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BOOK THREE

Experimentation, 1925-1931

PART I

The Nature of the Experiment

CHAPTER 13

The Unity of the Period, 1925–1931

From April 1925 to September 1931 Great Britain adhered to the international gold standard. These years are therefore a clearly defined and unique epoch in gold standard history. Yet the process of Restoration continued after this period began, and the process of Disintegration began before it ended. The year 1925 marks neither the substantial completion of the return to gold throughout the world nor the ending of the prosperity phase of the international business cycle which facilitated that return. It does not coincide with the maturity of the forces that gave France her peculiar and, at times, even dominant importance in international finance, or with the French return to gold, or with the legislation that gave final form to the British gold bullion standard. In these respects 1928 has a better claim to be considered the last year of Restoration, and since it was almost immediately followed by the first defections from the newly restored gold standard system, it is more truly an historical turning point than 1925. In 1925, moreover, there was no sharp or decisive reversal of underlying economic trends. The influence of the war and the peace settlements in accentuating some and retarding other secular trends in world production and trade had by no means fully worked itself out. The world economy was in a sort of rough equilibrium only because it was still incomplete. Countries dependent upon agricultural products and industrial raw materials still enjoyed a temporary respite in their search for markets because of the absence of certain competitors from world trade. Russia as an exporter of wheat, petroleum, and other natural products was still absent from the

world's commerce in large degree. Central European output of sugar, wheat, and other agricultural products was still low. Because of financial and exchange difficulties and lack of capital, Germany was temporarily eliminated as a major competitor in the export of manufactured goods. The competitive power of Japan had not nearly reached its full maturity. In general, in 1925 agricultural countries had not adjusted their economies to the return to production of the areas most seriously affected by war and revolution, and manufacturing countries had not adapted themselves to the full force of inevitable new competition.

If, therefore, the first phase of post-war economic history continued well into the 1925–31 period, and if both the end of the Restoration process and the beginning of the process of Disintegration came almost exactly in the middle of it, some further justification for treating it as a unified whole is needed. This is found in its two all-pervasive characteristics: experimentation and illusion.

The Element of Illusion in the Return to Gold

The announcement of Great Britain's return to the gold standard in April 1925 was the signal for the return to gold of Australia, New Zealand, South Africa, Danzig, Hungary, and the Netherlands. The number of countries related to gold in one way or another and enjoying stable exchange rates was raised to over thirty.[1] Most people then rejoiced that the world had returned to the solid basis of gold. They ceased to measure appreciation or depreciation of their currencies in terms of the American dollar. America ceased to drag her golden anchor. The currencies of many countries were joined to one another in a stable relationship. Gold was the *cement* that bound them together. But people did not commonly think of it in that way. Each country thought of itself as attached to gold rather than as attached to other countries through gold. This was a deep, instinctive feeling not incon-

[1] League of Nations, *Memorandum on Currency and Central Banks, 1913–1924*, I, 47.

sistent with very refined analyses of gold standard problems when the international gold standard actually exists over a wide area. It was confidently expected that the most disturbing financial influences of the post-war period would be eliminated by a redistribution of gold, by a definite end of flights and repatriations of capital, and by a permanent solution of the reparation and war debts problem. A stable economic equilibrium was expected to follow from the assertion of the underlying forces assumed in gold standard theory which would bring about an adjustment of international price levels and of the financial and commodity elements in the balances of payments of both debtor and creditor countries. It was expected that unusual modifications in central bank and treasury practice in the leading money markets would continue only as temporary expedients to provide time for the healing adjustments commonly associated with the gold standard.

Expectations of this character may be read in the Cunliffe and Vissering-Kemmerer reports, the Report of the Committee on the Currency and Bank of England Note Issues, the John Parke Young Report (Commission of Gold and Silver Inquiry, United States Senate), and in countless other sources in which the operation of the corrective forces of the international gold standard is described. They were not fulfilled. Up to the eve of the world crisis corrective forces produced no genuine economic balance for reasons ably and concisely stated in the League of Nations *World Economic Survey, 1931/2* (pp. 170–1):

"The balancing of international accounts, it must be repeated, is a continuous process into which enter, not only imports and exports visible and invisible, and capital movements both for long- and for short-term investment, but also interest rates and price changes. In the flexible pre-war organization, all these elements were kept in equilibrium by the manner in which the gold standard was operated. If anything more than temporary disequilibrium developed in the financial relations of any one country with the rest of the world, an outflow of gold brought about a restriction of credit, and therefore rising interest rates, which

attracted capital or checked its exportation, and falling prices which encouraged exports and checked imports till equilibrium was restored again. Such a corrective sequence of events was, however, dependent both upon a certain flexibility in the national price-structures and upon a smooth and efficient working of the standard. In the post-war world, neither of these conditions has been present, while, on the other hand, the balance of international obligations . . . demanded radical changes either in the balances of commodity trade, in relative price-levels and standards of living, or in both. There was reluctance to face the necessary changes either in the balance of trade or in the price-levels, but, on the other hand, there was rigid insistence on the financial obligations which made such changes necessary. For some years, the dilemma was evaded by a credit expansion which made possible international lending on a scale sufficient to balance the accounts for a time, but the piling up of these new obligations constantly aggravated the lack of real balance and, when the credit expansion came to an end in 1929, the 'gap in the balance of payments' yawned wider than ever."

The authors of these studies, however, have not found in any analysis based solely upon the failure of traditional corrective forces to operate successfully after 1925 a completely adequate explanation of why the gold standard proved at that time to be only a fair weather friend. We are convinced that this question can best be answered by placing the events of these years in their true perspective in the history of the standard. Our exposition of the 1925–31 period does not neglect the immensely important factors stressed in the passage just quoted: the increasing rigidity of prices, the grave maladjustments in balances of payments, the unprecedented growth of international debts, and the pressure for their repayment. In harmony, however, with the whole plan of these studies as set forth in the Introduction, it stresses also the replacement of an international gold standard system dominated by a single center by one dominated by a group of center countries. It emphasizes the relations of the center countries to one another, and the relations of the central group as a whole to other countries. It relates the operation of the international

gold standard system under these conditions to the course of the international business cycle. Finally, it endeavors never to lose sight of one new factor of paramount importance: the psychological hazard introduced into the operation of the gold standard in all its phases by the penetration into the consciousness of masses of people of the idea that money as such can lose its value.

The international gold standard system from 1925 to 1931 had to solve more difficult fundamental economic problems than the pre-war system. It had to do so with far less effective institutional equipment and was subject to immense new psychological dangers. The very strength that confidence in gold, based upon very ancient and deeply rooted instincts, brings to an effective international banking and credit system when that system rests upon a solid economic basis and is in the hands of competent management, becomes under other circumstances a threat and a weakness. The fact that the world returned to the gold standard without being fully aware of the strength of the cyclical forces at work, of the depth of the economic maladjustments, and of the meaning of the loss of centralized control and the new imperfections of international clearing, gave to the confidence that return inspired an element of tragic illusion. Under such conditions the international gold standard was a facade that masked the true nature of economic problems. It promised escape from radical economic readjustments by making hard and intractable problems appear transitory and transitional. It was a false sign-post that made dangerous ways seem safe.

Experimentation, the Parts and the Whole

In returning to or maintaining the gold standard from 1925 to 1931 every country faced peculiar problems which made the period one of experimentation in the management of its own currency. These special problems and the solutions reached have been abundantly and ably treated in the monographic literature of the period. It was easy both for the administrators of practical affairs and for writers about them to

regard these experiments in the light of more or less successful efforts to adjust the conditions in their own country or in a group of countries, of which theirs was a unit, to the gold standard in general. This gold standard they often conceived of as operating according to certain general principles developed during the period of British domination by British theory. Such a point of view ran the danger of underemphasizing the fact that an experiment was in progress greater than the sum of the experiments taking place within individual countries. The discussion of individual currency problems does not disclose the loss of stability and of economy in the use of gold which was a technical consequence of the transfer of international banking functions from London to New York. It cannot bring out the full implications of such a transfer for the success of the gold exchange standard or the full meaning for periphery countries of division at the center. Yet the experiment as a whole was defined by the relations of its parts, and therefore the parts must be separately considered in sufficient detail to make their nature clear. They are, however, never considered in isolation. The experiment of creating an international money market in New York, the experiment of defending sterling, and the experiment of operating a gold exchange standard without a focal point were all interrelated. When their effects are combined and considered in their general economic setting they lose their separate identity in one all-embracing experiment, that of attempting to operate an international gold standard with a decentralized financial system in an unbalanced world economy.[2]

[2] Ch. 18, 19, and 20 constitute the core of our analysis of the Experimentation period; Ch. 14, 15, and 16 place it in its contemporary setting; Ch. 21 places it in its historical setting. Ch. 17 develops certain aspects of clearing under a decentralized system in support of the general argument. Readers who are not interested in a survey of currency stabilizations outside the major powers may omit Ch. 14. Those who have no taste for an accounting analysis may omit Ch. 17.