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PART IV

The Conflict between Traditional Thinking and Economic Fact

CHAPTER 8

The Idea of Normal at the End of the War

It has been the object of our analysis of the events of the war years to show the complicated interaction of forces that preserved in part the forms of the gold standard and at the same time produced great changes in its economic environment and its institutional equipment. In the light of this analysis it is impossible to say that the gold standard was abandoned during the war. It is equally impossible to say that any country maintained it in its full integrity. The simple vocabulary used in speaking of countries leaving the gold standard and returning to it, or simply staying on it, is inadequate. The institution itself was changing.

The True Breakdown on the Pre-War International Gold Standard System Obscured by Certain Concepts of Normal

Many new problems relating to gold arose after the war, but unfortunately their discussion was subject to one common and almost all-pervading error—the tacit assumption that the gold standard after the war was the same thing as the gold standard before the war. In fact, the gold standard of tradition had passed its highest point of development even before the war, and during the conflict its very nature was profoundly and permanently altered. This alteration was obscured by the persistence throughout the war of certain concepts of normal—normal exchange rates, normal reserve ratios, normal techniques—and by an abstract conception of gold as an international monetary standard.

The Embodiment of these Concepts of Normal in the Cunliffe Report

Long before the conclusion of actual hostilities, the probable emergence of a serious post-war currency problem was felt to be a matter of grave concern by the British government. Therefore, in January 1918 the Lords Commissioners of His Majesty's Treasury and the Minister of Reconstruction appointed a committee "to consider the various problems which will arise in connection with currency and the foreign exchanges during the period of reconstruction, and report on the steps required to bring about normal conditions in due course." The famous First Interim Report of the Cunliffe Committee, which issued from these deliberations, was published in August 1918, three months before the Armistice. It proceeded upon the assumption that the gold standard existed in Great Britain, that it was, however, maintained only because it was protected by certain peculiar war-time conditions, and that the conditions for its effective operation after these war-time protections had been removed had ceased to exist. As a means of preventing a departure from the gold standard after the war, the Report recommended an immediate return to the use of the traditional methods of gold standard adjustment.

Three aspects of the Report are of particular interest for our analysis. In the first place, the Report did not regard the state of the exchanges as proof that the gold standard had broken down in Great Britain. It said:

"It will be observed that the fall in a number of the foreign exchanges below the old export specie points which has taken place since the early part of 1915 is not by itself a proof that the gold standard has broken down or ceased to be effective. During the present war the depredations of enemy submarines, high freights, and the refusal of the Government to extend State insurance to gold cargoes have greatly increased the cost of sending gold abroad. The actual export specie point has, therefore, moved a long way from its old position. In view of our enormous demands for imports, coupled with the check on our exports due to the war, it was natural that our exchanges with neutrals should move toward the export specie point. Consequently, the fall in the export specie point would by itself account for a large fall in our exchange rates. Such a fall must have taken place in the circumstances, even though all the conditions of an effective gold standard had been fully maintained."

In the second place, the Report stated that it was, nevertheless, 'practically certain' that sterling had depreciated somewhat in terms of gold, but how much was impossible to tell because the criteria of depreciation were absent during the war. On these two points the Report said:

"The essence of such a [gold] standard is that notes must always stand at absolute parity with gold coins of equivalent face value, and that both notes and gold coins stand at absolute parity with gold bullion. [Under war-time conditions, however] the public are content to employ Currency Notes for internal purposes, and, notwithstanding adverse exchanges, war conditions interpose effective practical obstacles against the export of gold. Moreover, the legal prohibition of the melting of gold coin, and the fact that the importation of gold bullion is reserved to the Bank of England, and that dealings in it are limited have severed the link which formerly existed between the values of coin and of uncoined gold. It is not possible to judge to what extent legal tender currency may in fact be depreciated in terms of bullion. But it is practically certain that there has been some depreciation, and to this extent therefore the gold standard has ceased to be effective."

In the third place, the Report stated that the danger to be apprehended from a removal of the artificial protections to the exchange and to the gold reserve then existing, while the essential conditions for maintaining an effective gold standard were not in existence, was a foreign drain of gold that would take England off the gold standard, and as a consequence, jeopardize the international trade position of the country. In summing up its recommendations, the Report deals with this conclusion as follows (our italics):

"In 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. Unless the machinery which long experience has shown to be the only effective remedy for an adverse balance of trade and an undue growth of credit is once more brought into play, there will be grave danger of a progressive credit expansion which will result in a foreign drain of gold menacing convertibility of our note issue *and so* jeopardizing the international trade position of the country."

The Committee recommended two methods for meeting these dangers:
1) the cessation of government borrowings immediately after the war and the repayment of government securities held by the banks through the establishment of an adequate sinking fund
2) the resumption of the long tested policy of credit control through the use of Bank of England discount rate policy.

In addition, the Committee recommended the end of the policy of attracting foreign balances by differential interest rate inducements, and held out the hope that the maintenance of the gold standard could be accomplished by means of a deflation in England which would be made less onerous in proportion as other countries continued to inflate.

The Idea of Normal in its Relation to Post-War Problems of Stabilization and Stability

Normal Techniques and the Changing Nature of Inter-Market Cooperation

An outstanding feature of the Cunliffe Report is its unshakeable confidence in the traditional British methods of controlling credit and supporting the exchanges. It is a trumpet call for a return to normal techniques. Yet it was the teaching of the war years that techniques must change as conditions change. The great increase in the public debt, permanent changes in the methods of financing trade, the loss of Great Britain's position of unquestioned predominance in international trade, and the rise of New York as a great international money market brought about changes in the technique of credit control in London. Furthermore, the maintenance of stable credit conditions in Great Britain was no longer the single dominant factor in maintaining stable international credit conditions. Stability in the United States was of equal importance, and the techniques of credit control had hardly begun to be worked out there. The decentralization of financial power characteristic of the war years altered the money market problems and increased the number of unstabilizing influences and dangers. It not only modified the techniques of domestic credit control in both countries but also gave rise to a new emphasis upon inter-money market cooperation. The discount policies of the Federal Reserve Bank of New York and of the Bank of England were very closely related during the war. Intimate cooperation between the two banks began with the establishment of a working account of the Bank of England with the Federal Reserve banks in 1917 and was of great importance in the conduct of the war. It established a cooperative relationship with America which British finance had long desired. Nevertheless, the conflict over the use of the proceeds of the American government's advances and the fundamentally competitive nature of the growth of the American banking system abroad and of the American discount market are equally plain. The nature of inter-money market cooperation, like the economic environment and the institutional equipment of the great financial markets, changed during the war. Before the war it was primarily unconscious cooperation obtained by conformity to the terms of the international gold standard convention. During the war it was cooperation through conscious arrangement from sheer necessity. After the war it was a combination of the two. In our view the cooperation of money markets has never been a matter of mere expediency; never a matter of free and independent choice on the part of the markets concerned. Like other forms of social cooperation, it has always been a way of finding solutions to conflicts. In the functioning of a great social institution like the international gold standard such conflicts frequently arose before the war, but they were never so acute or difficult. The increase in conscious money market cooperation after the war was in a deep sense a function of increased money market competition. The conflicts to be resolved were complex, involving the whole problem of stabilization and the whole problem of stability.

Normal Exchange Rates

These problems were, of course, intimately related to the question of what were appropriate rates of exchange under the new conditions. Yet the Cunliffe Report did not even refer to the appropriateness for the post-war period of the pre-war system of exchange rates. It was published at a time when the exchanges of the allied and neutral world were approaching closer to the central nucleus in anticipation of the return to normal which, it was assumed, would take place after the close of hostilities. That normal was a set of ratios fixed by the currency legislation of pre-war days. It had behind it the powerful sanction of law and tradition. But the closer it was approximated the less did it represent the true relationship of the various currencies at the close of the war. In spite of the very notable effects of exchange pegging in distributing war-time inflation internationally, the price levels of the various countries had diverged in a manner not truly reflected in the course of the exchanges. If we consider only Great Britain, the United States, France, and Germany, the situation is anomalous. In November 1918 the French franc was practically at pre-war parity with the pound and both were at a discount of about 2 per cent from pre-war parity with the dollar, but French prices had risen much more than American or British prices. The German mark, on the other hand, had sunk to 7 per cent of its pre-war dollar parity though the German price index was practically the same as that of Great Britain.[1]

[1] The index numbers of wholesale prices in November 1918 (1913 = 100) were: United States, Bureau of Labor Statistics, 203; Great Britain, *The Statist*, 229; Germany, Reichsamt, 234; France, *Statistique générale*, 358.

The relation of exchange rates to price levels at the time of the Armistice was, however, by no means a full measure of the instability and inappropriateness of 'normal' exchange rates. Over the exchange rates of the world hung a mass of short term foreign indebtedness that would have to be liquidated. Balances temporarily maintained abroad in anticipation of the conclusion of hostilities were bound to come upon the market and depress the rates of certain countries. There was an unsatisfied demand, especially in the Central Powers, for the purchase of goods of which they had been deprived for years by the blockade. There was an internal adjustment to be worked out in the price levels of the belligerent countries through the gradual lifting of government control over the necessities of life. There was great uncertainty with respect to the future. The terms of the peace were unpredictable, but they were certain to involve large movements of capital from country to country. The effort to maintain the exchanges and to keep the flag of gold flying in the form of undiminished gold reserves had been accomplishd by sacrifices that could not be made in peace-time. The greatest pressure for monetary inflation on all the belligerent countries directly attributable to the war was still to come when these sacrifices could no longer be imposed and the pent-up demands were released.

Normal Reserve Ratios

The maintenance in legal theory of the concept that the monetary units of gold standard countries continued to bear an unchanged relation to the metal gold introduced a fictitious element into the accounts of central banks as soon as the actual system of exchange rates began to deviate from that embodied in the pre-war system of mint pars. This method of accounting had the somewhat ironical effect of causing a serious understatement of the size of the gold reserves of many countries. The size of this understatement fluctuated widely throughout the war and post-war years.[2] It

[2] It may be followed for 1918–23 in the tables published by the League of

did not, however, come to public notice until it was formally recognized in connection with various currency stabilizations. During the war it was hardly noticed because of the dominant conviction that after the war there would be a return to normal.

As soon, however, as the nucleus of exchange rates about the pre-war system of mint pars was definitely broken up in 1919, it was evident that the use of gold to maintain and build up gold reserves without any change in the accounting treatment accorded them had created a series of domestic gold standards. Two systems of exchange rates existed side by side—one actual and practical, one theoretical, legal, and abstract. To treat gold in law and in accounting with total disregard of the former and in strict conformity with the latter was to fail to consider the actual significance of gold as an international standard. It is, therefore, something of a paradox that this practice contributed powerfully to maintain the conviction in the minds of most people that an objective standard of value existed outside the currency systems of the world in terms of which the appreciation or depreciation of currencies could be judged.

An Abstract Concept of Gold as an International Monetary Standard

It was laid down in the Cunliffe Report that the essence of the gold standard is that notes must always stand at absolute parity with gold coins of equivalent face value, and that both notes and gold coins must always stand at absolute parity with gold bullion. It was further laid down that sterling had probably suffered some depreciation in gold. No question, however, was raised as to the meaning of the term 'depreciation,' which was taken to be self-evident. No account was taken of the fact that depreciation in gold means one thing

Nations, *Memorandum on Central Banks, 1913 and 1918–23* (Geneva, 1924), Table H, pp. 32–41.

when many countries are bound together in an international gold standard system, and quite another thing when the major currencies of the world are fluctuating in terms of one another. Unless a large group of foreign exchanges is maintained in a stable relationship it is always necessary to choose one, or a group moving together in the total system, to serve as a basis of comparison. During the war the preservation of the sterling-dollar-franc nucleus provided a standard in terms of which appreciation could be judged. But even these rates had moved away from the pre-war system of mint pars. Only if a given exchange fluctuated, as the Swiss franc did on several occasions during the war, in terms of all the other exchanges, could it be said without further qualification that it was appreciated or depreciated. Under the existing circumstances it was impossible to speak of the depreciation of any given exchange *in terms of gold* without either using that term in a very abstract sense or making it synonymous with depreciation in one or a small group of currencies.

A mass of traditional and deeply rooted feelings and emotions concerning gold, and habits of thought long held, made it impossible for the stabilization problem to be conceived in terms of replacing an international convention that had become obsolete. One method of reestablishing gold as a true international standard was therefore ruled out—that of changing simultaneously the definition of the various standard gold coins in the different countries to conform with the actually existing exchange rates. Two others that were in harmony with the conception of reestablishing or maintaining parity with the metal gold remained. The first was to maintain the existing traditional legal system of gold pars and to bring the exchange rates in fact to the old relationship. The degree of similarity between the actual rates existing in November 1918 and the 1914 rates, except those of the Central Powers and Russia, made it natural to suppose that that would be the solution. The second was to choose one of the major currencies as a standard, *to identify it with gold,*[8] and to use the exchange rates of that country as measures of appreciation or depreciation. This was the course adopted during 1919–25. By so doing, however, the essential relativity of the whole problem was lost sight of and the world had to pay dearly for its faith in the existence of an absolute international standard of value.

[8] The elaboration of this conception, which involves a reexamination of the idea of par, is, as pointed out in the Introduction, a thread that runs through the rest of these studies; cf. especially Ch. 34, Gold wears a Coat of many Colors.