumes.

Cairncross believed that economists' advantage lay in their 'way of thinking', and the way in which they could bring their particular style of thinking to bear on policy decisions.⁷⁶¹ Thus they would not be 'at a loss, like Prime Minister Attlee, to understand how . . . when activity [was] so brisk at home, there should be so much trouble with the balance of payments'.⁷⁶² In his belief that economics was primarily a way of thinking before being a 'body of knowledge' Cairncross was being true to the Marshallian tradition in Cambridge economics.

Hawtrey placed his own theoretical model at the forefront of all his advice and it is probably fair to say that he ignored Cairncross's stricture, quoted above, that 'economics is by no means the whole story'. However, despite these criticisms and reservations, it would be premature, however to conclude that Hawtrey was of no importance to the work of the inter-war Treasury. Much of his value lay in his informal contacts.

⁷⁶¹ *Ibid.*, p.6.

⁷⁶² *Ibid.*

First, he was respected for the fairness of his criticisms of the work of other economists, and he played a role in interpreting advances in economic thinking to the Treasury. Sir Frederick Phillips, the creative architect of the Treasury's policies in the 1930s told the 1937 staffing review body that the reason he could not do without Hawtrey because Hawtrey understood other economists in a way that he did not, and was capable of making intelligible what other economists were saying. Not only did he clearly, and usually very fairly, interpret the implications of what other economists were saying, but he provided something which Phillips regarded as equally valuable, furnishing the Treasury with 'a constant commentary on the financial and economic side of Treasury work'.⁷⁶³ Thus Phillips, as we have previously noted, regarded the presence of an economist within the Treasury as 'a necessity'.⁷⁶⁴ Anticipating Hawtrey's retirement, Phillips was concerned that the Treasury would not be able to replace him with someone of sufficiently high calibre – 'the Treasury would have to look outside for a competent young economist and pay him what was necessary; there were not more than about a dozen men in the country fitted for the post'.⁷⁶⁵ There is no doubt that Phillips recognised Hawtrey's eminence as an economist and valued his presence.

⁷⁶³ Treasury Papers, T 199/50C. The Report of the Treasury Organisation Committee, 9 March 1937.

⁷⁶⁴ *Ibid.*

⁷⁶⁵ *Ibid.*

Sir Warren Fisher made a somewhat related point in his evidence to the Public Accounts Committee in 1936. He suggested that Hawtrey's real value to the Treasury lay in his foreign currency expertise being readily available and accessible through informal contacts. Thus, according to Fisher, whenever an Under-Secretary came across a difficult exchange issue 'he would get hold of Hawtrey . . . and he would advise'.⁷⁶⁶ Ever since his leading role in the Genoa negotiations of 1922 Hawtrey had continued to be regarded as a currency expert, and it is in this role, clarifying problems involving currency and exchange issues for his colleagues, that senior officials, largely through informal contacts, where Hawtrey's presence in the Treasury would have been valued. But Hawtrey's influence went beyond that of his expertise; throughout his period of office, Hawtrey could be seen to act as the 'Conscience' of the British financial authorities.⁷⁶⁷ In this context it is worth revisiting some of Hawtrey's first published words; the beginning of the 'Introductory' to his very first book, *Good and Bad Trade*.

In the last hundred years we have learnt to produce wealth on a grand scale. Our command of the necessaries, comforts and luxuries of life, so far as the material conditions of production are concerned, seems almost boundless. But in the same period we

⁷⁶⁶ *House of Commons Papers 1935-6*, 131-48, p.339.

⁷⁶⁷ I am indebted for this phrase, as for much else, to my principal supervisor, Professor Keith Laybourn.

have become acutely aware of certain imperfections in the distributions of all this wealth.

The general principle by which the distribution is at present governed is that those only are entitled to share in the accruing wealth of society who assist in the production of that wealth, whether through their personal services or by permitting the use of land or capital which is in their control. . . . The principle does in fact work imperfectly. For many people who possess no accumulated property find themselves from time to time without the opportunity of assisting through their personal services in the production of wealth, even though they would be perfectly competent to do so if the opportunity offered.⁷⁶⁸

This is true Hawtreyan prose – but disentangling the convolutions, it is possible to see Hawtreys concern about the unfairness of the distribution of wealth. The unfairness arose as a consequence of the trade cycle, particularly as it affected the working classes. Moreover, the unfairness arose not only through unemployment in the ‘bad’ part of the cycle, but also through inflation in the ‘good’ part of the cycle. He believed that whilst the cycle was unavoidable, judicious use of short-term interest rates could mitigate the worst consequences of each part of the cycle. His memoranda, whether advocating higher or lower rates, were driven by a determination to avoid the excessive unfairness of both parts of the trade cycle. To Hawtreys, it wasn’t sufficient for the authorities to balance the budget, safeguard the level of gold stocks, and then assume that ‘in

⁷⁶⁸ Hawtreys, *Good and Bad Trade*, p.1.

the long run' all would be well. Without having Keynes's facility for the memorable aphorism, he believed, no less than its originator, that 'in the long run we are all dead'. Thus, in the interests of mitigating the worst effects of the depression, Hawtrey believed that the Bank of England should have been prepared to lower interest rates, expand credit, and 'let gold go'.

The Bank of England, and most of Hawtrey's Treasury colleagues remained sceptical about this policy. It is also clear from their questioning that the members of the Macmillan Committee of Enquiry were sceptical. The lowest point of Hawtrey's professional career was Keynes's dismantling of his argument, before the Macmillan Committee, concerning the relative effect on British and world prices of releasing gold on to the international markets. However, another phrase of Keynes's, directly addressed to Hawtrey at the time of the Macmillan Enquiry – 'although we always seem to differ . . . ultimately I am joined in common agreement with you as against most of the rest of the world' – applied not only to their economic modelling, but also to their concerns for the economy and the unemployed. If, to the financial authorities, Keynes was the irritant from outside, then Hawtrey was indeed, the 'conscience' from within. The two men may have proposed different means, but their ends were similar, and they both played a part in moving Treasury concerns towards internal economic expansion.

As Hawtrey's stock fell at the Macmillan Enquiry, so it rapidly rose again on the retreat from gold. Throughout the discussions on the appropriate target level for the pound, Hawtrey's remained the one voice consistently arguing for

£3.40. His initial paper on the matter was clear that the *purpose* of devaluation *should* be 'to [secure] the maximum beneficial effect upon trade and industry' and that '[t]he detrimental effect on finance hardly enter[ed] into it'.⁷⁶⁹ His reasoning remained steadfast – that the last time when prices and wages could 'tolerably' be considered in equilibrium was 1925, and the wholesale index of prices had fallen by over 30 per cent since then, therefore equilibrium could only be restored by an equivalent fall in the value of sterling. The exchange rate of the pound, he concluded *ought* to be \$3.40. Niemeyer at the Bank, Leith-Ross, Hopkins, Phillips, Hubert Henderson and Keynes, all produced analyses or recommendations which differed from that of Hawtrey. In the end, it was Hawtrey's original recommendation which prevailed.

For the next couple of years, Hawtrey rode his moment of triumph, and was *the* authority on currency and the exchanges. Together with Phillips he was responsible, as Luthje has recounted, for designing exchange rate policy. His fall from influence came on his repetitive insistence that *international* agreement be sought on credit and interest-rate policy.

Peter Clarke has seized upon one particular note of Phillips's to query whether 'Hawtrey's long years in the dungeon had . . . in the end, given him a more subtly insidious influence in the 1930s than has usually been supposed'.⁷⁷⁰ This arose through a request from the Chancellor of the Exchequer, Sir John Simon,

⁷⁶⁹ Treasury Papers, T175/56. 28 September 1931.

⁷⁷⁰ *Ibid.*, p.319.

who had asked for material with which to respond to Harold Macmillan, who in a parliamentary question, had requested for public works to be targeted towards relieving unemployment in the most depressed areas. Hawtrey had prepared a note, and in an addendum, Phillips had added:

I agree with Mr. Hawtrey that the real stimulus comes from reflationary finance. If there were no reflationary finance, the government works would tend merely to replace private works without much effect on employment.⁷⁷¹

Phillips, though, was aware of the history of this particular debate, and went on to caution the Chancellor against using this argument of Hawtrey's in parliament:

. . . this is the famous or infamous 'Treasury View', still a most bitter subject of controversy which it would be a great mistake to raise.⁷⁷²

There seems little doubt that within the Treasury some version of Hawtrey's view, that public works without reflationary finance would not alleviate unemployment, persisted throughout the 1930s. A short note from the Chancellor's private secretary, Donald Fergusson, to Neville Chamberlain, on 26 January 1935, encapsulated the Treasury's existing thinking on public works.

⁷⁷¹ *Ibid.*

⁷⁷² *Ibid.*

The note arose from discussions at the highest level amongst a group which included Fisher, Hopkins and Phillips.⁷⁷³ It indicated that there was pressure from the Treasury, particularly from Phillips, for public works schemes around London and Birmingham. The pressure for such schemes came from population growth and the resulting strains on the transport infrastructure. Fergusson made two points which probably fairly reflect what, at that time, was the status of the 'Treasury View'. First, that –

[t]he trouble of course is that the money ought to be spent by Ashfield and the L.N.E.R. and not by the Government, but these people will not get on with their job.⁷⁷⁴

But, having made this particular argument *for* a public works programme, Fergusson hastened to add his second point:

. . . there was of course universal agreement that public works as a remedy for unemployment are quite futile.⁷⁷⁵

⁷⁷³ Treasury Papers, T 172/1828. Note from D.Fergusson to the Chancellor of the Exchequer, 26 January 1935.

⁷⁷⁴ *Ibid.*

⁷⁷⁵ *Ibid.*

Fergusson elaborated, a little, on this by adding a point which was to become a favourite theme of Phillips – that the places where public works schemes were *needed* were the prosperous areas, and not those of high unemployment.

In another memorandum at about the same time Phillips revealed his continued agnosticism over any kind of ‘multiplier effect’ arising from government sponsored works.

. . . advocates of public works in 1929 e.g. Keynes, based their argument largely on the belief that expenditure on public works had constant ‘repercussions’ in other directions. . . . [that] expenditure of money by these beneficiaries would in turn employ other people and so on indefinitely. . . . but it cannot be said that there is as yet any practical confirmation of the theory.⁷⁷⁶

Moreover, Phillips went on to discuss the financing of public works and suggested that whilst:

. . . it might be that under normal conditions a certain amount could be raised merely by restricting our external investment . . . at a time like the present external investment has shrunk to nothing, and it would seem that every pound raised must diminish the amount available for private enterprise.⁷⁷⁷

⁷⁷⁶ Treasury Papers, T172/1828. Memorandum by Sir F. Phillips, 31 January 1935.

⁷⁷⁷ *Ibid.*

If Hawtrey's original 'crowding out' position lived on within the Treasury, then it seems to have been largely through his close association with Phillips.

There is, of course, another of Hawtrey's frequent prescriptions which has become part of the modern financial structure. He preached the efficacy of frequent changes in Bank rate, and believed that regular adjustments of the rate should be considered, using all available data on prices, exchanges and employment. His ghost lives on. Not in Whitehall, but in Threadneedle Street.

Appendix I

Interpreting Keynes to the Treasury

1931, 1936

Upon the publication of each of Keynes's major works – *A Treatise on Money* and *The General Theory of Employment Interest and Money* – Hawtrey wrote extended critiques for the benefit of the Treasury. If they read them, his colleagues were not sufficiently stimulated to comment.

Keynes's *Treatise* is a much neglected book in the study of the development of economic ideas. Not the least reason for this being that Keynes, fairly soon after its publication, sought to distance himself from it. It relied on mathematical identities more than *General Theory*, and neither Keynes nor Hawtrey believed that economic ideas could be expressed with the kind of precision implied by mathematical equations.

As noted in an earlier section (The 'Prelude'), Sir John Hicks believed that Keynes wrote his *Treatise* for the purpose of replying to the parts of Hawtrey's *Currency and Credit* with which he disagreed. More overtly, he wrote it in response to his dissatisfaction with Irving Fisher's identity ($PT=MV$): an identity which related the general price level (P) to the number of trade transactions in a given time (T), the quantity of money in circulation (M), and the number of times, on average, which the stock of money changed hands within that given

time (V). Keynes did not believe that there was anything 'wrong' with Fisher's equation; but he regarded it as sterile in that it described a situation, without being of use in describing the dynamics of moving between two different situations. Keynes derived his own equations.

The theoretical sections of the *Treatise* revolved around two derived *Fundamental Equations*. They were similar in form, and because of that similarity the *first* of the two equations will serve to show how Keynes's thinking was revealed in their structure. Keynes's First Fundamental Equation was:⁷⁷⁸

$$P = \frac{E}{O} + \frac{I' - S}{R}$$

The terms involved were the price level of consumption goods (P), the total money-income of the community (E), the total volume of output of all goods (O), the money-income from the production of investment goods (I'), the net change in the community's savings (S), and the volume of consumer goods purchased (R).⁷⁷⁹

The first term describing the price level, (E/O), was the cost per unit of production. But within the term E, Keynes included not only the costs such as wages, rent and so on – but the 'normal remuneration' or 'normal' profit of the

⁷⁷⁸ J.M.Keynes, *A Treatise on Money* (London, Macmillan, 1930), p.135.

⁷⁷⁹ Keynes spent no little effort in trying to precisely define these terms. The brief definitions above are adequate for illustrating the thinking that went into the construction of the equations.

entrepreneur. What was 'normal'? A 'normal' profit level was that which just satisfied the entrepreneur to the extent that it induced him to neither expand, nor cut down on, production. This was a key point. If expansion of trade was desired, then the entrepreneur *would* expand if there were the possibility of 'above normal' profits.

The *second* term of the equation related to whether profits were above or below 'normal'. Keynes showed (within his definitions, of course) that the *sign* of the term $(I' - S)$ determined the deviation of the entrepreneur's profits from 'normal' – if it were positive, then profits would exceed the 'normal' value and business producers of consumption goods would endeavour to expand production.

Thus, Keynes's conclusion to this section of the *Treatise* was that prices would rise, and businesses would look to expand if I' exceeded S – earnings from the production of investment goods needed to exceed savings – a conclusion which, naturally, led to his support for government investment as a means of expanding trade.

Keynes also produced a Second Fundamental Equation, of similar form to the first, which described the *general* price level, but he did not produce an equation describing the price of investment goods. Rather, he incorporated the price of investment goods (bonds, shares, property etc.) into his equations. He introduced the term 'bearishness' to describe the situation where individuals believed the values of investment goods were likely to fall. Under such

conditions saving would increase, thus reducing the value of the term $(I' - S)$ in the first fundamental equation, and lowering the price of consumer goods, the profit from the manufacture of consumer goods, and employment within the consumer goods industries.

In Chapter 13 of the *Treatise* Keynes worked out his own position on interest rates – dismissing Hawtrey's theory in the process. Generally, an increase in bank-rate promoted saving and discouraged investment, therefore reducing the term $(I' - S)$ in the First Fundamental Equation, and so creating a tendency towards falling prices. He felt that this explanation – altering the relative attraction of saving and investment - rather than Hawtrey's explanation in terms of the level of dealers' stocks, more accurately described the transfer mechanism between high interest rates and falling prices. Keynes went as far as citing Tooke's classical criticism of Hume, in 1839, when Hume had laid chief emphasis on the effect of plentiful cheap money in stimulating speculation in commodities such as cotton and corn. Tooke's retort to Hume being that:

[f]ew persons . . . ever speculate but on the confident expectation of an advance of price of at least 10 per cent. . . . the utmost difference between the rate of discount of 3 per cent. and 6 per cent for three months, would on a quarter of wheat

amount to only 4.5d. per quarter, a difference which I venture to say, never induced or deterred a single speculative purchase.⁷⁸⁰

Keynes was at pains to add that Tooke had also noted that rising interest rates are more often associated with rising, rather than falling, commodity prices and therefore most unlikely to act as a deterrent to speculation in the purchase of stocks. Rather than emphasising the, somewhat immediate, effect of Bank rate, and short-term interest rates in particular, on dealers' stocks, Keynes's emphasised long-term rates and their effects upon investment spending. He argued that entrepreneurs took a much longer view of the possible profits from an investment, and that the effect of changes in short-term rates was realised through their effects upon long-term interest rates, and it was at long-term rates that businesses borrowed for investment in plant and buildings.

Keynes took it as axiomatic that there was a degree of competition for loans between providers of long and short-term loans, and that an increase in short-term rates would have an upward influence on long-term rates. An increase in long-term rates would reduce the net profits from any current investment – or, in Keynes's terms, reduce the discounted future yield of investment goods. He completed his analysis by once more returning to the Fundamental Equations. Higher rates leading to falling investment would, under conditions of equilibrium, turn the term $(I' - S)$ negative and lead to falling prices.

⁷⁸⁰ J.M.Keynes, *A Treatise on Money* (London, Macmillan, 1930), pp. 195-6.

Hawtrey's criticisms of the *Treatise* were presented in consolidated form in a Treasury memorandum 'Mr. Keynes's *Treatise on Money*'.⁷⁸¹

Hawtrey began by scrutinising the definitions of the terms which Keynes used to build up his Fundamental Equations, paying particular attention to his somewhat idiosyncratic definitions of income and profit, and also Keynes's definition of 'investment'. Keynes, remember, defined the 'normal' profit of entrepreneurs as income and part of the costs of production. Any profit above this level was not regarded as extra income, nor was it regarded as an additional cost of production, but as capital enhancement. Similarly, any level of profit below that of 'normal' was not regarded as a diminution of aggregate income, nor as a reduction in the cost of production, but as a capital loss. Hawtrey suggested that any level of profit above, or below, that of 'normal' might be usefully referred to as a windfall gain or windfall loss (in his preface, almost certainly influenced by Hawtrey's arguments, Keynes does suggest that profits in excess of 'normal' might be thought of as 'windfalls'). The other definition which caused problems for Hawtrey was Keynes's definition of 'investment'. Within Hawtrey's model of the economy, investment over a period of time was quantified as the outlay of a defined sum of sum of money over that period. Keynes defined the rate of investment as 'the net increment during a period of

⁷⁸¹ T 208/153. Hawtrey revised this commentary for publication. It subsequently appeared, in revised form, as chapter 6 of R.G.Hawtrey, *The Art of Central Banking* (London, Longmans, 1932).

time of the capital of the community'.⁷⁸² Hawtrey believed that this definition made Keynes's Fundamental Equations sterile since 'investment', as the 'increment of the community's capital', could not be assessed until *after* any price change had taken place. Given Keynes's definitions, Hawtrey argued that his difference between saving and investment had nothing to do with the decisions taken by individuals and businessmen, but was simply another name for the divergence between prices and costs. In effect, Hawtrey pointed out, there was a tautology within Keynes's Fundamental Equations, since he took entrepreneurs profits to be dependent upon the difference between investment income and savings, whilst he defined entrepreneurs profits as a capital increment. He took Keynes's terms and related definitions to algebraically prove this point. Adding,

. . . he is mistaken in treating the discrepancy between investment and saving, when it does occur. As the cause [Hawtrey's underlining] of the divergence between prices and costs; it is [Hawtrey] the divergence between prices and costs. When saving differs from investment, this represents not a change in the behaviour of the public in regard to the accumulation of unspent sums, but a change in the classification of the sums they receive as between earnings and windfalls. The occurrence of a divergence between prices and costs brings about this change of classification not in virtue of any causal relation, but in virtue of a definition; the change is not causal but logical.

⁷⁸² J.M.Keynes, *Treatise*, p.126.

Hawtrey argued that if anything occurred to affect the demand for goods of any kind, the first result was an increase or decrease of sales at *existing* prices. There would always be some interval of time before prices adjusted, and thus there would be a disturbance of equilibrium which preceded any disturbance of prices, and which therefore precedes any windfall gain or loss and any difference between saving and investment as defined by Keynes.

Pages 17-20 of Hawtrey's memorandum are his attempt to clarify the relationship between savings and investment. They contain a remarkable numerical example which a number of economists have regarded as an insight which amounted to an independent discovery of the multiplier theory.⁷⁸³

If the assumption was made, at the outset, that no change in price level takes place, then Hawtrey's position (using Keynes's definitions) regarding the initial effect of an increase in investment was relatively straightforward:

. . . addition to investment . . . is an addition to output and therefore to consumers' income. A part . . . will presumably be spent on (extra) consumption; the remainder is . . . an addition to saving. The additional consumption must be fed from accumulated stocks . . . (with) consequent decrement of stocks . . . a negative item in the total of investment. When it is set off

⁷⁸³ The most notable article on this theme is N.Cain, 'Hawtrey and the multiplier theory', *Australian Econ. Hist. Rev.*, 22 (1982), 68-78.

against the addition made to investment, the net increment of capital (is) the additional saving.⁷⁸⁴

Using another (long) numerical example, Hawtrey pursued this; considering the consequences when the stocks of consumer goods were exhausted and additional production was called for.⁷⁸⁵ Additional production would call for extra investment – which implied an increase in the consumers' income. Hawtrey then assumed that a proportion of the extra consumers' income would be spent on consumption, with a proportion saved. The proportion spent on consumption would generate a further secondary increment to the consumers' income – with yet further additions to consumption and saving. Hawtrey calculated that the process would eventually result in a new equilibrium at a higher level of consumers' income and generate sufficient extra savings to cover the initial increase in investment.

It remains a mystery as to why Hawtrey, having used the concept of the multiplier, failed to recognise the novelty of the concept, or develop it further.

Hawtrey's extract undoubtedly incorporated the multiplier principle, albeit working on the concept of secondary consumption rather than on Khan's secondary employment (the discovery of the concept of the multiplier generally being attributed to Khan). It incorporated the idea of 'propensity to consume'. It also established two concepts central to Keynesian economics. First, that savings need not precede investment, and that extra investment need not be inflationary since an injection of extra investment will, in time, generate compensatory extra savings. Secondly, it demonstrated that an economy is capable of moving from one state of equilibrium to another with an increased level of consumption output and correspondingly increased employment by the

⁷⁸⁴ T 208/153.

⁷⁸⁵ *Ibid.*

injection of extra investment. Hawtrey revised and extended this memorandum for publication, in 1932, as chapter 6 of his book *The Art of Central Banking*. The chief omission from the revised version being the section that incorporated the use of the multiplier concept. There seems to be no indication as to why Hawtrey found it necessary to suppress this idea from his subsequent publications.

The sensitivity of dealers stocks to changes in short-term interest rates was a central part of Hawtrey's theory of the trade cycle and so it was natural that he should respond, and at length, to Keynes's scepticism on this point. In rejecting Keynes's belittlement of his theory, he used statistics of the Harvard Bureau of Business Research, which indicated the relatively high ratio of interest payments to net profit of the average trader. He also took particular exception to Keynes's use of Tooke's refutation of his theory.

. . . the passage quoted from Tooke applies to "persons who, upon imperfect information and on insufficient grounds, or with too sanguine a view of contingencies in their favour, speculate improvidently." . . . This quotation from Tooke is entirely beside the point. My argument relates not to speculators (especially not to ignorant and improvident speculators) but to regular dealers and merchants.⁷⁸⁶

After long discussion on Bank-rate, stock markets, short-term and long-term rates of interest, and the ways in which they impinged upon investment followed

⁷⁸⁶ *Ibid.*

(apparently, when Keynes handed the transcript of Hawtrey's memorandum to his colleague Richard Khan, Khan returned it saying that he had found the section the relation between the stock markets and investment 'hard to follow'),⁷⁸⁷ Hawtrey concluded that:

[i]t will be seen that my difference from Mr. Keynes as to the influence of bank rate on investment is not very wide. He does not dispute that there is some effect upon the holding of stocks of goods. I do not dispute that there is some effect upon the holding of securities, and through it upon the long-term rate of interest, the amount of new issues and the amount of capital outlay. I attach importance to the early response of the holders of stocks of goods. He says that the effect on capital outlay occurs with "an appreciable time lag".⁷⁸⁸

Keynes's gratitude to Hawtrey is well known – on 16 February 1931 he wrote to him saying 'you have taken amazing pains about my book', and that 'it is very seldom indeed that an author can expect to get as a criticism anything so tremendously useful to himself'. Keynes added that he was 'working it out all over again' – a re-working which, of course, eventually lead to the *General Theory*.

⁷⁸⁷ P.Deutscher, *R.G.Hawtrey and the Development of Macroeconomics* (London, Macmillan, 1990), p.102.

⁷⁸⁸ T175/56

On 14 March 1936 Hawtrey circulated a memorandum for the benefit of his Treasury colleagues in which he both outlined and criticised the arguments which Keynes had put forward in the *General Theory*.⁷⁸⁹

Ignoring what most people would have regarded as the central message of *General Theory*, that in the absence of adequate investment it was possible for an economy to be in equilibrium at less than full employment, Hawtrey regarded the fundamental thesis of *The General Theory* to be 'a revision of the classical theory of interest'. The classical theory assumed that capital outlay would only be applied to investments whose yield was not less than the rate of interest. If the rate of interest were to be raised, then fewer investments would meet this particular criterion and therefore there would be a lower capital outlay on investment goods. In such circumstances the supply of savings (the money which households refrained from spending on consumption goods) might temporarily exceed the demand for investment goods, leading to a reduction in interest rates in order to discourage saving and stimulate investment. It was, Hawtrey explained, this function of interest rates which Keynes questioned.

Keynes, he expounded, regarded the rate of interest as 'the reward of *forgoing liquidity*. By tying up their savings in investments people forwent the convenience of having ready money, and the extent to which they were willing to do so depended on the rate of interest. Thus if the supply of money were small, and people had small cash deposits, it would require a high rate of interest to

⁷⁸⁹ Treasury Paper T208/195 (Hawtrey Papers). 'Mr. Keynes's General Theory of Employment Interest and Money', 14 March 1936.

persuade them to forgo that little liquidity which they possessed. Thus the money supply inversely determined the rate of interest, and the rate of interest, so determined, governed the volume of capital investment. Hawtrey then outlined the logical steps by which Keynes showed that, where there was a tendency for saving to differ from investment, the total of incomes was always adjusted in such a way as to bring them back to equality. The adjustment of the national income in order to restore the equality between saving and investment could leave it at such a level that the volume of output was incapable of employing the whole of the workforce, with resulting unemployment. At this point Hawtrey argued that there was no justification for Keynes's proposition that investment and saving needed to be equalised since equality arose out of the definitions which Keynes had opted for:

[a]n essential step in [his] train of reasoning is the proposition that investment and saving are necessarily equal. That proposition Mr. Keynes never really establishes; he evades the necessity of doing so by defining investment and saving as different names for the same thing. He so defines income to be the same thing as output, and therefore, if investment is the excess of output over consumption, and saving is the excess of income over consumption, the two are identical. Identity so established cannot prove anything. The idea that a tendency for investment and saving to become different has to be counteracted by an expansion or contraction of the total of

incomes is an absurdity; such a tendency cannot strain the economic system, it can only strain Mr. Keynes's vocabulary.⁷⁹⁰

Hawtrey's criticism of Keynes's focussed on his definition of 'investment' as the 'excess of output over consumption'.⁷⁹¹ Hawtrey argued that the excess of output over consumption amounted to 'unconsumed wealth', and the holding of this 'unconsumed wealth' did not necessarily constitute an 'active' investment decision. Hawtrey is, quite clearly, alluding to his concerns over the situation of dealers' unsold stocks, which come under Keynes's definition of 'investment' but which do not count as capital assets with a prospective yield. Hawtrey deemed that such accumulation of stocks should be deemed 'undesigned' or 'passive' investment.⁷⁹² Thus, Hawtrey argued, whilst under Keynes's definitions of 'savings' and 'investment' the two terms might necessarily be equal, 'active' investment, the acquisition of capital goods for the purpose of future yield, need not be equal to savings. According to Hawtrey, it was necessary that 'active' investment be sufficient to maintain the difference between incomes and consumption, and, if this were not sufficient to bridge the gap, the result would

⁷⁹⁰ *Ibid.*, pp. 3-4.

⁷⁹¹ On p.63 of *The General Theory* Keynes wrote as follows – 'Provided it is agreed that income is equal to the value of current output, that current investment is equal to the value of that part of current output which is not consumed, and that saving is equal to the excess of income over consumption – all of which is conformable both to common sense and to the traditional usage of the great majority of economists – the equality of saving and investment necessarily follows'.

⁷⁹² Treasury Paper T208/195 (Hawtrey Papers). 'Mr. Keynes's General Theory of Employment Interest and Money', 14 March 1936. P.4.

be an accumulation of unsold goods which, whilst adding to investment under Keynes's definition, would ultimately lead to a growth in unemployment.

As for measures to reduce unemployment, Hawtrey believed that Keynes was too easily convinced that unemployment could not be solved by monetary expansion. Keynes had argued that an increase in the quantity of money might lead the public choosing to hold larger sums of money, and the need to overcome their liquidity preference would cause interest rates to rise. This would inhibit investment. Hawtrey, however, thought that such cautions were not very relevant.

. . . all that is required is a continuous growth in the quantity of money just sufficient to satisfy the liquidity preferences corresponding to the desired rate of interest. That should do no more than maintain stable prices, and no sudden or spectacular monetary expansion need be involved. If in any period of time there has on the whole been no deflationary tendency, then we can conclude that enough money has been created to satisfy the liquidity preference.⁷⁹³

After critically considering a number of Keynes's measures for reducing unemployment – reducing wages, embargoes on foreign investment, increases in direct taxation, 'communal saving' in which the state acted as an agent of capital

⁷⁹³ *Ibid.*, P.7.

acquisition – Hawtrey turned back to a consideration of the Keynesian concept of 'liquidity preference'.

. . . the magnitude of the pool of idle savings is a vital matter. For example, for all we know, the existing level of direct taxation may be enough or more than enough, with existing rates of interest, to reduce the pool to zero. . . . Mr. Keynes . . . does not throw much light on its possible magnitude.⁷⁹⁴

Hawtrey queried Keynes's view that low interest rates might encourage people, fearing increased interest rates might involve them in a capital loss, holding on to cash. He thought most investors would be more anxious to avoid loss of income than a reduction of capital value, and found it difficult to see how any investor who was not 'dominated by the primitive instincts of the miser should be driven to hold his money idle for any considerable length of time'.⁷⁹⁵

Hawtrey did not entirely dismiss Keynesian liquidity preference – 'the state of mind of the intending investor who holds back his money because the price of securities is too high is . . . possible',⁷⁹⁶ and 'there may actually be a minimum rate of interest below which no active investment would in practice be

⁷⁹⁴ *Ibid.*, p.13.

⁷⁹⁵ *Ibid.*

⁷⁹⁶ *Ibid.*

undertaken'.⁷⁹⁷ But he suggested that since liquidity preference was playing such a prominent role in Keynes's theory, then Keynes might be postulating that the current rate of interest was very near to that minimum value. Hawtrey pointed out that whilst that might be so, the 'rate of interest, low as it [wa]s, [wa]s still higher than it was forty years ago, and no lower than it was in 1750'.⁷⁹⁸

Hawtrey thought that people were guided by their experience on the level of liquidity which they chose; 'they expected the future to resemble the past',⁷⁹⁹ If a rate of interest which appeared low persisted, then people would become accustomed to it, accept it, and the pool of idle savings would gradually disappear. The period of liquidity preference would be a transitory phenomenon leading to a 'slight lag in the adjustment of active investment to savings'.⁸⁰⁰ In picking away at Keynes's concepts in this way, it is hardly surprising that Skidelsky should describe Keynes as a 'saint' for continuing to maintain a patient dialogue with Hawtrey.⁸⁰¹

It was inevitable that Hawtrey should use this memorandum to return to a major theoretical difference between Keynes and himself, the relative

⁷⁹⁷ *Ibid.*

⁷⁹⁸ *Ibid.*, p.16.

⁷⁹⁹ *Ibid.*, p.17.

⁸⁰⁰ *Ibid.*, p.18.

⁸⁰¹ Skidelsky, *John Maynard Keynes: the Economist as Saviour*, p.586.

effectiveness of short and long-term interest rates. Hawtrey recalled that, in his *Treatise on Money*, Keynes had expressed the view that 'investment in working capital and stocks of goods is not sensitive to changes in the short-term rate of interest'.⁸⁰² If that were so, Hawtrey deduced, the regulation of credit by the banks could only work through the effect of the short-term rate of interest on the long-term rate. However, he remained unconvinced by Keynes's claim for the importance of the long-term rate.

If credit regulation can take effect through short-term investment, if, that is, traders' purchases of goods can be accelerated by credit relaxation or retarded by credit restrictions, then an expansion or contraction of demand can be brought about by these means far more quickly than by the expansion or contraction of long-term investment. . . . And an expansion or contraction of a demand for goods in general has a much more potent effect on long-term investment itself than the rate of interest.⁸⁰³

Their views seemed irreconcilable. Whereas Keynes saw very low interest rates during a depression as leading to liquidity preference and the worsening of the depression, Hawtrey saw them as a means of enticing traders to expand their inventories, stimulating the demand for finished goods from the factories, who in

⁸⁰² *Ibid.*, p.19.

⁸⁰³ *Ibid.*

turn would be encouraged to increase their levels of investment. Hawtrey seems to have ignored the level of demand from the public for the traders' stocks – a problem which the greater part of Keynes's book was directed towards addressing. Pages 20-24 of the memorandum continued to criticise Keynes's concept of liquidity preference as a determinant of the level of interest rates.

Hawtrey forwarded a copy of his memorandum to Keynes on 14 March 1936. Keynes was, unsurprisingly, disappointed with the Treasury paper; feeling that Hawtrey had focussed narrowly on the difference between their two theories of interest whilst ignoring the greater part of the book devoted to showing how equilibrium could be established at less than full employment, and to which Keynes attached the greatest value.⁸⁰⁴ To Keynes, the effect of *General Theory* on Hawtrey had been like 'water off a duck's back' and he was driven to suggest, at one point, that they should discontinue all correspondence on the matter.⁸⁰⁵ But the correspondences continued.

The 1976 Nobel Prize winner, Milton Friedman, has claimed that his monetary economics stemmed from a 'Chicago Tradition'. Friedman's theory offered a monetary explanation of the Great Depression which was applicable to the general trade cycle. It also provided for a monetary means of controlling the economy by strict rules and allowing no part to government discretion. Friedman's work influenced the economic policies of Margaret Thatcher in Britain

⁸⁰⁴ G.C.Peden, *Keynes and his Critics; Treasury Responses to the Keynesian Revolution 1925-1946* (Oxford, O.U.P., 2004), p.154.

⁸⁰⁵ Skidelsky, *John Maynard Keynes: The Economist as Saviour*, pp. 586-7.

and Ronald Reagan in the United States. David Laidler of the University of Western Ontario, but formerly Professor of Economics at the University of Manchester, has argued convincingly that there is a direct line of influence running backwards from the 'Chicago School' to Harvard, and the period of Hawtrey's temporary tenure as Professor of Economics there.⁸⁰⁶

Previous studies of the origins of the 'Chicago Tradition' had subscribed to the view that it was largely influenced by the work of the Yale professor, Irving Fisher. However, Laidler notes that most of the characteristics of Chicago monetary economics can be found in the work of two Harvard economists, Allyn Young and Lauchlin Currie. Moreover the same characteristics could be 'found in the writings of the British economist Ralph Hawtrey, who . . . provided a far richer description of the phenomenon . . . than Irving Fisher ever produced'.⁸⁰⁷ Young was instrumental in arranging Hawtrey's secondment to Harvard in 1928-29, and Currie sat in on Hawtrey's graduate lectures.

During the period 1922-28 Young acted as consultant to the New York Bank during which period he produced his *Analysis of Bank Statistics for the United States* (1928); a work in which he analysed sources of instability in the American banking system and in which he added that 'I know of no better analysis of the essential instability of bank credit than is to be found in R. G. Hawtrey's work,

⁸⁰⁶ D. Laidler, 'Hawtrey, Harvard and the Origins of the Chicago Tradition', *Journal of Political Economy*, 1993, vol. 101, no.6. pp. 1068-1101.

⁸⁰⁷ *Ibid.*, p.1069.

Currency and Credit'.⁸⁰⁸ Currie built on the work of Hawtrey and Young, and his work led to his book *The Supply and Control of Money in the United States* (1934); a book in which he cited Hawtrey as a monetary authority.

In considering the extent to which the Chicago tradition was a simultaneous and independent development from Harvard, Laidler considers the question of 'rules versus discretion'. Friedman and the Chicago school placed great emphasis upon a commitment to the governing of monetary policy by strict rules rather than discretion. Conversely, such rigidity is rejected in the writings of Hawtrey, Young and Currie. Hawtrey, in particular, described central banking as an 'art' in which there was considerable scope for discretion.

Nevertheless, Laidler gives sufficient instances of links between Chicago and Lauchlin Currie to justify his assertion of a link. He gives particular prominence to the Harris Foundation Conference on Gold and Monetary Stabilisation, held at the University of Chicago in 1932, from which came a manifesto sent to Herbert Hoover, recommending that 'the Federal Reserve banks systematically pursue open-market operations with the double aim of facilitating necessary government financing and increasing the liquidity of the banking structure'.⁸⁰⁹ In his *Art of Central Banking* (1932) the major distinguishing feature of Hawtrey's policy recommendations had been its emphasis on the controlling power of open-

⁸⁰⁸ *Ibid.*, p.1081.

⁸⁰⁹ *Ibid.*

market operations by central banks. Laidler concluded that the circumstantial evidence of Hawtrey's influence was compelling.⁸¹⁰

An essential building block in Keynes's transition from his *Treatise on Money* to his *General Theory* was the discovery of the mechanism of the 'multiplier' – a discovery generally attributed to Richard Khan. In the multiplier mechanism an initial injection of investment into the economy generates further secondary, tertiary and higher level injections in such a way that the total boost to economic production exceeds that of the initial injection. Khan was not the first economist to consider a multiplier effect. In 1922 Frederick Lavington had described a mechanism of cyclical fluctuations that made use of multiplier effects to explain enhanced magnitudes of departures from normality.⁸¹¹ But Hawtrey had also worked out a theory of the multiplier in his criticisms of Keynes's *Treatise*. In the paper which Hawtrey prepared for the Macmillan Committee after his appearance

⁸¹⁰ *Ibid.*, p. 1099.

The steps by which Keynes made the transition from the *Treatise* to the *General Theory* are examined in Clarke (1988), Moggridge (1992; 1993) [D.E.Moggridge, *Maynard Keynes; An Economists Biography* (London, Routledge, 1992); *Keynes* (London, Macmillan, 1993)] and Patinkin (1976a) [D.Patinkin, *Keynes' Monetary Thought: A Study of its Development* (Durham N.C., Duke University Press, 1976)]. Richard Khan, generally accredited with discovering the 'multiplier' principle, was a member of the Cambridge 'circus' of younger academics who held regular meetings back in Cambridge to discuss the developments of Keynes's ideas (with Khan as its secretary) and reported the findings of their discussions back to Keynes. The intense atmosphere in Cambridge at this time has been recorded by Marcuzzo and Rosselli [M.C.Marcuzzo and A.Rosselli, *Economists in Cambridge: a study through their correspondence, 1907-1946* (London, Routledge, 2005)].

⁸¹¹ F. Lavington, *The English Capital Market* (London, Methuen, 1921).

there, there were a number of numerical examples.⁸¹² One was on the role of investment. His example assumed investment to increase by £5 million per month, with the extra investment working its way through into consumers' incomes. On the assumption that £2 million of this would be saved, a further £3 million would be spent, and so feed through into extra consumers' incomes. Hawtrey went on to argue that the limit would be reached 'when income had been increased by £12.5 million per month and consumption by £7.5 million a month; leaving £5 million saved to balance the £5 million of additional investment'.⁸¹³

This remarkable section not only outlines the mechanism of the multiplier but anticipates Keynes's thesis that investment generates its own savings. It was of limited importance to Hawtrey because, to him, the extra investment would be forthcoming, anyway, through the extension of credit, whereas Keynes was to use the multiplier as part of his argument for the extension of public investment. Clarke has claimed that after so successfully outlining the multiplier principle Hawtrey suppressed it in his further work.⁸¹⁴ Dimand has pointed out that far from suppressing the idea, Hawtrey went on to restate the principle in an

⁸¹² Committee on Finance and Industry, Minutes of Evidence (H.M.S.O., 1931).

⁸¹³ *Ibid.*

⁸¹⁴ P. Clarke, *The Keynesian Revolution in the Making, 1924-1936* (Oxford, Clarendon, 1988). p. 243.

'elegant algebraic form' in his *Art of Central Banking*.⁸¹⁵ There seems to be no evidence that Khan had been aware of Hawtrey's work.

⁸¹⁵ R.W.Dimand, 'Mr. Meade's Relation, Khan's Multiplier and the Chronology of the General Theory', *The Economic Journal*, Vol. 104, No. 426 (Sept. 1994), pp.1139-1142.

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