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PART II

*Completing the International Gold Standard  
Facade, 1925-1928*



## CHAPTER 14

### *The Substantial Completion of the International Gold Standard Facade outside the Central Nucleus*

The currency history of 1925 to 1928 was exceedingly complex, for it was dominated by the mutual impact of three major and simultaneous lines of development:

- 1) the return of many countries, of which France was the most important, to the gold standard
- 2) the consolidation of their positions within the gold standard system by many countries, of which Germany was the most important
- 3) the operation of a wide-spread international gold standard system with New York and London as major centers.

Only after examining each development separately can the grand lines of the international gold standard system as a whole as it stood in 1928-29—the only year from 1914 to the date of writing in which it was substantially complete—be made clear and definite.

#### Growth of the Gold Standard Area, 1925-1928

##### *The Position at the Close of 1925*

The increase in exchange stability of 1924 was continued in 1925. In its *Memorandum on Currency and Central Banks* the League of Nations presented a list of 48 countries grouped according to the status of their currencies with respect to stabilization at the end of 1925. Of these 48 currencies 29 had by then returned to their pre-war par, or been devalued, or had been stabilized de facto for one year. In this last category the *Memorandum* includes only Honduras, Bulgaria, Estonia, and Siam, but British India and Czechoslovakia should be added. The rupee had reached the level of 1 s.

6 d. sterling in October 1924, which at that time was the equivalent of 1 s. 4 d. gold. When the pound reached its pre-war parity with the dollar, the 1 s. 6 d. level in sterling became also a 1 s. 6 d. level in gold. The rupee rate was prevented from rising higher by the government which, as currency authority, freely purchased sterling at 1 s.  $6\frac{3}{16}$  d.; and was prevented from falling lower because, after April 1926, the government authorized the Imperial Bank to make offers on its behalf to sell sterling at 1 s.  $5\frac{3}{4}$  d.<sup>1</sup> The Czechoslovak currency was stabilized de facto at just under 3 cents to the crown beginning in 1923, and held there by the operations of the Banking Office of the Ministry of Finance.<sup>2</sup>

The addition of these two currencies to the list of the *Memorandum* gives a total of 31. There was also the United States dollar, not included in the list because it constituted the central point of reference in the whole post-war stabilization effort and was throughout the period of stabilization 'at par with gold.' With the dollar should be linked the currencies of Cuba and the Philippine Islands, and somewhat more loosely, Mexico. This brings the total to 35 countries.

These 35 countries composed a stable exchange area that existed throughout 1925. The exchange rates of two groups of countries that had been, or intended to become, gold standard countries were still fluctuating with reference to this area. "In Denmark, Norway, the Kingdom of Serbs, Croats and Slovenes, Brazil and Bolivia, the instability of the currency during 1925 took the form of a rapid appreciation in value. But in Belgium, France, Italy, Greece, and Poland the external purchasing power of the currency was less at the end of the year than at the beginning."<sup>3</sup> The appreciation of the

<sup>1</sup> *Report of the Royal Commission on Indian Currency and Finance* (1926), Cmd. 2687, pp. 4-5.

<sup>2</sup> This system of pegging was introduced after a period of rapid appreciation and was carried out with the aid of foreign credits. It was accompanied by a deflationary crisis. D. T. Jack, *The Restoration of European Currencies* (London, King, 1927), pp. 162-4.

<sup>3</sup> League of Nations, *Memorandum on Currency and Central Banks, 1913-1925* (Geneva, 1926), I, 7.

three exchanges—of Yugoslavia, Bolivia, and Denmark—brought these currencies to levels at which de facto stabilization was begun during 1925. The Yugoslav dinar was stabilized de facto about June 1925 and this stabilization was maintained by the intervention of the National Bank in the exchange market in cooperation with the Ministry of Finance.<sup>4</sup> The Boliviano was stabilized de facto in January 1926, and the Danish krone in March 1926.<sup>5</sup> In addition, the Uruguayan peso, which had appreciated rapidly throughout 1924, reached 99 cents to the peso in August 1925, and was 101.6 cents in December 1925. In February 1926 the average rate on New York was 103.1, just under par, 103.42.

With the further addition of these 4 currencies, therefore, the system of stable exchange rates existing early in 1926 comprised 39 countries:

Europe (17)	United Kingdom, Netherlands, Sweden, Denmark, Switzerland, Germany, Danzig, Estonia, Latvia, Lithuania, Finland, Austria, Hungary, Czechoslovakia, Yugoslavia, Bulgaria, Russia
North America (2)	United States, Canada
South and Central America (12)	Chile, Uruguay, Venezuela, Colombia, Bolivia, Nicaragua, Salvador, Costa Rica, Guatemala, Honduras, Cuba, Mexico
Africa (2)	Egypt, Union of South Africa
Asia (2)	British India, Siam
Oceania (4)	Dutch East Indies, Australia, New Zealand, Philippine Islands

<sup>4</sup> National Bank of Yugoslavia Annual Reports for 1927 and 1928 (*Federal Reserve Bulletin*, June 1928, p. 409, and July 1929, p. 497). The date of stabilization is taken from the tables of exchange rates published in the *Bulletin*, January 1928, pp. 57-62.

<sup>5</sup> "Fiscal reform began in Denmark at the end of 1923. Two foreign loans were raised, one in London and one in New York to constitute an 'Exchange Equalization Fund.' A period of exchange stability followed, but it was intended that there should be a gradual appreciation of the krone until the pre-war parity was restored. In February 1924 the exchange was put under the management of a specially organized Valuta Control. A special commission then considered and rejected proposals for devaluation, and reported in favor of a return to the old parity. The National Bank was then given the proceeds of a \$40 million state guaranteed loan and directed to maintain rates on a progressively rising scale. Speculation induced by this plan brought the exchange up from 66% of the old parity in December 1924 to 99% of that parity in June 1926." (Jack, *op. cit.*, pp. 74-5). By March 1926 the average rate on New York was 26.1, par being 26.8 cents to the krone. This appreciation was accompanied by deflationary pressure on the Danish economy.

*De Facto and De Jure Stabilizations, 1926-1928*

Most of the countries that were members of this group by virtue of de facto stabilizations either adhered to the gold standard de jure in some form or bound themselves by law to continue the de facto stabilizations in anticipation of a later de jure return to gold during 1926-28. Finland returned to gold de jure on December 31, 1925, Chile on January 11, 1926, Canada on July 1, 1926, Denmark on January 1, 1927, and Estonia on January 1, 1928.<sup>6</sup> On April 1, 1926 the Na-

<sup>6</sup> *Finland.* The Finnish mark was devalued and a new standard unit fixed on the basis of 29.70 marks to the dollar, the rate at which the mark had been de facto stabilized since the last quarter of 1924. The central bank, which had accumulated large foreign exchange holdings and whose gold holdings were automatically increased in nominal value by the devaluation, was placed under obligation to redeem its notes in gold or gold exchange. Gold was not returned to circulation. Jack, *op. cit.*, pp. 200-4.

*Chile.* The Chilean stabilization was carried out on the basis of recommendations made by the Kemmerer Commission of Experts. A new central bank, the Banco Central de Chile, was organized and began operations on January 11, 1926. On that date the peso was devalued and a new standard equal to one-third its former parity, or 6 d. as compared to 18 d., was introduced, and the new central bank was placed under obligation to redeem its notes in gold or gold exchange. The Banco Central was modeled on the Federal Reserve system of the United States. Its stock was owned by member banks, including foreign banks operating in Chile. It was required to keep a reserve of 50 per cent of its combined note and deposit liability in gold or in deposits abroad in banks of high standing. League of Nations, *Legislation on Gold, 1930*, pp. 59-60.

*Canada.* The Canadian dollar had been practically at par with the American dollar since the middle of 1924, and by agreement sufficient gold was allowed to flow between New York and Canada to prevent any large movement in the exchange. Under the Finance Act of 1923 the suspension of gold redemption authorized by the Finance Act of 1914 was continued, bank notes were made legal tender, and control of gold exports was vested in the government. These provisions of the Act, however, expired by limitation on July 1, 1926, and the de jure return of Canada to the gold standard was accomplished on that date by allowing them to lapse.

The circumstances favorable to a return to the gold standard by Canada are summarized by the *Federal Reserve Bulletin* in its issue of July 1926 (p. 534):

"Among the principal factors facilitating Canada's return to the gold standard have been the growing favorable balance on external trade account, to-

tional Bank of Czechoslovakia was placed under legal obligation to keep the relation of the crown to undepreciated foreign currencies at the level of the preceding two years.<sup>7</sup> The National Bank of Bulgaria was given on January 1, 1927 the duty of maintaining the gold value of its notes unim-

gether with a decline in the net trade balance due the United States; the liquidation of British indebtedness to Canada; the restoration of the pound sterling and other foreign currencies to a gold basis; the resumption of cash or short-term payments in international trade; the complete funding of the national debt, the major portion of which is internal; the increasing American and foreign investments in Canada; the rise in other 'invisible' items in her balance of payments, notably tourist expenditures; and the continued expansion in the annual gold production."

*Denmark.* On January 1, 1927 the exemption granted to the National Bank of Copenhagen from its obligation to redeem its notes in gold expired by statutory limitation. A gold bullion standard modeled upon that of Great Britain was adopted in spite of a strong sentiment in Denmark in favor of a return to the full gold standard (Jack, *op. cit.*, pp. 74-5). The influence of the Bank of England was probably exerted to achieve this form of gold economy in Denmark.

*Estonia.* In the middle of 1924 an effort was made to stabilize the Estonian currency on the Swedish krona. After the return of England to the gold standard stabilization was continued on the basis of 375 marks to the dollar and 1800 marks to the pound. A currency and banking reform was legalized by the Act of April 1, 1927 and was put into effect on January 1, 1928. A new unit of account was introduced and a foreign loan was raised to carry through the stabilization by the League of Nations, which appointed a Financial Advisor. The Eesti Pank was placed under obligation to give official notice of at least one foreign gold currency in which it would redeem its notes. It gave notice on January 2, 1928 that that currency would be sterling. *Ibid.*, pp. 197-9.

<sup>7</sup> The National Bank of Czechoslovakia was organized and put into operation on April 1, 1926. It was permitted to keep 75 per cent of its reserve in gold and 25 per cent in foreign exchange, and was obligated to maintain the crown at between 2.90 and 3.03 dollars to 100 crowns. This involved a change in law but not in substance in the currency condition of the country, for the Bank took over the exchange operations of the Banking Office of the Ministry of Finance. In order to facilitate the pegging of the exchange the government was authorized to raise a loan of \$50 million or its equivalent in sterling; and in the spring of 1926 revolving credits of this amount were obtained. The notes of the Bank remained inconvertible. On January 1, 1929 control of the foreign exchanges was removed and the Bank of Issue moved into a period of de facto conversion of its notes into the exchanges of gold standard countries. This further step in the process of returning to the gold standard was



paired by all means in its power.<sup>8</sup> In India the agitation for a depreciation of the rupee to 1 s. 4 d. was stopped by the Indian Currency Act of 1927, which placed upon the government the obligation to buy gold and to sell gold or sterling at prices that continued de jure the de facto stabilization already in effect.<sup>9</sup>

These various legal measures were of great importance in establishing the basis upon which it was hoped to operate the international gold standard in countries outside the central nucleus. They applied the principle of the independent central bank and illustrated the work of the new agencies of cooperation—inter-central bank cooperation, the money doctors, and the Financial Section of the League of Nations. They illustrated the development of the gold bullion and gold exchange standard as instruments of gold economy and gave rise to the accumulation and use of large foreign exchange balances by central banks in the central money markets. In several cases they put an end to the double accounting long practiced with reference to gold in the balance sheets of central banks. They did not greatly influence the course of the exchanges, as they were almost all preceded by periods of de facto stabilization of varying duration. At the beginning

directly influenced by the Italian and French stabilizations. On November 7, 1929 the de facto gold exchange standard was legalized by a decree which went into effect on November 27. The Bank reserves were legally established at 25 per cent, to be raised later to 30 per cent, and in 1935 to 35 per cent, against notes and deposits, of which one-half might be in foreign exchange. League of Nations, *Legislation on Gold, 1930*, pp. 209-10.

<sup>8</sup> The National Bank of Bulgaria was reorganized by law of November 13, 1926, effective January 1, 1927, as one of the preliminary conditions laid down by the League of Nations for arranging a refugee loan. Its main task was to maintain the stability of the leva at .72 cents per leva, a point at which it had been stable for about four years. The reserves of the Bank were fixed at 33 $\frac{1}{3}$  per cent, to be increased later to 40 per cent, either in gold or in foreign exchange. The Bank was greatly aided in carrying out its main functions by the inflow of foreign funds into Bulgaria based on confidence inspired by the refugee loan. *Ibid.*, pp. 178-9.

<sup>9</sup> For the terms of this Act, cf. Ch. 23, *The Influence of World-wide Deflationary Forces on Indian Demand for Gold and Silver.*

of 1926, however, 15 countries still had to carry out de facto stabilization operations preparatory to their return to the gold standard system:

Europe (9)	Poland, Belgium, Italy, Spain, Norway, Greece, Portugal, Roumania, France
South America (5)	Argentina, Paraguay (since 1923 pegged to the Argentine peso), Brazil, Ecuador, Peru
Asia (1)	Japan

By the end of 1928 this task was largely accomplished. De facto stabilization was achieved in 1926 in Italy, Poland, Belgium, and France; in 1927 in Greece, Brazil, Argentina, Paraguay, and Ecuador; and in 1928 in Norway and Peru. In most instances, de jure stabilization followed before the end of 1928.

Italy stabilized de facto in August 1926 and de jure in December 1927. Poland, the only country that, after a de jure stabilization, was forced by a renewed depreciation of its currency to abandon the gold standard after 1925, carried out a second de facto stabilization in the autumn of 1926, followed by a second de jure return to gold on a new basis on October 13, 1927. In this she was aided by credits obtained from a group of 14 central banks—a high point in post-war inter-central bank cooperation.<sup>10</sup> Belgium attempted unsuccessfully

<sup>10</sup> The first Polish stabilization was accomplished in 1924 by a banking reform carried out with the aid of foreign credits and by the introduction of a new currency, the zloty. This new unit, on the advice of Hilton Young, was made the equivalent of the French gold franc. A new central bank was established, and the government's power to borrow from it was limited to 50 million zloty. The government, however, was permitted to continue to provide metallic currency and to issue notes up to 50 million zloty. In addition, another state bank, the Bank Gospodarstwo Kragowego, held part of the state funds and was able to pursue an independent credit policy. In spite of these limitations on its power, the new central bank was able to maintain the new parity of 25.2215 to the dollar during the rest of 1924. But by August the government had exhausted its power to borrow and had rapidly increased its own note issue. On November 28, 1924 it got parliamentary authority to increase the fiduciary issue 50 million zloty, on condition of raising a loan of double that amount. Bank of Poland notes were rapidly reduced by being converted into foreign exchange, and were replaced by state notes. The internal circulation rose rapidly, and prices also rose. During 1924 an un-

to stabilize de jure in March 1926, after a de facto stabilization at 107 francs to the pound which had lasted six months, and stabilized successfully de facto and de jure at 175 francs to the pound in October 1926. The French franc was stabilized de facto in December 1926 and de jure in June 1928. From the beginning of 1927 the Greek drachma was stabilized with only a minimum of fluctuation, and on May 14, 1928 it was officially devalued and a gold exchange standard introduced. This reform was carried out under the auspices of the League of Nations, and involved the setting up of a new central bank whose constitution embodied the best expression of post-war experience in central banking principles. The Brazilian milreis was stabilized de facto in January 1927, following the Law of December 18, 1926 which set up a stabilization Bureau pending a definite return to gold.<sup>11</sup> The Argentine favorable balance of trade was offset by large foreign credits, but many of these were short term. With the internal inflation, the foreign exchange and metallic reserves of the bank of Poland began to decline in spite of 123 million zloty made available to it from the proceeds of a government loan placed in New York. At the end of July 1925 pegging was abandoned and the zloty began to depreciate. There was a severe crisis in August and foreign balances were rapidly withdrawn. The zloty fell to 48 per cent of its 1924 parity with the dollar. After a sharp recovery early in 1926 it reached a new low in May. The gold and foreign exchange reserves of the Bank of Poland had been practically exhausted by the end of 1925, but when in 1926 inflation was stopped, the zloty again began to appreciate and gold and foreign exchange holdings were reconstituted. Following the recommendations of the Kemmerer Commission the zloty was stabilized de facto at close to 11 cents in the summer of 1926, and de jure stabilization followed at 11.22 cents per zloty on October 13, 1927. A foreign financial advisor to the government and to the Bank of Poland was appointed and an international loan of \$72 million was floated in the principal money markets of the world. In addition, a credit of \$14 million was extended to the Bank of Poland by a group of 14 central banks under the leadership of the Bank of England and the Federal Reserve Bank of New York. Internal banking reform was completed by giving to the Bank of Poland a monopoly of note issue. A reserve of 40 per cent in gold and foreign exchange was established against note and sight liabilities, of which 75 per cent, or 30 per cent of notes and sight liabilities, must be in gold. The government budget was balanced and final unification of the currency completed. Jack, *op. cit.*, pp. 179-80.

<sup>11</sup> This office was authorized to exchange notes for gold and gold for notes at the fixed rate of 200 milligrams of gold  $\frac{9}{10}$  fine per milreis. Provision was made for the accumulation of resources to carry out this function, and the

peso, which had appreciated rapidly throughout 1924, stood at the end of 1925 at a discount of only 2 per cent from its pre-war parity. It declined several points in the spring of 1926, but appreciated steadily thereafter, reaching parity in June 1927. On August 27, 1927 the Caja de Conversion was opened, and this constituted the official Argentine return to gold. With the Argentine peso the Paraguayan peso joined the stable exchange area. On August 10, 1927 Ecuador reorganized its currency in accordance with a plan recommended by the Kemmerer Commission, and set up a new central bank which was obligated to redeem its notes in gold or gold exchange. The Norwegian krone reached its pre-war parity in New York in May 1928, and on May 1 Norway returned to the gold standard at the old par.<sup>12</sup> Finally in May 1928 de facto stabilization was achieved in Peru at \$4 to the Peruvian pound.<sup>13</sup>

Executive was authorized to purchase and sell foreign exchange at the rates established by the new parity, entrusting such portions of this duty as could not be performed by the Caixa to the Bank of Brazil. These measures introduced a third note issue into the currency system of Brazil, in addition to the notes of the Treasury and those of the Bank of Brazil, pending such time as all the paper money of the country should be convertible into gold. This conversion was required by the Law of December 18, 1926, but was to go into effect upon a date to be fixed by executive decree. For the text of the law and other material bearing upon this stabilization cf. Bank of London and South America, *Monthly Review*, Feb. 1927.

<sup>12</sup> The Norwegian crown had depreciated in New York almost continuously from 1922 to 1925 but during 1925 and 1926 it appreciated rapidly and continuously. By the end of 1925 the krone had risen to 75 per cent of its former parity. A special Commission reported in June 1926 in favor of stabilization at the rate then prevailing—about 82 per cent of the old parity—but this policy was not carried out, and after three months of stability appreciation was resumed. In December 1926 a level of 94 per cent of the old parity was reached. In February 1927 the krone stood at 96 per cent of parity and was finally stabilized at par in May 1928. As in Denmark the steady appreciation of the currency produced deflationary pressure in the country during 1926. Jack, *op. cit.*, pp. 71-8.

<sup>13</sup> In December 1927 a Peruvian loan of \$50 million was floated in New York. Part of the proceeds were assigned to serve as a gold exchange fund. After March 1928 the exchange rate was held steady at 3.91. The de facto stabilization of May 1928 was followed on February 2, 1930 by a de jure stabilization which established a new standard coin, the sol, with a par value of 40 cents, and lifted the gold export embargo.

*Unfinished Business, 1929*

By the end of 1928, therefore, the international gold standard system was substantially completed. Only the de facto and de jure stabilization of the exchanges of Spain, Portugal, and Roumania in Europe, and of Japan in Asia, and the completion of the final steps in the de jure stabilization of Czechoslovakia, and de jure stabilization in Brazil, Uruguay, and Peru remained as unfinished business in this great effort to achieve permanent exchange stability. A vast area of stable exchange rates was in existence, which, as long as it retained its internal cohesion, would fluctuate as a whole with reference to the silver standard world—China, Persia, Abyssinia, and certain other eastern countries. The process by which, for a brief moment in post-war history, this great objective of international financial statesmanship was achieved was one that revealed the extremely diverse international financial relationships included in the catholic term "return to gold." It was also a process that increased the potential strains to which the international gold standard system was subject both at its periphery and within its nucleus of center countries. These two facts may be clearly seen by a brief examination of the special relations of Russia, Argentina, and Japan to the gold standard area, of certain aspects of the Belgian and Italian stabilizations, and of the place of the French stabilization in gold standard history.

The Special Relations of Russia, Argentina, and Japan  
to the Gold Standard Area

*Russia*

Only by the widest license of expression could Russia be described as a gold standard country, but after 1924 she was part of the gold standard system of stable exchange rates. She used gold as a balancing item in her balance of payments, as well as an article of export from her own production, and was aided by the stability of her exchanges in negotiating credits

in the central money markets. At times, in subsequent gold standard history, these relationships of Russia to the gold standard world became of major importance.<sup>14</sup> Some account should therefore be given of the peculiar place of gold in the Russian currency system.

Following a short period of effort to establish a moneyless economy in 1921 the Ninth All-Russian Congress of Soviets decided to introduce "a sound monetary system on a gold basis" and placed upon the Commissariat of Finance the duty of establishing such a system. In November 1921 an unsuccessful attempt was made to restore the pre-war gold rouble. The Soviet rouble was officially rated at 60,000 to one gold rouble, but with the progress of inflation this index had to be increased monthly. In March 1922 it had reached 200,000 Soviet roubles for one gold rouble, and the attempt to fix a ratio was then abandoned. In October 1921 a new State Bank was founded and a year later was given the right to issue notes. These notes were expressed in a new unit, the Tchervonetz, the equivalent of 10 pre-war roubles, against which a reserve of 25 per cent in gold, silver, platinum, or stable foreign currencies, and 75 per cent in liquid bills and in readily marketable goods was to be maintained. Advances to the Commissariat of Finance were not limited but were to be secured by the precious metals up to 50 per cent. No ratio of exchange between the Tchervonetz and the Soviet rouble was established, and for a while two paper currencies circulated side by side, fluctuating in terms of each other. During 1923 the Soviet rouble depreciated violently in terms of the Tchervonetz. In October an effort was made to fix official rates of conversion between the two units, but these could not keep pace with the actual depreciation of the Soviet rouble. In February 1924 the Commissariat of Finance was authorized to issue notes of 1, 3, and 5 rouble denominations to an

<sup>14</sup> Cf. Ch. 25, The Gold and Foreign Exchange Reserves of the Reichsbank during the Period of Chronic Emergency, March 1930 to May 1931, and Ch. 32, The Place of Germany in the World of Gold.

amount of not over half the Tchervontzi in circulation. In March 1924 Soviet rouble notes were demonetized, their issue stopped, and a final rate of redemption of 50 billion Soviet roubles to one gold rouble was decreed.<sup>15</sup> These last stages of the depreciation of the Soviet rouble, leading to its total loss of value, were a deliberate revenue-raising measure on the part of the government.

From 1921 to 1924, while the final transition to a new and unified currency system was in progress, the technical procedures and administrative organs of the planned economic life of the U.S.S.R. were being developed.<sup>16</sup> Under the resulting controlled economy the statistical measures customarily used to indicate differences between the external and internal values of currencies, and changes in the gold holdings of the central bank no longer had the significance properly attributed to them elsewhere. Beginning with 1924 the State Planning Commission developed for the whole Union of Soviet Republics a series of one-year plans which were progressively broadened in scope. The last, for 1927-28, was succeeded by the first Five-Year Plan. The essential feature of the state controlled internal economy of the Soviet Union was that the greater part of domestic production and consumption was planned. The balancing of the planned demand for goods of the consumer, of the government, and of industrial and

<sup>15</sup> These details are taken from Jack, *op. cit.*, pp. 170-5.

<sup>16</sup> The planning work of the R.S.F.S.R. (Russia proper) involved establishing in February 1921 a State Planning Commission (Gosplan) to draw up an economic plan for the country. Its primary concern was with electrification. It was limited at first to mere cooperation with regional planning bodies and government departments. In 1922 Gosplan was reorganized and strengthened but even in 1923 at the Twelfth Party Congress the scope of its operations was indefinite. In 1923 the U.S.S.R. was organized. The Gosplan of the R.S.F.S.R. became the State Planning Commission of the entire U.S.S.R. From 1923 to 1928 state planning commissions were set up in the various republics, including the R.S.F.S.R. . . . After the scissors crisis of 1923 the functions of *Gosplan* were extended, and in 1924 the country embarked on the path of planning without reservation (W. A. Brown, Jr. and A. Ford Hinrichs, 'The Planned Economy of Soviet Russia,' *Political Science Quarterly*, Sept. 1931). The details given below of the Russian system are taken from this source.

agricultural production units against the total planned production for sale of industry and agriculture left over an unabsorbed surplus of certain kinds of products and an unsatisfied demand for others. The sale abroad of part of this unabsorbed surplus and the purchase abroad of part of the means for meeting this unsatisfied demand were carried out by a government foreign trade monopoly. The fundamental principle of this monopoly was to balance exports against imports. Temporary deficits were covered by borrowing abroad. If loans could not be obtained, they were not incurred. Temporary surpluses were covered by accumulating gold and foreign exchange reserves. The unsatisfied demand and unabsorbed production resulting from failure of the plans to work out precisely in all details were brought together in the private market within Russia, where the output of the small uncontrolled sector of Russian production was also disposed of.

This system of planned production and consumption was carried out within a money economy in which the roubles paid out as costs of production and as state expenditures were returned in the form of prices, loans, and taxes. In order to maintain this circulation unimpeded, the planning of physical production and consumption was accompanied by a parallel system of price fixing and planning of production costs. In a system of fixed prices production costs cannot be allowed to fluctuate freely. In calculating them, therefore, a special method was worked out for averaging the cost of goods purchased abroad and entering into Russian production with the cost of goods produced at home. This prevented the planned internal price structure from being continuously disturbed by world-wide price making forces. These elements in the production costs of Russian industry which consisted of goods partly produced abroad and partly in Russia such as cotton, were not wholly determined by the supply and demand forces that cleared the world's markets and did not fluctuate from day to day. Finally the Russian system included



the planning of profits and losses and their allocation to different enterprises. Thus the productive plant of the country was treated as a whole and the survival of productive units was predicated upon their value to the general plan of economic development, not upon their ability to produce profits.

If, therefore, the expenditures of the productive units of the country as a whole were held within the limits of the planned costs of production, and if the budget of the state as a whole was balanced by loans and taxes, the circulation of money would be completed, and inflation, in the sense of a more rapid increase in the means of payment than in production, would not take place. The inflation that actually occurred in Russia took the form of a failure to hold production costs within the limits fixed by the planning authorities, so that there was a continuous increase in the amount of roubles put into circulation by Russian industry and collective agriculture in excess of the amount returned from circulation through the sale of the product at fixed prices. Since prices to the consumer and to industry itself were fixed over a wide area, the curious phenomenon resulted that the impact of this excess was felt exclusively in the restricted private market where prices rose very rapidly, and that at times people even came into possession of roubles they could not spend.

Under this type of economy, the banking system was developed as a device for allocating the necessary credits to the state and the productive economy in accordance with the various plans. There was no place in Russian theory for reserves against these credits. Under the Russian system reserves could have no practical importance, nor did metallic reserves against notes in circulation play a real economic role; they were in effect only a concession to established habits of thought abroad where confidence in Russia was influenced by the published reserves of the Russian State Bank.<sup>17</sup>

<sup>17</sup> The importance attached to large central bank reserves by *foreigners* was partly responsible for the development of ideas of credit reform, finally put into effect in 1930, which had as one of their aims the transfer of as many

After 1924 the Tchervonetz consistently maintained its external value, but, as measured by price indexes, its internal value declined. A black bourse developed in which foreign currencies were quoted at a premium over the Tchervonetz. Beginning in 1925 the State Bank began to lose gold and foreign exchange, note circulation rapidly increased, and the ratio of metallic reserves to notes fell.<sup>18</sup> For the reasons given above, however, these developments did not have the same significance as would be attached to them in western countries. Price indexes were not a good measure of the internal value of the rouble. Losses of gold reserves were not the forerunners of either devaluation or deflation. Yet Europe and America continued to give to these signs a western and traditional interpretation, and Russia continued, as a gold producer, to reap a harvest because of the unlimited willingness of other countries to give goods for gold.

### *Argentina*

The official Argentine return to gold in 1927<sup>19</sup> was an event of little technical importance in the management of the Argentine currency system. Under the Law of 1899 the Argentine Caja de Conversion was obligated to convert paper pesos offered to it into gold pesos weighing 1.6129 grams of gold  $\frac{9}{10}$  fine at the rate of 44 centavos gold to one paper peso, and to issue paper pesos against deposit of gold at the same rate. The Argentine currency expressed in gold pesos therefore fluctuated at all times exactly as the gold reserves of the Caja fluctuated and a constant ratio between the gold and the paper peso was maintained. In a formal legal sense Argentina was on the international gold standard when no legal prohibi-

payments as possible out of the sphere of note circulation to that of offsetting entries on the books of the State Bank. Cf. W. A. Brown, Jr. 'Credit Reform in Soviet Russia,' *American Economic Review*, Supplement, March 31, 1930, pp. 47-53.

<sup>18</sup> Jack, *op. cit.*, p. 178.

<sup>19</sup> Cf. 'The Return to Gold, Summary by Countries,' *Federal Reserve Bulletin*, Aug. 1928, p. 562.

tion was imposed upon the import or export of gold and when there was no suspension of the Law of 1899, that is, when the Caja de Conversion was 'open.' Between 1900 and 1914, and from August 27, 1927 to December 27, 1929, all these conditions were present but from August 9, 1914 to August 27, 1927, and after December 27, 1929, the Caja de Conversion was 'closed' in the sense that it was no longer obligated to exchange gold for notes. From a strictly legal point of view it is therefore true to say that Argentina left the gold standard on August 9, 1914, returned to it on August 27, 1927, and departed from it again on December 27, 1929. Several considerations, however, prevent so simple a statement from being at all satisfactory as a description of the relation of the Argentine currency to gold during these years, even in a formal sense:

- 1) The period during which the Caja de Conversion was closed did not coincide with the period during which gold exports were prohibited.
- 2) The requirement that all new issues of paper currency should be backed 100 per cent by gold remained in force throughout the period and was by no means a dead letter even when the country was 'off' gold.
- 3) The circulation did not, however, at any time vary directly with gold imports and exports.
- 4) The obligation of the Caja to buy gold remained in force and was of great practical importance during certain periods when the country was 'off' the gold standard and also during certain periods when the country was 'on' the gold standard.
- 5) The obligation of the Caja to sell gold, the suspension of which took the country 'off' the gold standard, was of no practical importance when the country was 'on' the gold standard.

The official return to gold was also an event of singularly little economic importance. From 1925 to 1929, as throughout the Restoration period, the relations of Argentina to the gold standard world were not determined, or even largely

influenced, by the effects upon the Argentine economy of international gold movements. As was true of raw material countries in general, these relations were shaped by her own fiscal policies, the state of her harvests, and the whole general environment created by the effort of other countries to return to gold, including the effects of that effort upon the central capital markets and upon the purchasing power of her customers. In particular they were influenced by her dependence upon two major products, meat and grain, and her relationships to two competing money markets, London and New York. These must be taken into account before the bearing of the legal arrangements referred to above upon the gold standard problem can be made clear.

We therefore note briefly the major facts of Argentine currency history after 1914 in order to free the statement that Argentina returned to gold in 1927 and left it in 1929 from the connotations of generalized gold standard theory, and clothe it with realistic meaning. In making this summary statement the excellent monograph, *The Foreign Debt of the Argentine Republic* by H. E. Peters, will be taken as a guide.

It was never the practice of Argentina to concentrate her gold holdings in a single central reservoir. Before the war the Banco de la Nacion held large amounts of gold in its own vaults against which no currency was or could be issued, but which was used to stabilize the issue of currency by the Caja. In the event of heavy gold exports by other banks that had obtained the gold from the Caja by redemption of currency, the Banco de la Nacion, at its own discretion, pursued the opposite course. It deposited its own gold with the Caja in exchange for currency which it put into circulation by discounting commercial paper. It also carried free gold reserves through the dull season and used them in a similar way to expand the currency to facilitate the financing of the harvest in expectation of a later seasonal inflow of gold from abroad. These practices were continued and developed during and after the war, and during the two and a half years when Ar-

gentina was 'on the gold standard' after 1927 the most important gold imports and exports were effected without passing through the Caja de Conversion at all. In some respects the Banco de la Nacion and the Caja together acted as the Banking and Issue Departments of the Bank of England do when Great Britain is on the gold standard. The analogy, however, is not exact in several respects. The purchase and sale of gold by the Bank of England, for example, entails, with very minor exceptions, the issue or contraction of notes by the Issue Department, and the Banking Department cannot stand aside and allow a drain of gold to take effect upon the Issue Department without trenching on its own reserve. The Banco de la Nacion, however, could act in this way. It could also, as a matter of policy, assimilate Argentine to British practice, and the more it did so, the less accurate were the dates of the closing and opening of the Caja as indications of the return to and departure of Argentina from gold.

At the outbreak of the war when the Caja was closed and the convertibility of the note issue suspended, the Banco de la Nacion was given large emergency powers, among them supervision of the foreign exchanges. The exchange had to be supported for only a short time, however. In spite of poor crops, especially in 1917, the Argentine trade balance during the war was favorable, owing to a large contraction of imports and a moderate expansion of exports. In 1916 it became profitable to ship gold from New York to Buenos Aires, and gold continued to flow in during 1917. Argentina, however, on account of her budget difficulties, continued to be a borrower abroad in 1914, 1915, and 1916, and because the London market was partly closed to her, turned to New York for help. A series of short term American loans were floated, but with the American entry into the war the New York market was not able or willing to refund these and they began to be repaid in 1917 from the accumulating credits from trade. The Argentine government meanwhile financed its needs by increasing its home floating debt. In 1918, 1919, and the first

part of 1920 Argentine exports increased greatly, and in order to prevent the peso from rising too rapidly in terms of dollars, francs, and pounds, Argentina became an international lender, accumulating large balances in New York and lending directly to England and France.

Gold continued to flow to Argentina—partly to its embassies abroad and partly to the Caja in exchange for notes. Since the basic law governing the issue of currency had not been altered, no multiple expansion of note issue followed, but dollars accumulated in New York, when deposited by the Banco de la Nacion with the Federal Reserve banks, were considered as gold reserves against which banking credits would be extended.

In addition to drawing gold to a country not on the gold standard, the strength of the Argentine exchange in 1919 and the first half of 1920 had another curious effect, that of closing the American capital market to Argentine borrowers. Argentine loans were officially discouraged as likely to lead to further gold losses from America, and therefore Argentina was obliged to pay off the balance of her maturing debts in America, partly from funds received from Great Britain in payment of war-time advances. By the end of 1920, the slate was swept clean of Argentine dollar loans. The government meanwhile continued to finance itself through the floating debt at home.

In the second half of 1920 the situation began to change rapidly. Argentine currency was brought to the Banco de la Nacion for dollars in New York, and the New York balances began to shrink. They were being used now to peg the Argentine exchange, and by July 1920 had fallen from \$70 to \$25 million. Further withdrawals were then suspended. The peso declined rapidly to 66 per cent of parity. In 1921 the situation again changed. From August 1921 the peso began to appreciate steadily, but since it was still far below parity the 1920 objections to further American loans no longer held. American bankers began once more to compete for Argen-

tine loans. As long as the depreciation of the peso was less in terms of dollars than the depreciation of sterling in terms of dollars, the London market was not a good place for Argentina to borrow, for the announced determination of Great Britain to return to the gold standard at the old parity with the dollar meant under these circumstances an appreciation of sterling in pesos also. More pesos would be required to repay a given amount of sterling than were received when it was borrowed.<sup>20</sup> Borrowing in New York was not easy, however, in spite of banking competition, for terms were difficult to agree upon and negotiations were often marked by misunderstanding and disagreement. Yet sufficient credits were obtained in 1921 and 1922 to tide the government over difficulties arising from its continued failure to balance the budget. In 1923 a large refunding loan was urgently desired, but the European crisis of 1922 and 1923 had had a marked effect on the Argentine exchange which declined sharply in New York in the first half of 1923 and caused a crisis in Buenos Aires. This loan was not finally placed until January 1924, and then only for a smaller amount than actually needed. In no sense was it a successful loan.

The whole situation was altered by the return of confidence in Europe and the general opening of the American capital market to foreign borrowers in 1924. Coinciding with good crops which met a steady European demand, it brought prosperity to Argentina. The peso began a steady rise from 74 American cents in July 1924 to 91 in January 1925. When England returned to the gold standard the peso was close to par, and in May the embargo on the export of gold from Argentina was lifted. The decree lifting the embargo was issued three days after England's return to gold, but applied only to banks and individuals; the Caja remained closed. Two banks,

<sup>20</sup> Dr. Peters also mentions other exchange difficulties connected with the transfer of the proceeds. *The Foreign Debt of the Argentine Republic* (Johns Hopkins Press, 1934), p. 117.

the Banco de la Nacion and the Banco de la Provincia, held at that time about \$20 million in gold, which was most of the gold outside the Caja.<sup>21</sup> These private gold holdings were not increased greatly during the next two years but in 1927 and 1928 they were rapidly built up and provided the source from which the first large gold losses of the depression were met. Depression prevailed in Argentina throughout 1925 and 1926. The exchanges were weak, but since foreign capital continued to flow in did not depreciate much. The great and indiscriminating foreign loan market in New York was getting under weigh. In 1927 a bumper crop and continued large capital imports forced the Argentine peso over par in New York. Small imports of gold were made in June and July 1927 and in August the government felt itself obliged to reopen the Caja de Conversion. This, as Dr. Peters says, had no immediate effect, as even when 'closed' the Caja would exchange paper for gold. The strength of the Argentine demand for gold was further revealed by imports from South Africa and the Bank of England which were made possible when still further borrowing in America gave added strength to the peso. The impact of this demand was felt in England at the moment when a policy of diverting a large part of the world's gold demand from London to New York was just beginning to come into effect. The Argentine position, therefore, at this particular juncture was of peculiar importance as a factor in the relations of the central nucleus of gold standard countries (cf. Ch. 18, *The Critical Decisions of 1927*).

It was from 1924 to 1927 that the really important relations between Argentina and the New York money market were established. "The determining causes of international borrowing," Dr. Peters writes (p. 123), "appear in this case at least to be more closely related to the situation of the lending capital market than to conditions in the debtor country. The cost of capital declined consistently from 1924

<sup>21</sup> *The Economist*, June 20, 1925, p. 1248.



to late 1928, and Argentine securities were sold at increasingly favorable rates throughout that time regardless of the less satisfactory internal situation." Argentina was able to rid herself completely of her external floating debt by 1928 by refunding loans in New York, and thereafter the government was not a borrower in foreign markets. The inflow of American capital was continued, but on a declining scale by direct private investment for some months more.

Three-quarters of the gold imported into Argentina through the combined effects of this great capital import and the good crops of 1927 and 1928 was not brought to the Caja de Conversion but was retained by the Banco de la Nacion to prevent possible inflation through expansion of the currency. When in 1929 the peso began to decline it was from this source that gold was drawn for export. As soon as it became evident late in 1929 that gold would have to be withdrawn from the Caja the right of conversion was once more suspended.

Dr. Peters has succinctly summarized the role of the Argentine Caja de Conversion after the war (p. 133): "Since 1914 this institution has served only to limit the rise in value of the peso as compared with gold, instead of holding its value up to that of gold, ordinarily regarded as the main function of a conversion agent." The Caja performed the first of these functions in precisely the same way in 1917-20 when Argentina was 'off' gold and in 1927-28 when she was 'on' gold. So far as the function of holding up the value of the peso as compared to gold was performed at all it was performed by the gold operations of the Banco de la Nacion.

### *Japan*

The relations of Japan to the rest of the gold standard world were profoundly influenced between 1920 and 1929 by the long established pre-war practice of maintaining exchange stability through the use of London balances; the extraordinary transformation in the Japanese economy during the war;

and a continuous series of unfavorable merchandise trade balances, especially following the earthquake of 1923.

The interaction of these three influences produced two striking results: (a) Japan, though one of the few countries that had remained a faithful member of the dollar group from 1919 to 1923 (Charts 10 and 21) did not lift her embargo on gold exports imposed in 1917 until January 1930; (b) while the effort to return to gold was leading to an accumulation of balances in the central money markets by central banks all over the world,<sup>22</sup> Japan was rapidly dissipating large balances already in her possession.

In 1914 Japanese balances abroad were steadily running down. Junnosuke Inouye estimates that immediately available balances plus the Bank of Japan's gold reserve in London were not more than 200 million yen.<sup>23</sup> Japan had a heavy sterling and franc debt and faced the prospect of having to borrow to pay the interest on old loans. The crisis of 1914 in the London money market consequently created an extremely difficult problem of remittance for Japan for about six months, of the same sort that the United States had to contend with. But in 1915 Japan's position began to improve radically. Large orders for supplies of every sort from the Allies, the contraction of European competition in the home market, an unequalled opportunity to gain a foothold in the markets of Asia, South Africa, South America, Australia, and the Southern Pacific, and a greatly expanded American demand for silk, all contributed to Japanese prosperity. Exports and income from shipping and insurance grew by leaps

<sup>22</sup> Cf. Ch. 20, *The Gold Exchange Standard as a Gold Economy Measure*.

<sup>23</sup> *Problems of the Japanese Exchange, 1914-1926* (London, Macmillan, 1931), p. 2. Our summary statements in the text are largely based on this authoritative source. The Bank of Japan's gold reserve in London came into existence as part of the indemnity received by Japan after the Sino-Japanese war. It was kept in London because England at that time was unwilling to see the whole amount shipped to Japan in gold for fear of adverse effects in the London money market. It was added to in 1902 and after the Russo-Japanese war from the proceeds of loans placed abroad, and fluctuated between 100 and 200 million yen.

and bounds and transformed the balance of payments,<sup>24</sup> the main features of which from 1914 to 1924 are here given.

	MDSE. TRADE	INVISIBLE INCOME & EXPENDITURE	BULLION & SPECIE
	Imports—(millions of yen)		
1914	-4	-6	20
1915	175	69	20
1916	371	277	-72
1917	567	415	-238
1918	293	578	-4
1919	-74	504	-322
1920	-387	420	-400
1921	-361	195	-138
1922	-252	154	1
1923	-534	169	5
1924	-646	162	-4

The Japanese exchange banks were wholly unprepared for the flood of foreign exchange that the new export surpluses brought them. They could not get gold in London at all during the war. Before the American gold export embargo was imposed they imported gold from New York and gold held in Japan increased 235 million yen, but in September 1917 this means of remittance home was shut off. Therefore other means of dealing with the new foreign assets had to be found. There were no institutions in Japan organized to sell foreign securities and practically no market for them. In spite of great efforts Japanese foreign investments could only be increased 1,400 million yen from 1915 to 1919.<sup>25</sup> Half of this increase was in the form of Japanese government war loans to Great Britain, France, and Russia, and a substantial part of the rest is accounted for by the political Nishihara loans to China. The government converted only 90 million yen of sterling and franc debt into internal debt and reduced its total external debt only 182 million yen. Consequently Japanese bank balances abroad grew with surprising rapidity. Most of them came first to the Yokohama Specie Bank and the Bank of Taiwan which financed the bulk of Japan's export

<sup>24</sup> *Ibid.*, pp. 222-3, 234-5.

<sup>25</sup> H. G. Moulton and Junichi Ko, *Japan, an Economic and Financial Appraisal* (Brookings Institution, 1931), pp. 282, 289.

trade. These exchange banks were put in a difficult position. They could not get yen to pay the exporters by importing gold, and had to borrow from the Bank of Japan at rates higher than they could earn on their balances abroad. At the same time they had to watch the value in yen of their sterling and even of their dollar balances decline. By May 1918 these balances reached approximately 500 million yen and were prevented from being much larger only by sales of foreign exchange to the Japanese government which took advantage of this unique opportunity to prepare for the maturity, still six years distant, of the 4½ per cent sterling loans of 1905. The Bank of Japan also purchased some foreign exchange from the exchange banks and added to its holdings by advancing working capital to Japanese traders exporting to India, South Africa, South America, and the Southern Pacific. These advances were repaid in foreign exchange, which brought the equivalent of about 130 million yen in sterling and dollars to the Bank of Japan. From these two sources the Bank acquired a new foreign asset, distinct from its 'reserve deposit abroad,' known as 'foreign currency balances.' When the American gold embargo was lifted in June 1919, the difficulties of the exchange banks were extreme, and in spite of an informal gentleman's agreement not to take more gold than was absolutely necessary from America, they felt obliged to import gold and reduce their loans at the Bank of Japan. From June to December 1919 gold held in Japan increased 252 million yen.

In this way Japan, from being an international debtor to the extent of 1,223 million yen in 1914, became an international creditor to the extent of 1,398 million yen in 1919,<sup>28</sup> and the balances of the Bank of Japan and of the government (inconveniently lumped in Japanese statistics under the heading 'gold funds abroad') rose from 213 to 1,343 million yen.

The Armistice, however, had radically altered the whole underlying position. Exports did not decline in 1919, but

<sup>28</sup> *Ibid.*, p. 308.

imports began to grow rapidly in the summer, and for the whole year there was a slight merchandise import surplus. This increased rapidly in the first quarter of 1920. The exchange banks, with their foreign balances depleted, were now having difficulty in financing imports rather than exports. They consequently asked the Bank of Japan and the government to resell to them part of their previously accumulated foreign balances. The equivalent of almost 100 million yen was obtained in this way with a corresponding reduction in the Japanese circulation. Mr. Inouye, at that time Governor of the Bank of Japan, states categorically that the fear and uncertainty inspired by this operation was the immediate cause of the ending of Japanese prosperity in March 1920, and this in its turn was the forerunner of the end of the world-wide restocking boom.

With the end of the artificial prosperity of Japan's over-expanded industries, Japanese exports declined, and the exchange banks found that they did not need the balances they had just acquired. They resumed the import of gold. At the same time the Bank of Japan began to liquidate its 'foreign currency balances' and bring them home in gold. Consequently in 1920 'gold held abroad' declined 219 million yen and gold in Japan increased 419 million yen. The gold reserve of the Bank of Japan, immobilized by the continuation of the gold export embargo of 1917, reached about 1,100 million yen. This did not quite end Japanese gold imports. The bulk of America's gold exports after the lifting of the embargo had gone to Hong Kong, Shanghai, and India, and in 1921 gold began to flow back from these markets to the United States. This movement was checked by Japanese purchases against dollar balances in New York, and the government used the gold thus acquired as a reserve against notes of small denomination and to meet domestic requirements in the arts. In May 1921 gold in Japan touched 1,200 million yen, and remained at about that figure until after the earthquake. Foreign balances, on the contrary, continued to be

drawn down, and for three years were the chief means of supporting the yen. This was in accordance with long established practice, for ever since the receipt of the Chinese indemnity in 1897 the Japanese had been accustomed to supporting the exchanges by drawing on balances in London.

From 1920 to 1922 the yen tended downward, but it was prevented from falling below 47½ cents. The exchange was supported by the repayment of Japanese war advances to Great Britain and France of 196 million yen, but foreign balances had to be drawn on to the extent of 706 million yen. This supported the exchange but did not reduce the cost of living in Japan. Japanese prices declined much less than prices in Great Britain and the United States, and the yen was becoming over-valued. The exchange banks encouraged their customers to continue their imports, indicating to them that the financing could be easily accomplished with the aid of government foreign balances. Large scale internal credits were made available by the banks. As a consequence, liquidation was very incomplete and many unsound positions were carried forward to add later to the severity of the banking crisis of 1927.<sup>27</sup>

Recovery from the 1920-21 crisis was stimulated in part by the development of the chemical and public utility industries, and in part by the growth of exports which in the spring of 1922 seemed to be benefiting from the weakness of the yen. Though foreign balances were low and falling gradually, the economic position was improving in 1923 until the whole course of events was changed by the earthquake of September 1. This disaster was followed after a few months by a reconstruction boom which continued throughout 1924 and 1925 and rivaled that of the war years in intensity. Both public and private finance, however, were in serious difficulties. Many bills and loans became uncollectible and very large new advances were made to finance reconstruction. Heavy

<sup>27</sup> *Ibid.*, pp. 305, 308. The summary of events after 1926 in the text is based on Moulton and Ko.

imports, timber in particular, were suddenly required, and in the first quarter of 1924 the yen for the first time became seriously depreciated in dollars. At the time of the earthquake the government's foreign balances were down to 550 million yen, but of this amount 350 million yen were earmarked for the repayment of the  $4\frac{1}{2}$  per cent sterling loan falling due in 1925. The exchange banks tried to support the yen, but succeeded only in opening a wide spread between the dollar rate as quoted in Tokyo and in New York, and were forced to follow the New York quotation downward. By December 1923 the foreign balances were reduced to 444 million yen, and in January and February 1924 no returns were published. This gives rise to a presumption that the balances so carefully husbanded to meet the approaching sterling maturity had been trenched on. In any event they were rendered unnecessary by the appearance of Japan for the first time as a large scale borrower in New York in February. A \$150 million  $6\frac{1}{2}$  per cent loan was placed, of which about two-thirds was used to repay sterling loans and one-third for earthquake reconstruction; <sup>28</sup> a series of other loans extending into 1925 followed. In March Japanese foreign balances were again published, but were only 292 million yen. The American loans caused merely a brief recovery in the yen, and the downward movement was soon resumed. At the end of the year the rate was being held at  $38\frac{1}{2}$  cents. No returns of foreign balances were made from April to December 1924 and they were apparently exhausted.

During 1925 the yen continued to be weak, but was made a vehicle for Chinese speculation as a hedge against seasonal changes in the price of silver. Consequently it rose in February, but fell again in July. More constructive influences, however, soon began to appear. The weakness of the yen stimulated Japanese exports, and the government began to make small gold exports from its own stock in Japan. These were

<sup>28</sup> Cf. Peters, *op. cit.*, p. 119, for the adverse effect of this operation upon Argentine borrowing in New York.

not important in themselves, but the construction put upon them was that the embargo might be lifted, and they might soon be followed by large exports from the immobilized reserve of 1,100 million yen of the Bank of Japan. Based on this expectation, sustained speculation for the rise began in New York late in 1925. The yen began a long upward movement which continued throughout 1926. Early in 1927 the yen was just below par and the government made preparations for lifting the embargo.

Mr. Inouye has pointed out the striking analogy between the position of Japan at this time and that of England in 1924. The yen, like the pound, was over-valued and both countries were bound to increase the difficulties of a basic export commodity, coal in the case of England and silk in the case of Japan, by returning to par unless a painful internal price readjustment were carried out. Both the yen and the pound had been carried close to par by speculative purchases, and had to meet the danger of a withdrawal of foreign speculators' balances after stabilization. On the other hand the success of France in stabilizing on a low level had not been lost upon the Japanese. Furthermore, 1924 and 1925, when the yen was falling, had been years of feverish prosperity in Japan, and 1926, when the yen was rising, had been a year of depression, and this association was firmly fixed in the public mind. For these reasons the return to gold at par had become a burning political issue in Japan.<sup>29</sup>

The government, however, was determined to act, and as a preliminary step tried to liquidate some of the 'earthquake' bills held by the banks. General discussion of measures designed to indemnify and otherwise protect the banks from losses arising from this liquidation undermined public confidence. Runs by depositors began and loans were called in to assure liquidity. A severe banking panic ensued during which 36 institutions were closed. It was stopped by legislation permitting the Bank of Japan to grant emergency ad-

<sup>29</sup> Cf. Inouye, *op. cit.*, pp. 131 ff., and Moulton, *op. cit.*, p. 404.



vances to banks subjected to withdrawals and giving large scale assistance to financial institutions in Taiwan which were hard hit by the calling in of loans. The lifting of the embargo was again postponed, but the banking crisis of 1927 was followed by readjustment, liquidation, and rationalization of industry. It was a period of great industrial advance. Though Japan had again become a debtor country, the large adverse trade balances of 1923 to 1926 were not repeated, and in 1929, for the first time in a decade, an approximate balance was struck in Japan's merchandise trade, and a new government came into office pledged to carry through a rigid policy of deflation leading to a *de jure* return to gold.

Japan, therefore, was finally ready to return to gold when the gold standard system was beginning to disintegrate at the periphery, when her large war-time accumulations of foreign exchange had been spent, and when she had once more become a debtor country. The success of this return was unusually dependent upon the expansion of exports, but these were already menaced by the clouds of an approaching world depression.

#### Certain Aspects of the Belgian and Italian Stabilizations

The relations of the three countries just considered, Russia, Argentina, and Japan, to the international gold standard system present a picture of great diversity which is in sharp contrast to the generalization of the principles of currency stabilization contained in the currency resolution of the Genoa Conference and embodied in the stabilization programs of many states. Even within the group of countries in which these general principles were honored there were great differences in their practical application, some of which are well illustrated by the Belgian and Italian stabilizations. In particular the struggles of the Belgian and Italian authorities to free their respective currencies from their dependence upon the French franc in order to stabilize 'in gold' exemplifies some of the effects of the breakup of the sterling-dollar-

franc nucleus, and the different attitudes of the two countries in their choice of a stabilization level brings out two strikingly different facets of the competitive element in the return to gold.

#### BELGIUM

From 1919 to 1925 Belgian exchange on New York followed the French exchange in both its trends and major fluctuations (Charts 22 and 24). But the minor fluctuations of the two currencies were not the same. Until the end of 1920 the Belgian exchange appreciated in Paris, but from December 1921 to August 1923 the French franc rose in Brussels to 124.24 and remained strong until March 1924, when it was 121.22. This relationship was in general maintained during the rest of 1924 in spite of substantial fluctuations in both currencies in terms of pounds and dollars, though the tendency of the French franc was to fall in Brussels.<sup>80</sup> In 1925 there was inflation in France and the French franc depreciated continuously in London and New York. Early in the year the

<sup>80</sup> L. H. Dupriez, 'Les Etapes de l'Adaptation Economique à une Inflation Soudaine: France et Belgique, de 1919 à 1926,' *Economic Essays in Honor of Gustav Cassel* (London, Allen and Unwin, 1933), pp. 126-7. The thesis of M. Dupriez is that the French and Belgian exchanges moved together only so long as the internal monetary developments of the two countries were similar, and that their mutual fluctuations were governed by their internal monetary policies. He describes the rise of the French franc in Brussels from 1921 to 1924 as follows: "On the one hand, in France, the circulation was slightly contracted in 1921 and kept stable in the next two years, on the other hand in Belgium notes in circulation continued to rise slowly: in 1921 and 1922 to replace current accounts, and in 1923 thanks to an increase in commercial discounts related to a business revival."

His charts show the beginnings of a divergence between French and Belgian prices, deposits, and note circulation in 1924, which became very marked during 1925, when there was inflation in France but not in Belgium. M. Dupriez treats the whole period from March 1924, when the French franc stood at 121.22 in Brussels, to February 1926, when it had fallen to 80.88, as one phase (the third since 1920) in Franco-Belgian currency history: "The third phase is that of the stability of the Belgian franc, while the French franc depreciated, the divergence being especially noticeable after the spring of 1925. The cause is not far to seek: on the one side there is absolute sta-

Belgian government began to take measures looking toward a stabilization of the London-Brussels exchange and intended to counteract the forces that bound the French and Belgian francs together.<sup>31</sup> Inflation was not permitted in Belgium, and in the spring of 1925 the Belgian franc remained stable in New York, and therefore continued to appreciate in Paris. The declining French exchange however did exert sufficient pressure on the Belgian franc to destroy its stability in New York and London, and in the summer of 1925 both currencies fell rapidly and together in these markets. The French franc was temporarily pegged after this decline, but the Belgian franc continued to depreciate and in September 1925 the relation of the two currencies was again what it had been at the beginning of the year.

The situation was then altered by a definite stabilization plan in Belgium, which contemplated balancing the state budget, the repayment of a large part of the state debt to the National Bank of Belgium, a foreign loan of from \$100 million to \$150 million to build up the reserves of the Bank, the formal devaluation of the currency, and the resumption of convertibility into gold or gold exchange. This plan began to go into practical operation in June 1925. The government transferred to the Bank as an exchange fund part of a \$100 million loan placed in New York in December 1924 and June 1925, and in the autumn the Bank received a special exchange credit of \$27.5 million. By October the Bank was able to stabilize the exchange de facto at 107 francs to the pound. The Belgian franc ceased to share in the further depreciation of the French franc and once more rose rapidly in Paris. In November the government demanded 600 million francs in

bility of the fiduciary circulation, on the other side, inflation is foreshadowed and is realized." The considerations stated in the text suggest that this position greatly underestimates the power of attraction of the French franc over the Belgian franc.

<sup>31</sup> League of Nations, *Memorandum on Currency and Central Banks, 1913-1925*, I, 32; a chart shows clearly the relative movements of the two currencies noted in the text.

new taxation to balance the budget and the necessary fiscal laws were passed by the end of 1925. The National Bank "applied a severe discount policy, and those who required foreign exchange had to obtain the necessary payment by drawing against their bank deposits. This led the commercial banks to dispose of treasury bonds by presenting them for payment."<sup>32</sup> The utility to private banks of short term treasury obligations as a means of resisting deflationary policies of central banks was thus illustrated in Belgium, as in England in 1920, and in Italy and France at various times. Early in 1926 laws necessary to give effect to the currency plan were passed. Provisional foreign credits had been established and only the final negotiation of the foreign loans was needed to complete stabilization.

During the entire de facto stabilization, however, the Belgian exchange had been under pressure. The continued decline of the French franc had created difficult competition for Belgian exporters and had encouraged a flight of capital from Belgium, partly because of the traditional relation of the two currencies.<sup>33</sup> The foreign credits available to support the exchange were heavily drawn upon.<sup>34</sup> Within Belgium the high level of stabilization was effectively attacked politically, and difficulties encountered in the final stages of the negotiations of new foreign loans caused them to fail. On March 15, 1926 the National Bank ceased to intervene in the exchange market and the whole stabilization proposal had to be postponed.

A rapid decline in the Belgian franc followed, accompanied by a sharp increase in both the wholesale price and cost of living indexes. The government was forced to obtain new credits from the Bank to meet an ever increasing demand for

<sup>32</sup> Jack, *op. cit.*, p. 139. Mr. Jack adds that "les grosses coupures" or bonds of 100,000 francs and upward, mainly held by banks, declined from 1,800 million in September 1925 to 520 million in May 1926.

<sup>33</sup> Dupriez stresses the influence of the fall of the French franc upon capital exports from Belgium in the winter of 1925-26; *op. cit.*, p. 128.

<sup>34</sup> Jack, *op. cit.*, p. 139, states that de facto stabilization cost Belgium \$107 million.

the repayment of treasury bills. At the end of May a new cabinet was formed with M. Franqui as Finance Minister. He immediately began to prepare for a new stabilization at a much lower level. Drastic steps were taken to eliminate the large floating debt and restore confidence in government finances. On June 7, 1926 a new institution, the Fonds d'Amortissement de la Dette Publique, was established to which special revenues were assigned, an example later followed in France. New taxes calculated to yield 1,500 million francs were at the same time imposed. In July an extremely acute financial crisis occurred in France, which led to the assumption of power by Poincaré, and in the same month the Belgian government was granted exceptional financial powers for six months. It proceeded vigorously to solve the problem of the floating debt and forced the conversion of treasury bills and five month treasury bonds into the preferred stock of the National Railways, whose 'industrialization' had been one of the stumbling blocks to the earlier stabilization negotiations.

July 1926 was the low point in the depreciation of both the French and Belgian francs. The average rate of the Belgian franc in New York was 2.4250 cents and of the French franc, 2.4658 cents. The forces that had so long bound the two currencies together had once more asserted themselves. This did not, however, mean the renewal of a new constant relationship between them. During the rest of 1926 the French franc was rising, but the Belgian franc was held near its low level. Belgian exports were stimulated by the low exchange and by the British coal strike. Confidence in the government was increased by the consolidation of the floating debt. In October it was possible to renew negotiations for a stabilization loan. A \$100 million loan was raised and on October 24, 1926 the National Bank pegged the exchange at 175 francs to the pound. A new currency unit, the Belga, was introduced, largely to distinguish the Belgian from the French franc and to emphasize its independence. Repatriation of capital helped

to strengthen the market and the new stabilization was successful. The rise of the French franc to 3.91 cents, before it was stabilized de facto, completely reversed the position of the two currencies as compared to March 1926, at the close of the first period of de facto Belgian stabilization. Belgium entered the ranks of countries on a de jure gold exchange standard with a currency whose undervaluation in terms of the dollar was almost double that of the French franc.<sup>85</sup> There is no doubt that the wish to obtain this 'prime de change' was an essential part of the plan worked out by M. Franqui. In this respect the Belgian stabilization was radically different from that of Italy.

#### ITALY

When the European-American exchange rate of 1920-22 was broken up, the Italian lira followed neither sterling nor the French franc. It displayed no general trend in terms of the dollar, and was in fact a member of the dollar group. Its fluctuations, however, were larger than those of other members of that group, and from April 1922 to October 1923, and again during the last three quarters of 1924 they were similar to those of the French franc (Chart 24). Toward the end of 1924 the lira began to decline slightly in New York, and during the first seven months of 1925 it depreciated rapidly. The balance of trade during the winter of 1924-25 was unusually adverse to Italy, and speculation in the Italian securities and exchange markets was active. In June 1925 an exchange crisis developed which was checked in August only by vigorous governmental action.<sup>86</sup> The decline in the exchange was faithfully reflected in the course of Italian prices. In this depreciation the lira followed the downward course of the

<sup>85</sup> Jack states that on the basis of wholesale prices this undervaluation was 22 per cent; *op. cit.*, p. 141; cf. Dupriez, *op. cit.*, p. 121, charts.

<sup>86</sup> C. E. McGuire, *Italy's International Economic Position* (Macmillan, 1926), p. 191.

franc in both its trend and fluctuations until July,<sup>37</sup> when the decline of the franc was halted by pegging operations. These were, however, only temporarily successful and in September the franc began to decline again. This time the lira, like the Belgian franc, did not follow, but after a sharp recovery entered into a period of de facto stabilization. The Italian government, like the Belgian, wished to break the connection binding its currency to Paris. Restrictions were placed upon the freedom of the exchange markets, and the National Exchange Institute was revived with nearly all its war-time powers. Mr. McGuire summarizes the new exchange restrictions (p. 129) as follows:

"New open credits in lire for foreigners were forbidden, as well as the discount of exchange drawn by foreign firms on their lira deposits in Italy. The purchase of foreign bills was forbidden except when the price in lire should be immediately paid in full. Detailed reports from the banks to the Ministry of Finance were exacted, particularly with a view to determine whether proceeds of credits abroad would henceforth be disposed of at prices exceeding their cost."

On November 14, 1925 the Italian war debt to the United States was settled. A \$100 million Italian government loan was immediately placed in New York by a Morgan syndicate. On January 27, 1926 the Anglo-Italian war debt was settled. Both war-debt agreements were exceptionally favorable to Italy and led to an inflow of foreign capital, which was further encouraged by the balancing of the budget for the financial year 1924-25 and the reduction of the internal debt. Conditions were favorable to de facto stabilization and the exchange was kept steady at about 4 cents to the lira from September 1925 through April 1926.

In May an elaborate plan for the consolidation of the note issue and the concentration of the gold and foreign exchange

<sup>37</sup> These close relationships between Italian prices and exchange, and between the Italian and French exchanges are clearly shown in a chart in the League of Nations *Memorandum on Currency and Central Banks, 1913-1925*, I, 59.

reserves of the note issuing banks in the hands of the Bank of Italy was carried through, but the lira was unsettled by new crises abroad. The British coal strike, which, instead of stimulating exports, as in the case of Belgium, had added to the cost of Italian imports, now reached its culmination in the general strike. This spread uneasiness in Europe and led to withdrawals of capital throughout the continent. The internal crisis in France was growing more intense and the franc was steadily falling. The lira, which had again begun to depreciate, continued to decline until August.

This situation was met by a vigorous policy of deflation. On September 1 the government announced a plan of currency reform. It turned over to the Bank of Italy the proceeds of the Morgan loan of November 1925 as an aid in supporting the exchange. This reduced the outstanding debt of the government to the Bank  $2\frac{1}{2}$  milliard lire as a first step toward its liquidation,<sup>38</sup> and added to the reserves of the central bank (Table 59 B and C).<sup>39</sup> This and other less important measures of reform dealing with the composition of the currency were easily carried through but, in applying strict deflationary pressure on the banks, resistance was encountered. An unusual demand for the repayment of treasury bills, of which  $15\frac{1}{2}$  milliard were outstanding in October 1926, immediately arose. Italy shared the experiences of England, France, and Belgium in this respect. In its Annual Report for 1926 the Bank of Italy spoke of the treasury bills as containing "elements of inflation obviously detrimental to price levels." This statement can be generalized into a principle of great importance for the whole problem of credit control. Whenever a large volume of short term government obligations is outstanding in the hands of banks, a great potential power of

<sup>38</sup> The government debt to the Bank of Issue had been gradually diminished since the advent of the Fascist regime; McGuire, *op. cit.*, p. 189, table.

<sup>39</sup> The specie reserves of the note issuing banks had been at a low level during the entire post-war period, about  $6\frac{1}{2}$  per cent of the note issues, largely because of the transfer of gold to the Bank of England during the war; *ibid.*, p. 188; cf. Ch. 2, Gold Concentration.



resistance against any deflationary central banking policy is present. To eliminate such resistance the Italian government carried out a large scale consolidation of the floating debt in November 1926 which was partly voluntary, but also partly compulsory. During 1926 the freedom of the foreign exchange market was further restricted by limiting the right to deal in foreign exchange to Italian banks having a capital of over 100 million lire, and on November 14 control was extended to private borrowing abroad by a decree the relevant parts of which read:

"The Finance Minister is authorized to purchase, up to a total amount of \$100,000,000, the proceeds of foreign loans concluded abroad by enterprises of Italian nationality, whose production is likely (1) to affect considerably the employment of labor and the economic activity of the country; (2) either to increase exports, or utilize national resources with the effect of reducing imports. Each particular transaction will be submitted by the Finance Minister to the approval of the Cabinet Council.

For the above transactions the Finance Minister is authorized to order that the Royal treasury give a guaranty to the borrowing concerns that the same exchange rate at which the foreign currencies have been taken over will apply to the currencies which will be necessary for the service of the loans. The borrowing concerns, however, must supply the Italian currency which is required to meet the service of the loans, at the agreed rate of exchange."<sup>40</sup>

In February 1927 the National Institute of Foreign Exchange was reorganized, practically as a department of the Bank of Italy, and its powers broadened. Throughout 1927 it carried out the government policy of exchange appreciation by continually intervening in the market. It acquired the resources to do so by borrowing at the Bank of Italy and repaid its loans by transferring the foreign exchange it had bought to the Bank. By this means the gold and foreign exchange reserves of the Bank of Italy were regularly built up (Table 59 C).

<sup>40</sup> *Federal Reserve Bulletin*, Aug. 1927, p. 595.

From August 1926 to June 1927 the Italian lira rose from an average rate in New York of 3.295 cents to 5.5819 cents, a level slightly higher than the rate finally chosen for de jure stabilization. Without having suffered an equal previous depreciation, it was forced upward for four months after the rise of the franc had been checked. In 1927 it was a definitely overvalued currency. This policy of exchange appreciation was accompanied by persistent deflationary pressure on the Italian economy. In its annual reports the Bank of Italy has stated that in 1926 "almost every branch of Italian industry experienced a slowing down of activity," and in 1927 "almost every industry felt the consequences of the currency revaluation, which was not immediately followed by corresponding changes in price levels, and still less by changes in wage levels." In neither year, of course, could the rise of the lira be held accountable for all aspects of the unfavorable economic position of Italian industry and agriculture, but it was one cause among others, and as such it was more strongly stressed by the Bank of Italy in 1927 than in 1926.

Count Volpi, the architect of the Italian return to gold, has summarized the successive stages of the Italian stabilization: "1. Balancing of the national budget. 2. Consolidation of war debts. 3. Unification of the note issue and its concentration in the hands of the Bank of Italy. 4. Progressive and more efficient utilization of Italian resources in raw materials. 5. Gradual deflation in currency and in credit. 6. Consolidation of the floating debt, and reorganization in the Treasury department. 7. Regulation of the influx of foreign capital into Italian industry. 8. Reorganization in the whole field of production, and readjustment of taxes with a view to increased industrial efficiency. 9. Gradual amortization of the domestic debt. 10. Defense of the Treasury surplus by the reduction of State expenditures."<sup>41</sup>

One of the dominant motives in the formulation and execution of this program was national prestige. In surveying the results of the whole effort the Bank of Italy wrote in its An-

<sup>41</sup> 'Stabilizing the Lira,' *Foreign Affairs*, April 1928, pp. 467 ff.

nual Report for 1927: "When we think of the level of depreciation which had been reached and the improved level which has been recovered by force of will and patience, we cannot help having every confidence in the future, provided that the determination of not deviating from the main road which has been followed in the last years remain firm and is adhered to, as it doubtless will be."

On December 31, 1927 Italy adopted de jure a gold exchange standard system at a new parity of 7.919113 grams of fine gold per 100 lire, or 19 lire per dollar. For the first time since 1894, the currency was made convertible into gold or into foreign currencies convertible into gold at prices not exceeding gold export point. The profit resulting from the revaluation of the gold assets of the Bank of Italy was used to cancel the state debt to the Bank, and the gold held abroad at the Bank of England was eliminated from the reserve and carried as a liability of the state to the Bank. A twelve month stabilization credit for \$125 million with one renewal was negotiated, of which \$75 million was an inter-central bank credit with 16 central banks participating, and \$50 million was a credit extended by British and American private banking firms. In these respects the Italian return to gold illustrated the Genoa principles of gold economy, the attraction of foreign capital, and inter-central bank cooperation. It illustrated also the basic principles of balancing the state budget and freeing the central bank from demands for credit from the state. But it was accomplished by a revival of many war-time mechanisms of exchange control and large restrictions on the free movement of private capital.

## CHAPTER 15

### *The Place of the French Stabilization in Gold Standard History*

Our account of the substantial completion of the gold standard facade outside the central nucleus is a summary of events at the periphery. It does not, in its skeleton form, and could not even if greatly elaborated, interpret the significance of the legal measures which by 1928 bound the outside world in a stable exchange relationship to the great powers at the heart of the gold standard system. The true meaning of this series of de jure stabilizations must be read in the light of the fundamentally unbalanced world economy in which they took place and of the interrelationship existing between the central money markets. These brief summaries have, however, touched at many points on the major stabilization operation of 1925–28, the French stabilization, and an examination of the French stabilization leads straight to the heart of the post-war gold standard labyrinth. It provides the key to many of the most important relationships existing between Great Britain, the United States, France, and Germany. Further, just as the German stabilization of 1924 left a technical heritage that modified the whole subsequent history of the gold standard, so the French stabilization left a technical heritage that gave France a peculiar and at times a dominant position in the gold standard world. In order to provide the background for the extraordinary transformation in the international position of the franc that produced this result, a brief recapitulation of French currency history from 1919 to 1924 is necessary. It was the other side of the shield which in the case of Germany was designated 'Political Economics, 1919–

1924.' The same caption may therefore be applied to France also.

### Political Economics, 1919-1924, Recapitulation

When the franc was unpegged in March 1919 no serious doubts were entertained in France as to the resumption by the franc of its 'normal' position in the world's currency system. Taking into account changes in the value of gold,<sup>1</sup> the French note issue was not excessive. A temporary decline in the franc to give time for a correction of the obvious overvaluation of war-time pegging did not seem disastrous. Inflationary finance in 1919, however, brought about a collapse. The franc fell in New York far more rapidly than the pound (Chart 10), and by April 1920 was only 32.36 per cent of its pre-war dollar parity. Thereafter the imposition of new taxes and the flotation of loans prevented further inflationary finance. The French government, moreover, formally committed itself to a deflationary policy by embodying in legislation the terms of a convention reached with the Bank of France. By the Law of December 31, 1920 it undertook to repay to the Bank of France advances of two milliard francs per annum. Though this repayment was made in full in 1921 only at the expense of an increase in other floating debt,<sup>2</sup> and was only partly made in 1922, still the Law of December 31, 1920 established a policy and increased confidence. As a consequence the franc was able to move in general harmony with sterling, and from April 1920 to April 1922 the franc-dollar rate, as part of the general European-American exchange rate, rose from 6.27 to 8.99 cents (Chart 22).

The franc, however, was subject to certain influences not shared by sterling. The French budget, which specialists unite in identifying as the primary source of French currency difficulties, was burdened by reconstruction expenses which from

<sup>1</sup> Cf. Ch. 8, An Abstract Conception of Gold as an International Monetary Standard, and Ch. 10, America drags her Golden Anchor.

<sup>2</sup> E. L. Dulles, *The French Franc, 1914-1928* (Macmillan, 1929), pp. 137-8. Liberal use has been made of this source in the summary account of French currency history given in the text.

1920 to 1923 ranged from 111½ to 171½ milliard francs. These were met from a special budget covering expenses recoverable under the Versailles Treaty, pensions, and interest on debt incurred to meet expenditures under these heads. R. G. Hawtrey points out that this special budget was responsible, in a sense, for the collapse of the franc, for it was, in his striking phrase, "a consecrated deficit."<sup>3</sup> It tied up the prospects of the French franc with those of the German mark. Any doubts concerning Germany's capacity to pay were immediately reflected in diminished confidence in the franc. Because of this deficit also, the Bank of France was burdened with advances to the state and was not technically in a position to counteract flights from the franc.

The franc, therefore, was peculiarly sensitive to the acute reparation crisis of 1922 which was brought to a head by the accession of Poincaré to power in July and the end of Briand's conciliatory policy toward Germany. In May it began to fall in New York and parted company with the sterling nucleus (Chart 24). In November foreign speculation for the decline became very active and the confidence of the French in their own currency began to be seriously undermined. The average daily rate on New York declined to 5.25 cents in December from 8.99 cents in April. The government deficit for 1923 was 18 milliard, of which only 11½ milliard was due to reconstruction expenses, and the government was again unable to comply with the terms of the Law of December 31, 1920. In January 1924 a loan offered by the Crédit National<sup>4</sup> was a failure. This was ominous because the floating debt was kept

<sup>3</sup> 'French Monetary Policy' in *The Art of Central Banking* (Longmans Green, 1932), p. 4. Mr. Hawtrey's penetrating analysis of French finance has also been freely drawn upon in this chapter.

<sup>4</sup> The Crédit National was formed in October 1919 to facilitate the reparation of war damages in France. Its capital of 100 million francs was subscribed by credit institutions and industrial enterprises. It did not receive deposits but secured funds by offering its own debentures to the public, investing the proceeds in advances to victims of war damage against their claim for indemnity and in three to ten year loans to industry and commerce. With the completion of its war functions it became a bank for making industrial advances. Cf. Willis and Beckhart, *Foreign Banking Systems* (Holt, 1929), p. 618.

down only by the flotation of bonds, and the government was completely dependent upon the willingness of the public to take bonds if it was to escape outright inflationary finance. The franc continued to fall in New York, reaching 3.49 cents on March 8, 1924.

On the eve of the Experts Report on reparation and at the moment when Dr. Schacht was negotiating in London for credits for his Gold Discount Bank, France was faced with a serious financial crisis. Increases in the Bank of France discount rates in January 1924 had proved ineffective, and the crisis was actually met, first by the imposition of new taxes, the 'double décime' of M. Poincaré enacted on March 13, and second by foreign borrowing. Largely because of the decision to impose new taxes it was possible for the government to secure credits of \$100 million and £4 million through J. P. Morgan and Company and Lazard Brothers and Company against pledge of part of the gold reserve of the Bank of France. These credits were at once utilized to support the franc which rose from 3.49 cents on March 8 to 6.71 cents on April 22.

The extreme rapidity of this improvement brought out an institutional factor of great importance which had a direct bearing upon the technical methods later developed for handling the greater crisis of the summer of 1926. The Bank of France, in 1924, had no power to buy gold at a premium or to buy securities in the open market. It was not technically equipped, therefore, to combat a violent rise in the franc exchange,<sup>5</sup> and by so doing to prevent loss of confidence following a subsequent technical reaction in the rate. Such a technical reaction did occur, and the franc fell steadily from April 22 to the end of May. On June 1, 1924 it was just under 5 cents in New York. The Treasury had been able, however, to replenish the Morgan credit largely by selling 7 per cent bonds in New York, and the Bank of France had bought dollars and pounds in the strong markets of March and April.<sup>6</sup>

<sup>5</sup> Hawtrey, *op. cit.*, p. 6.

<sup>6</sup> Dulles, *op. cit.*, p. 176.

After the crisis of 1924 France was in the position of having reasonable assurance that the ordinary budget would be balanced by the new taxes and that cash expenditures for reconstruction would be met by payments under the Dawes Plan, the acceptance of which by France was greatly facilitated by the return of the Left to power. Yet certain dangers to the currency remained; first, the psychological danger created by the recent violent fluctuations in the exchanges; second, the large volume and short maturity of the floating debt. At the end of 1924 the floating debt was about 60 milliard francs, of which the main constituent was the Bons de la Défense Nationale. Of these, 54,538 million were outstanding in December 1924,<sup>7</sup> of which 7 to 8 milliard matured each month. In addition, from July 1925 to May 1926 bonds amounting to 27½ milliard francs were maturing. The public was therefore in a position to force the government to borrow from the Bank of France if for any reason it was unwilling to renew the government's maturing debt.<sup>8</sup> The defeat of Poincaré and his replacement as Premier by M. Herriot, by increasing the nervousness and distrust of financial interests in the economic policies of the government, did in fact lead to the exercise of this power. Toward the end of 1924 and in the beginning of 1925 the circulation of Bons de la Défense National was substantially reduced. The legal limit of borrowings at the Bank of France by the state was also reduced under the Law of December 31, 1920, and in April 1925, at the very moment when England was returning to the gold standard, the Herriot government was obliged to admit that this legal limit had been exceeded and this excess borrowing concealed in the published balance sheets of the Bank.<sup>9</sup> Miss Dulles states that these concealed borrowings approximately equaled the entire reduction in advances actually made under the Law

<sup>7</sup> Dulles, *op. cit.*, table p. 186.

<sup>8</sup> Cf. Ch. 14, Italy, pp. 429-30.

<sup>9</sup> A ministerial crisis was provoked on April 3 over the question of increasing the note circulation of the Bank of France and M. de Monzie supplanted M. Clementel as finance minister; Dulles, *op. cit.*, p. 182.



of December 31, 1920.<sup>10</sup> These disclosures revealed the degree to which the Genoa principle of an independent central bank had been undermined by the peculiar form of political economics that prevailed in France from 1919 to 1924. They also inaugurated a new and severe series of currency crises.

### Laying the Foundations for Future Power in the Gold Standard System, 1925-1926

One of the most striking paradoxes of post-war gold standard history is that during this series of financial crises the foundations were firmly laid for the assumption by France of a role in the gold standard world such as she had not enjoyed at any previous period in her history. The paradox is resolved by a consideration of the peculiar characteristics of the moderate inflation that took place in France at this time and of certain institutional elements in the French money market.

#### *Inflation, 1925-1926*

The remedy proposed by the Herriot government in April 1925 for the acute French budget problem was a capital levy or forced loan. This measure was bitterly opposed, and when the condition of the balance sheet of the Bank of France was revealed in April the Herriot ministry was obliged to resign. M. Caillaux became Finance Minister in a Briand cabinet. His two most important measures to meet the situation were first, to consolidate the floating debt by an internal loan bearing an interest rate varying with the French exchange on London; second, to obtain further credits in America in connection with the settlement of the Franco-American war debt. The internal loan failed to achieve the hoped for results,

<sup>10</sup> Cf. *op. cit.*, p. 232, and charts, pp. 233, 236-7. Miss Dulles states that the most common method of concealment was for the government to borrow directly from the private banks and to force the Bank of France to rediscount for them the treasury certificates they had received. This suggests a reason for the stiff attitude of M. Moret toward rediscounting treasury bills in 1933-34 which caused the government to borrow £30 million in London in 1933 and eventually led to M. Moret's retirement in favor of M. Tannery.

TABLE 35

*French Government Short Term Debt and Certain Balance Sheet Items of the Bank of France, 1924-1926 (millions of francs)*

A BONS DE LA DÉFENSE NATIONALE OUTSTANDING, AND ADVANCES TO THE STATE AND NOTE ISSUE OF THE BANK OF FRANCE, 1924-1926, MONTHLY

	BONS DE LA DÉFENSE NATIONALE OUTSTANDING <sup>1</sup>			ADVANCES BY THE BANK TO THE STATE <sup>2</sup>			NOTE ISSUE OF THE BANK <sup>3</sup>		
	1924	1925	1926	1924	1925	1926	1924	1925	1926
Jan.	54,889	54,886	46,089	22,840	21,520	34,850	38,825	40,726	51,186
Feb.	54,682	54,992	46,068	23,000	21,900	34,462	39,083	40,799	50,878
March	54,552	53,945	45,783	22,925	21,825	35,350	40,012	40,882	51,802
April	56,194	52,246	46,212	22,800	22,440	35,710	40,031	42,515	52,329
May	56,780	51,245	46,384	22,780	23,938	35,275	39,729	42,962	52,809
June	56,343	50,569	46,157	23,000	25,325	36,575	39,817	43,272	53,212
July	56,287	50,690	44,218	22,940	27,520	37,730	40,188	44,308	54,945
Aug.	56,598	50,330	45,973	22,900	28,013	37,137	40,314	44,931	56,084
Sept.	57,180	51,202	46,850	23,025	28,787	36,850	40,324	45,575	55,047
Oct.	57,181	46,623	45,886	22,840	30,390	36,288	40,547	46,741	55,248
Nov.	57,045	45,571	48,542	22,900	31,575	36,037	40,579	47,930	54,476
Dec.	54,538	45,735	49,079	22,675	34,360	36,460	40,597	49,873	52,866

*Changes Cumulated Monthly*

Jan.	0	-3	-8,800	0	-1,320	12,010	0	1,901	12,361
Feb.	-207	103	-8,821	160	-940	11,622	258	1,974	12,053
March	-337	-944	-9,106	85	-1,015	12,510	1,187	2,057	12,977
April	1,305	-2,643	-8,677	-40	-400	12,880	1,206	3,690	13,504
May	1,891	-3,644	-8,505	-60	1,098	12,435	904	4,137	13,982
June	1,454	-4,320	-8,732	160	2,485	13,735	992	4,447	14,387
July	1,398	-4,199	-10,671	100	4,680	14,890	1,363	5,483	16,120
Aug.	1,709	-4,559	-8,916	60	5,173	14,297	1,489	6,106	17,259
Sept.	2,291	-3,687	-8,039	185	5,947	14,010	1,499	6,750	16,222
Oct.	2,292	-8,266	-9,003	0	7,550	13,488	1,722	7,916	16,423
Nov.	2,156	-9,318	-6,347	60	8,735	13,197	1,754	9,105	15,651
Dec.	-351	-9,154	-5,810	-165	11,520	13,620	1,772	11,048	14,041

B LEGAL LIMIT OF ADVANCES BY THE BANK OF FRANCE TO THE STATE<sup>4</sup>

1923		1925	
Dec. 27	23,200	April 15	26,000
		June 30	32,000
1924		Nov. 24	33,500
Dec. 22	22,000	Dec. 3	39,500
		1926	
		Dec. 31	37,500

C LEGAL LIMIT OF NOTE ISSUE OF THE BANK OF FRANCE<sup>4</sup>

1920	
Sept. 28	41,000
1925	
April 15	45,000
July 12	51,000
Dec. 3	58,500

<sup>1</sup> E. L. Dulles, *The French Franc, 1914-1929*, p. 186. Miss Dulles' table does not state whether the figures are for the beginning of the month, the end of the month, or are averages.

<sup>2</sup> Average of Bank of France weekly figures compiled from Dulles, *op. cit.*, tables, pp. 489-90.

<sup>3</sup> *Ibid.*, pp. 485-6.

<sup>4</sup> *Ibid.*, table, p. 232.

though by October it had brought in 6 milliard francs.<sup>11</sup> In that month the negotiations in Washington collapsed, Cail- laux was forced to resign, and a turning point in the long crisis was reached.

The major characteristics of the crisis up to this point may

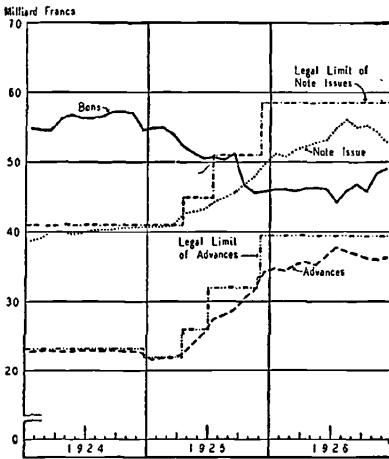


CHART 26

*Influence of Changes in the French Government Short Term Debt upon the Bank of France, 1924-1926, monthly*

be easily summarized. The inadequacy of the government's revenue was not very great, the increase in the public debt for 1925 being only 3 milliard francs. It was however sufficient to undermine confidence in the ability of any political combination to deal successfully with the budget problem. This loss of confidence impaired further the government's ability to deal with the floating debt. The failure to renew in sufficient volume floating debt as it matured led to increases in the legal limits up to which the Bank of France could make advances to the state and issue notes. This was a conspicuous visible sign of inflation. It exaggerated the true dimensions of the problem and was perfectly calculated to undermine still further the confidence of the general public and to discourage subscriptions to the Bons.

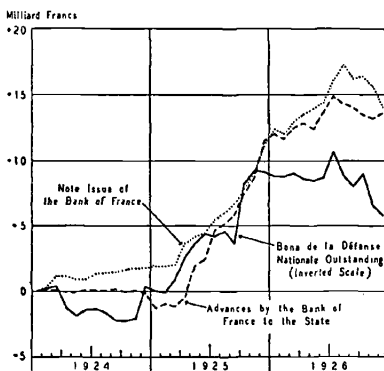
These relationships are shown in Chart 26 in which the

<sup>11</sup> Of this, only 3 milliard was in cash, the rest being refunding; Dulles, *op. cit.*, p. 22.

Bons de la Défense Nationale outstanding, Bank of France advances to the state, and Bank of France note issue are plotted,<sup>12</sup> together with the legal limits of advances and note issue. In Chart 27 the cumulative changes in these series from January 1924 are shown in order to bring out the fidelity with which

CHART 27

*Bons de la Défense Nationale Outstanding, and Advances to the State and Note Issue of the Bank of France, 1924-1926, changes cumulated monthly*



the Bank of France items reflected the decline in the outstanding Bons during 1925. The budget difficulties were accompanied by a rapid expansion of bank credit and a moderate rise in wholesale prices and the cost of living. Meanwhile the franc was gradually yielding to the pressure of a persistent transfer of capital from France which often took the form of French purchases of securities payable in gold, such as Suez Canal, Rio Tinto, and DeBeers, and British and American bonds. This decline was at times checked by official support which helped to keep the New York rate at approximately 5.18 during March, April, and May, and at approximately 4.70 during July, August, and September.

All these tendencies were sharply accentuated by the failure of M. Caillaux' measures in October 1925. The legal limit of 'advances to the state' by the Bank had to be raised twice in quick succession, and a further increase in the legal maximum of note issue was made. M. Caillaux was succeeded as Finance

<sup>12</sup> In this chart the figures graphically presented by Miss Dulles in her charts on pp. 187 and 232 are combined.

Minister first by M. Painlevé and then by M. Loucheur. Though further restrictions were placed upon the export of capital in October the temporary pegging of the franc was followed by a rapid decline. The monthly average rate on New York for September was 4.71 cents, for October 4.43 cents, and for December 3.74 cents. In December the crisis became very acute and M. Loucheur was able to force through the Chamber a measure of emergency taxation calculated to raise about 3 milliard francs almost at once. Confidence, however, was not restored. The government was saved only by an impassioned appeal by Briand in the Chamber, and the crisis continued under successive finance ministers, reaching its peak in July 1926 when Caillaux, recalled to office on June 25, was refused the dictatorial financial powers he demanded. This led to the fall of the Briand-Caillaux ministry on July 17.

On June 26 M. Caillaux had appointed Emile Moreau as Governor of the Bank of France, and just before the fall of the ministry he had asked the Bank to purchase from the Treasury the balance of the Morgan loan, \$31 million, still remaining in the government's hands. On July 19 the Bank of France agreed on condition that the legal limit of its note circulation be increased by a corresponding amount, about 600 million francs. The formation of a new ministry with M. Herriot as Premier and M. de Monzie again as Finance Minister was completed the next morning. This ministry was unwilling either to stop the drain on the Treasury caused by the redemption of short term Bons by a forced funding of the Bons or to give public notice of an inflationary policy by consenting to an increase in the legal limit of the note circulation. M. Moreau, however, was adamant in his refusal to purchase the balance of the Morgan loan without an increase in the legal limit, and in his resolve to force the government to disclose publicly the bad situation of the Treasury and to prevent it from escaping this necessity by recourse to "illegal subterfuges." On July 21 he addressed the following letter to M. de Monzie (*italics M. Moreau's*):

July 21, 1926

M. le Ministre:

As I had the honor to inform you orally yesterday the position of the Treasury's account at the Bank grew still worse yesterday.

The margin still legally available to the Treasury is this morning reduced to 60 million francs.

It is to be feared that it will be completely exhausted today, and that our weekly statement, which will be made up tonight and published tomorrow, will show an excess of advances to the state over the legal limit *which will oblige the Bank to cease making payments everywhere for the account of the Treasury.*

In order to furnish the Treasury with immediate funds, while awaiting the effect of proposed measures, your predecessor proposed the transfer of the unutilized balances of the Morgan loan to the Bank. I advised him in my letter of July 19 that the general council of the Bank would consent to this operation, under conditions stated in that letter, as soon as Parliamentary authority was obtained.

Without prejudice to the measures which it is the government's province to take to assure the regular supply of the Treasury in the immediate future, and unless your department has at its command immediately available resources which it might obtain, for example, by the discount of a part of its portfolio, *I believe that the only means of avoiding the publication tomorrow of a debit balance in the Account of the Treasury at the Bank and the suspension of payments, which would be its inevitable consequence, is the approval this very day, by both Chambers, of the proposed transfer of foreign exchange.*

Accept etc.,  
Emile Moreau

The Treasury did not show a debit that day, and the government in the evening submitted to the Committee of the Chamber a bill to sell the Morgan balance to the Bank without raising the limit of the circulation. M. Moreau immediately wrote to the Premier that the Bank of France would not yield,<sup>18</sup> but the Premier's Declaration to the Chamber that

<sup>18</sup> Emile Moreau, 'Le Relèvement Financier et Monétaire de la France, 1926-28,' *Revue de Deux Mondes*, March 1, 1937, pp. 53-63.

night contained the explicit statement that he would not ask for an increase in the note issue. The government, however, was overthrown, without ever having obtained a vote of confidence on its general policy, including heavy capital taxes. At a special session of both chambers immediately following the fall of the ministry a bill embodying the Bank's terms was passed into law.

During this crisis prices were rising rapidly and unemployment suddenly increased. The franc fell to 243 to the pound and to 2.05 cents to the franc on July 21. Assistance from the United States in stabilizing the franc was not to be had, as M. Moreau learned from Governor Strong at two conferences with him at Versailles during the height of the crisis, unless the French war debt agreement with the United States was ratified.<sup>14</sup> It seemed, for the moment, as if France was incapable under the existing form of government of solving her financial problems.

*Elements of Potential Strength developed during Inflation*

Throughout this troubled period, however, France was forging certain weapons with which to extricate herself from its culminating phases, and with which to play a great role in the gold standard world.

First, the transfer of French capital abroad, which had for years contributed to the weakness of the franc, was not in the main a speculative movement. Lack of confidence in French securities had resulted in a fall in their price and a restriction of new French securities offered for sale. Savings that would normally have gone into French securities were transferred abroad.<sup>15</sup> Foreign assets were accumulated that would be drawn upon surely but gradually as need arose or opportunity developed for profitable employment or investment of funds in France. This was all the more certain because the French appetite for permanent investment abroad had been dulled

<sup>14</sup> *Ibid.*, pp. 56-7, 62.

<sup>15</sup> Cf. Hawtrey, *op. cit.*, pp. 22-5. Mr. Hawtrey here discusses the concepts, flight, and repatriation of capital.

by the great losses suffered on pre-war French foreign investments. The export of French capital was not only non-speculative and temporary, but also formidable in amount, and a reversal of the movement was bound to be a powerful factor in the exchange market.

Second, the depreciation of the franc was sufficiently favorable to French exports to facilitate this export of capital and the simultaneous movement of short term funds and balances of a speculative character, and to give, in combination with the French reluctance to make new permanent foreign investments, promise of a favorable balance of payments once the pressure of capital flight was relieved.

Third, the chronic condition of crisis had forced the imposition of new taxes in 1920, 1924, and 1925 adequate to meet the basic budget difficulty in combination with the Dawes Plan annuities.

Fourth, the fall of the franc made it possible to abandon the idea of a 'return to normal' and to choose a new rate of stabilization under plea of absolute necessity.

Fifth, the fact that the fall of the franc in the exchange markets, particularly during the acute phases of the 1926 crisis, was more rapid than the rise in prices, made it possible, without additional shock to public confidence, to fix upon a rate that undervalued the franc and to avoid a prolonged post-stabilization policy of deflation.

Sixth, the crisis forced political unity upon the country in the form of a government of national union under M. Poincaré, who took office on July 24, 1926 at a moment when financial chaos had brought France to the brink of revolution. Without such political unity no ministry could have met the crisis successfully.

Finally, it produced, in the report of a committee of experts (the Sergent Committee) appointed by M. Briand on May 21, 1926, a simple and technically effective plan of stabilization by which advantage could be taken of all the potential elements of strength in the French position.



### De Facto Adherence to the Gold Exchange Standard, August 1926 to June 1928, and the Realization of the Potential Elements of Strength

This plan, which was submitted on July 3, proposed three stages of stabilization: (1) to stop inflation while letting the franc fluctuate; (2) de facto stabilization; (3) de jure stabilization. It suggested that the rate of stabilization be between the rate appropriate to the wholesale price index and that appropriate to the cost of living index. It suggested two methods of dealing with the budget problem: first, further taxes—a final attack upon the underlying disturbing cause; second, a special allocation of revenue to a new government body, the Caisse d'Amortissement, responsible for the refunding and administration of the floating debt—a final attack upon the major secondary cause of disturbance. Finally, it recommended a technical change of great importance, namely, to grant to the Bank of France the right to buy gold and foreign exchange at a premium and to issue notes against these assets without having to include them within the legal maximum of note issue. This recommendation put France de facto upon the gold exchange standard.

M. Herriot was succeeded as Premier by Raymond Poincaré. The balance of the Morgan loan was placed at the disposal of the Treasury in francs and M. Poincaré took vigorous steps to give legislative effect to the recommendations of the Sergent Committee concerning the budget and the Bank of France. The franc recovered immediately. By November it was  $3\frac{1}{2}$  cents and by December approximately 4 cents in New York. The new powers of the Bank of France were little used. Some gold was enticed out of hoarding by the offer of a premium on September 27, but in the main the Bank was passive. In December 1926 de facto stabilization was begun. The Bank of France bought dollars from all comers at not over 4 cents per franc, and pounds at not less than 122 francs per pound. The large amount of foreign exchange offered at

these rates, together with the freedom to decide whether and in what markets this foreign exchange should be converted into gold, and if not so converted, to determine in what markets and in what forms it should be employed, gave the Bank great powers in the decentralized post-war gold standard system. The degree and permanence of these powers depended upon the sources from which sprang the large offers of foreign exchange to the Bank. This was the root question for France as a gold standard power.

The international position of France during the period of *de facto* adherence to the gold exchange standard is summarized in a document prepared for the Bank for International Settlements by Dr. Blessing in October 1932:<sup>16</sup>

"The stabilization rate selected by France fixed the level of prices in that country below the price level in other countries with a gold currency. In consequence of this and of other circumstances (reimbursement of the State debt to the Banque de France by the French Treasury and the Caisse d'Amortissement, operations which, until about the middle of 1927, in effect counteracted the notes issued by the Banque de France against foreign exchange; disinclination of the French banks to develop French credit on a basis of the growing gold and foreign exchange holdings of the Banque de France and to increase their calls on the Banque de France; measures of customs policy which impeded the importation of commodities, thus obstructing the normal outflow of gold and exchange) France had an extraordinarily favourable balance of payments during the *de facto* stabilisation and in the years following the *de jure* stabilisation. Owing to the mentality of the French public, political unrest and a system of tax legislation which for a time stood in the way of the issue of long term foreign loans on the French market, it was not possible for the excess of assets over liabilities in the French balance of payments to be placed at the disposal of foreign countries in the form of long term loans, as it was before the War. The Banque de France was accordingly compelled to take over this surplus in the form of either exchange or gold, against the issue of notes. In the period

<sup>16</sup> The Gold Exchange Standard, B.I.S. Monetary and Economic Department (C.B. 60, Basle, Oct. 26, 1932).

from the end of 1926 to the middle of 1928 (from the *de facto* to the *de jure* stabilisation of the franc), during which France applied the pure gold exchange standard, the Banque de France purchased almost exclusively foreign exchange. By the date of the legal stabilisation (June 25, 1928) its foreign exchange holding had risen to 26.5 milliard francs. This rapid rise was due—apart from the current favourable balance of payments—to the repatriation of emigrated capital and to foreign speculation in francs and in French securities. After the legal stabilisation, the funds loaned to France for speculative purposes were withdrawn, the withdrawals being, however, easily made good out of amounts coming into the country in respect of the current balance of payments.”

In this summary stress is laid upon the fact that the withdrawal of funds from circulation by the government for the repayment of advances to the Bank of France served to cancel an increase in notes in circulation arising from Bank of France purchases of gold and foreign exchange, which, by implication, might otherwise have eliminated the special stimulus to French exports gained by the low rate of stabilization by causing prices to rise. Mr. Hawtrey has shown <sup>17</sup> that the withdrawal of notes from circulation by the government, looked at in another way, directly promoted the French export surplus which brought exchange to the Bank and made possible the replacement of the notes withdrawn by the government. There was a double relation of cause and effect. Mr. Hawtrey's analysis has the great merit of bringing out the grave economic consequences of certain institutional factors in the organization of the French banking system and the French money market. Our studies have consistently sought to emphasize considerations of this type, and it is therefore appropriate to repeat the main points in his analysis:

When Poincaré took office in July 1926 the French Bank rate and market rate were both high, the former being 7½ per cent. It, however, soon became ineffective because of a shortage of commercial bills in the French market which

<sup>17</sup> *Op. cit.*, pp. 13-25.

caused a sharp decline in bills discounted at the Bank of France. These fell from 7,864 million francs to 3,604 million in one month. By June 1927, when all the very short term Bons had been retired, discounts at the Bank of France were only 2 milliard francs, Bank rate had been reduced to 5 per cent and the market rate was only 2 per cent, but the long term rate of interest was still high. The decline in discounts reduced the note circulation of the Bank of France, and the shortage of commercial bills which caused it put the banks in a difficult position with respect to their secondary reserves. Mr. Hawtrey stresses the fact that as a consequence the government's attempts to refund and to reduce the floating debt met with unequal success. First, the one-month maturities were retired, and then those of three and six months, until only two-year Bons de la Défense Nationale were left outstanding. The refunding was successful but the effort to reduce the debt was unsuccessful because the banks had to have prime short term assets for portfolio purposes, and in the absence of bills continued to buy Bons. The Caisse d'Amortissement, meanwhile, continued to receive the revenues assigned to it, but, being unable to use them to pay off Bons, accumulated large balances at the Bank of France. Bank of France notes in circulation were therefore still further reduced. In addition, other Treasury deposits were built up by the inflow of other revenue, and the government further increased its deposits by offering special interest inducements to the banks to keep deposits with the Treasury. These resources were used partly to reduce debt held by the public other than floating debt, but also partly to reduce advances by the Bank of France. Mr. Hawtrey concludes therefore that there was within France a deflationary force of large proportions that reduced domestic expenditures, including expenditure on exportable goods, on imports, and on foreign investments, and also a strong motive for the sale of foreign assets temporarily held abroad as a means of replenishing depleted balances in France. These internal pressures therefore com-

bined to swell the favorable balance of payments of France, but because they were relieved by the pegging of the franc, they did not become strong enough to cause a severe deflation. After the de facto stabilization the favorable French balance of payments could no longer express itself in rising rates of exchange, but built up the balances of French banks abroad. The primary reserves of these banks were being reduced by the forces tending to contract the French note circulation, and the cheapest way to build them up was to sell foreign exchange to the Bank of France, rather than to borrow from it. Consequently large purchases of foreign exchange were made by the Bank of France against which notes were issued under its new technical powers. A gap of 18 milliard francs made in the circulation by the government was filled by August 1927 by 18 milliard francs of notes issued against foreign exchange. Thereafter the Bank of France tried to prevent further note issues in connection with further purchases of foreign exchange by purchasing forward exchange. This could be only a temporary expedient, for as the forward contracts fell due they had perpetually to be renewed as long as the underlying forces continued.<sup>18</sup>

These various economic pressures tending to strengthen the franc in foreign markets, especially in London, were reinforced by the attraction of relatively high long term interest rates in Paris and relatively low rates in London and Berlin, and by speculative purchases based on the certainty that the franc would not fall, but *might* rise.<sup>19</sup>

The Bank of France, however, in order to avoid the adverse and deflationary effects of such a rise on the French economy, was determined not to permit further appreciation of the franc. By February 15, 1927 its 'working fund' (*masse*

<sup>18</sup> *Ibid.*, p. 18.

<sup>19</sup> Cf. the causes leading to the large movement of gold into India in 1925, Ch. 23, *The Influence of World-wide Deflationary Forces on Indian Demand for Gold and Silver*, and Ch. 12, *The End of the Regular Pattern of Gold Distribution*.

*de manoeuvre*) in foreign exchange amounted to £22 million (2,750 million francs).<sup>20</sup> The Bank was already planning for a definitive stabilization, and as a preliminary wished to free its balance sheet of all doubtful items, chief among them the item 'gold held abroad.' At that time this item was regulated by an agreement made in 1923 that had given the French Treasury an extension of its war-time British credits but had suspended the original arrangement whereby as these credits were repaid the gold pledged by the Bank of France as security was to be returned proportionately. After arduous negotiations, the French contentions prevailed,<sup>21</sup> and in April the government was able to pay off the residue of its war-time loan amounting to £33 million, thus releasing £18 million of pledged gold belonging to the Bank of France, and also to accumulate a large fund of dollars in New York to meet payments that would fall due in the United States if the pending war debt settlements were not ratified. The building up of dollar balances in New York was facilitated by the shipment of the gold released from pledge in London to America.<sup>22</sup> The franc continued to be very strong and by May 10, 1927, the Bank of France held in foreign exchange the equivalent of £100 million sterling (12½ milliard francs).

According to the estimates of J. M. Keynes French balances in London grew £100 million during 1925, 1926, and 1927.<sup>23</sup> The Bank of France was acquiring balances from sellers of all sorts, British and continental, and also from other French holders of sterling. The passage of an increasingly large proportion of the total of French balances abroad to the Bank of France and other French banks from those who had ac-

<sup>20</sup> Moreau, *op. cit.*, p. 300.

<sup>21</sup> *Ibid.*, pp. 298-319.

<sup>22</sup> Albert Aftalion, 'The Causes and Effects of the Movements of Gold into France,' *Selected Documents of the Gold Delegation* (Geneva, League of Nations, 1931), p. 71.

<sup>23</sup> 'The British Balance of Payments 1925-27,' *Economic Journal*, Dec. 1927, p. 556.

quired them by the export of French goods or capital was of the greatest significance for all international money markets. It was a concerted transfer of French credits previously accumulated and currently accumulating abroad into the hands of those who were bound to employ them at short term, instead of their transfer into the hands of permanent investors in foreign securities. It contributed substantially to the friction that impeded the free flow of capital in London and New York from long to short term employment<sup>24</sup> and the international equalization of interest rates in the long and short term markets and led to competitive bidding by banks in London and New York for French funds and thereby contributed to pressure on these markets to find outlets for such funds in Germany and other capital-poor countries. It was also a source of embarrassment to the Bank of France which was being subjected to an active propaganda at home to force it to allow the exchange to appreciate. The Bank therefore was very anxious to secure a *de jure* stabilization as soon as possible and M. Moreau tried to persuade President Doumergue and M. Poincaré to advance the date of the French elections, scheduled for May 1928, in order to hasten a decision on this matter. This effort was unsuccessful, and the *de facto* stabilization had to be continued.

Under these circumstances the Bank of France, in May 1927, began to buy gold in London. Its purpose was to restrict credit in the London market, force an increase in interest rates there, and thus make speculation for the rise in francs more expensive and less attractive. It began to act, as Charles Rist, its vice-governor, was soon to point out to the Governor of the Bank of England, as if the gold standard were in effect in France. This observation was made at the close of an interview in Paris on May 27 between Messrs. Norman and Siepmann of the Bank of England and MM. Moreau and Rist of the Bank of France concerning the French gold purchases.

<sup>24</sup> Cf. Ch. 18, An Improvised Institutional Equipment.

*The Moreau-Norman Conversations of May 1927*

M. Moreau's account of these conversations in the *Revue de Deux Mondes*<sup>25</sup> gives the background for an understanding of the action taken by a meeting of central bankers in New York the following month which was of outstanding importance in the history of the international gold standard during the Experimentation period. He records his own exposition of the French position as follows:

"The sales of foreign exchange, pounds sterling especially, to Paris have reached considerable amounts. The high interest rate and the prospect of a revaluation of the currency are attracting not only French funds exported abroad, but foreign funds also, of which the greater part are borrowed to speculate with on our market. . . .

These heavy receipts of foreign exchange on the French market have unquestionable advantages, for they make it possible to put the financial situation in order; but they have the serious disadvantage of frightening a section of the public and playing into the hands of those who want to revalue the franc. If this inflow of foreign exchange continues, the pressure of the revaluers to induce the Bank to cease its purchases and so allow a revaluation of the franc to take place will be increased. We wish to avoid such an eventuality; at least for the moment.

The measures taken on the Paris market (alteration in the buying price of foreign exchange for example) are for this purpose. But to achieve the desired result we must act abroad also. For the employment abroad by the Bank of France of the foreign exchange it has bought leaves the sums offered to Paris at the disposition of foreign markets, and, by a circuit that can easily be imagined,<sup>26</sup> facilitates the continuation of the movement.

<sup>25</sup> *Loc. cit.*, April 1, 1937, pp. 550-61.

<sup>26</sup> Professor Aftalion describes this "circuit" in the following terms (*op. cit.*, p. 8):

"After December 25, 1926, when it was decided to stabilize the franc de facto and the Banque de France began to purchase foreign exchange at fixed prices, many Frenchmen brought their capital back into the country—that is to say they handed over their foreign exchange to the Banque de France in return for francs. The French holding of foreign exchange then passed in successive stages into the hands of the Banque de France.



Further, certain continental markets with too low interest rates have allowed their capital to move to Paris and have even given credits. M. Bruins, the Dutch member of the Administrative Council of the Reichsbank has informed me that Berlin has lost a milliard gold marks (£50 million) in foreign exchange reserve in the past few months. The speculation there was financed by foreign credits.<sup>27</sup>

This speculation is adverse to our interest and must be stopped. However reluctant Berlin is to bring home its foreign assets, and so to facilitate the transfer of reparations at a moment when Germany wishes to prepare opinion for a revision of the Dawes Plan, the Reichsbank should raise its discount rate and recall its funds. Other markets should imitate it. These great international movements of speculative capital must be stopped, and a lesson must be taught to these modern freebooters (*capitaines de grandes compagnies*) who, with their gangs, have exhausted one

Other large quantities of foreign exchange were handed over to the Banque de France in return for francs by foreign capitalists speculating, first on the rise of the franc, and later on the rise of French securities which they purchased with the francs they received.

Fed from these two sources the foreign exchange holdings of the Banque de France continued to grow. The Banque de France placed this foreign exchange in other countries thus returning to foreigners the capital which it had just received from them. The latter were thus enabled to bring it to the Bank once more, and as the Bank in its turn again placed these sums abroad, there was nothing to prevent this cycle of operations with the same capital from continuing indefinitely, swelling the Bank's holdings immoderately and producing inflation twice over—in France by reason of the francs given by the Bank in return for the foreign exchange, and in other countries by reason of the investments of foreign exchange effected there by the Bank.

This was one of the reasons which led the Banque de France to exchange a part of its foreign exchange in other countries for gold. By purchasing gold it reduced its foreign investments, and diminished the multiplication of capital which has been described."

Professor Aftalion seems here to have discovered the secret of perpetual motion. It is not clear to the writer, however, why the 'placement' of, let us say, dollar funds by the Bank of France in America should inspire those who have sold, let us say, acceptances to the Bank to go straightway and buy francs. The transfer of French capital home was indeed the transfer of a finite amount not capable of being multiplied in this way. The connection, however, between the Bank's purchases of short term instruments, easy money abroad, and speculation in francs was undoubtedly a real one.

<sup>27</sup> Cf. Ch. 16, *The Retreat from the Principle of Stopping Inflation*, 1927-1928.

market after another. Paris cannot act against them directly for their transactions are not really in marks, florins or crowns, but in pounds and dollars. Paris finds that it has acquired considerable power over London and New York, but not over Berlin and Amsterdam. It is quite clear, at any rate, that London and New York must have acquired simultaneously assets in the markets which have sold their own currencies to get the pounds and dollars they have sold in Paris.

Therefore London and New York should use their powers by falling back on the markets where the movement originates. The Bank of France could force them to do so. By converting her pounds and other foreign currencies into gold, she would oblige London, in self-defense, to realize its assets in Berlin. To conserve its cash or to attract funds to replace the withdrawn English credits, Berlin would have to raise its rates.

But the Bank of France does not want to use this pressure on London. Though obliged to strangle speculation, it prefers not to have to draw on London. Let the English be the first to draw, of their own accord, on Central Europe, and the desired result will be achieved by a completely frank collaboration without disturbing intermediate markets.

In conclusion I said that the role of international clearing house gives great advantages to a market, the London market in this case, but that it also implies duties. Mr. Norman would understand that the better, since he has no interest in seeing the Bank of France enjoy an excessive power in his market as it does at present."

In reply to this exposition Mr. Norman made the following points:

- 1) Dr. Schacht's policy in Berlin was not *entirely* based on political considerations. The Berlin market had just gone through a wild speculation while Germans were at the same time speculating abroad and drawing reserves from the Reichsbank. But Schacht could not raise his rate and recall German foreign balances without attracting more American credits and facilitating further speculation in Germany.
- 2) If German speculation could be checked Dr. Schacht would raise the Reichsbank rate, but Mr. Norman would not urge him to

do so now. Even if he did it was doubtful if German funds would be attracted home.

3) The trouble was more in Paris than in other markets. The power of Paris to attract funds is due to the following circumstances: a currency guaranteed against any decline, but with the possibility of a rise left open; a long term interest rate higher than anywhere else in the world in a great confidence inspiring country whose government has too often undertaken not to refund its debt for several years; refusal to borrow abroad or to allow the great public companies (*collectivités*) to borrow abroad, another check to the decline in interest rates; the wish of private companies to prevent the inevitable rise in their shares in order not to have to raise dividends, while foreigners are convinced that French securities will rise. Never have conditions been so favorable for the attraction of capital—"6½ per cent for life, and the prospect of a possible large profit from currency revaluation!" Therefore at all costs quotations on the Bourse should be allowed to rise and the French rate of interest should be reduced.

4) London has not acquired any power over third markets by the concentration of London balances in French hands, for what has happened is a transfer of prime sterling bills already held by foreigners in London to the Bank of France. No change in the composition of its portfolio by the Bank of England could help, as its assets were invested in the same type of asset as is held in London by the Bank of France. A contraction of credit in London was not practical, as the amount of credit outstanding was finely adjusted to the needs of the British economy.

5) To help the French, Mr. Norman had nevertheless tightened the London market rate of interest by selling securities at  $3\frac{13}{16}$  per cent and then at  $4\frac{1}{8}$  per cent. The market which had expected a reduction of Bank rate from  $4\frac{1}{2}$  to 4 per cent had followed (Chart 48). Mr. Norman was willing to maintain the market rate at  $4\frac{1}{8}$ , and had even thought of raising it to  $4\frac{3}{8}$ , but the ability of the Treasury to sell treasury bills would be endangered if the margin between Bank rate and market rate became too slight.

6) Mr. Norman sincerely believed he could not raise the Bank of England rate by a full one per cent, the customary practice, without provoking an uprising in England. The British banks had

immobilized 54 per cent of their assets in loans to industry which could not do without these credits even if Bank rate went to 10 per cent. And the banks would not lend more even if Bank rate went to 2 per cent. Paris could force the Bank of England to raise its rate, but he would not raise it on his own responsibility alone. Perhaps in a few weeks a different psychological situation would permit him to do so.

7) If the Bank of France took gold from the Bank of England it would not thereby restrict credit in London, for the Bank of England would return the sterling to the market. Such purchases would reduce the proportion of the Bank and threaten the gold standard in England.<sup>28</sup>

M. Moreau summed up Mr. Norman's position as follows: he would not raise the Bank of England rate, he was not inclined to press Dr. Schacht to raise the Reichsbank rate, and French purchases of gold in London would endanger the gold standard in Great Britain.

M. Moreau replied to Mr. Norman that the French gold purchases had already modified the speculation in the franc and that he did not wish to seem to abandon them. He therefore intended to continue to buy gold in New York, and in order not to inconvenience Mr. Norman requested him to buy for the Bank of France all the gold that came into the free market in London. Since none was coming forward the next week, he expressed a wish to take a further million or half million pounds in gold from the Bank of England on the day following any exceptionally heavy offer of foreign exchange to the Bank of France.

Finally M. Moreau and Mr. Norman agreed on a program of cooperation to control and defend both markets, to coordinate British and French interests on the war debt and reparation questions, and to restore the finances of various European countries.

Though the technical officials of the Bank of France continued to press for gold purchases in London to tighten that

<sup>28</sup> Cf. Ch. 19, Bank Rate and the Defense of Sterling.

market, M. Moreau felt more strongly inclined after this interview to exercise moderation, not to throw the pound sterling to earth, and, incidentally, to avoid further reproaches from America. This conversation was in fact the immediate forerunner of a vitally important conference of central bankers in New York which enlisted American cooperation in the program of diverting French gold demand from London, and relieving London of other pressures.<sup>29</sup>

During the rest of 1927 and the first six months of 1928 the Bank of France bought gold steadily abroad. Mr. Hawtrey estimates its purchases between December 1926 and June 1928 at 7 milliard francs.<sup>30</sup> The item 'divers' in its balance sheet grew from 5,010 million francs on December 30, 1926 to 26,551 million francs on December 29, 1927. The total increase in its foreign exchange holdings during the de facto stabilization was first revealed in the balance sheet of June 25, 1928 which showed foreign exchange held at 26,529 million francs, in addition to 9,778 million francs in forward contracts carried as a contra-entry.

### The De Jure Stabilization of June 1928 and its Technical Heritage

The foreign exchange holdings of the Bank of France on June 25, 1928 included substantial amounts which it had had to buy to maintain the de facto stabilization immediately after the Parliamentary elections of May 1, 1928. Hopes that stabilization would be abandoned and be replaced by revalorization had been strengthened, and the feeling that national honor was involved in a return to par, which had been so decisive in the basic decisions of British currency policy (cf. Ch. 9), was strong in the highest French quarters. M. Moreau had the greatest difficulty in overcoming this feeling in MM. Poincaré, Herriot, Marin, and Briand, among the Ministers, and Baron Rothschild and M. de Wendel, among the Regents

<sup>29</sup> Cf. Ch. 18, *The Critical Decisions of 1927 in their Inflationary Setting.*

<sup>30</sup> Hawtrey, *op. cit.*, p. 21.

of the Bank of France. The latter two were opposed to de jure stabilization at the de facto rate of 125 to the pound. M. Moreau carried the other Regents with him, however, and even threatened to resign if immediate stabilization were not voted. After a short but severe struggle,<sup>81</sup> the advocates of stabilization were successful. The defenders of revalorization were fighting a rear-guard action, for the French public was already accustomed to the new rates of exchange. The psychological barriers to devaluation arising from the attitude of the large rentier class were weakened. The losses of this class had over many years been gradually distributed by the turnover of the French public debt among individuals. All that remained to be done was to recognize officially an accomplished fact. There was no danger that the new rate could not be held. The stabilization crisis of 1926 had been mild and was already in the past. Government resources were ample for all needs, and no technical obstacle stood in the way of a transition to a gold bullion standard.

#### *The Law and the Conventions*

This transition was accomplished by three Conventions concluded between the government and the Bank of France; the government and the Caisse d'Amortissement; and the Bank of France and the Caisse d'Amortissement—all dated June 23 and all approved by the Law of June 25, 1928.

This law defined the franc as 65.5 milligrams of gold 9/10 fine (Art. 2). It repealed the Law of August 7, 1926 which permitted the Bank of France to purchase gold at a premium and to buy foreign exchange in the open market (Art. 2). It imposed upon the Bank the obligation to buy all gold offered to it at one franc for 65.5 milligrams of gold 9/10 fine, and to redeem its notes in legal tender gold coin or in gold bullion at 65.5 milligrams of gold for one franc, but only at its central office and only in such minimum amounts as were agreed upon by the Minister of Finance and the Bank (Art. 3).

<sup>81</sup> Moreau, *loc. cit.*, April 15, 1937, pp. 824-46.

Until a date to be specified by decree of the Council of Ministers it restricted the right of gold coinage to the Bank of France (Art. 6). It repealed the Law of November 15, 1915 prohibiting the export of gold and other laws preventing dealings in and melting of gold (Art. 12). It ended the unlimited legal tender power of silver coins and provided that gold alone should be legal reserve for the Bank of France (Art. 7 and 4). These provisions legally devalued the franc, ended the long history of the limping standard in France, and placed France upon a gold bullion standard. The law, however, was silent concerning the disposition of the large volume of foreign exchange already held or contracted for by the Bank of France. Because of this remarkable inheritance from the preceding gold exchange standard, the gold bullion standard now established in France was unique. No conventional rubric based solely on the legal arrangements of June 1928 is sufficiently broad to describe fully and accurately the monetary standard of France after her legal return to gold.

The Law of June 1928 also abolished the time-honored system of a legally defined maximum of note issues and substituted the minimum reserve ratio system, requiring that a gold reserve ratio of 35 per cent of its combined note and deposit liabilities be held by the Bank of France (Art. 4), and terminated the various arrangements, beginning with that of December 1920, under which the Treasury accepted deposits from the public (Art. 11).

The Convention between the Bank of France and the government provided for the revaluation of the gold of the Bank of France and certain other of its assets and for the application of the profit to a reduction of the Bank's advances to the Treasury. The relations between the Bank and the Treasury were subjected to a thoroughgoing reform summarized by Mr. Hawtrey as follows:

"Besides the 17,900 millions of advances to the state so designated in the balance sheet, provision had to be made (1) for the debt due by the Treasury for gold withdrawn from the Bank during

the war and handed over to the Bank of England for the purpose of maintaining the American Exchange; (2) for certain bills discounted by the Bank for Russia during the war, amounting to:

	MILLIONS OF FRANCS
Advances	17,900
Gold Debt	1,350
Russian Bills	5,930
	25,180

against this had to be set:

Revaluation of gold, etc.	16,431
Treasury Credit Balance	553
Other Funds of the Treasury	4,346
	21,330

The net debt was thus reduced to 3,850 millions. Nevertheless separate provision was made for the Russian Bills, the Caisse Autonome being made responsible for them. And it was decided that there should be a permanent statutory advance of 3 milliards to the state. The result was that the Treasury acquired a *credit* balance of 5,080 millions. Along with the sinking fund balance of 1,934 millions the public deposits at the Bank of France thus amounted to 7 milliards." <sup>82</sup>

The Convention between the government and the Bank also ended the long established system of temporary advances to the state by the Bank under a legal maximum, for it provided, in Article 8, that the account of temporary advances of the Bank to the government and the account of French treasury bonds discounted for advances of the French government to foreign governments should be 'finally closed' upon the ratification of the Convention.

Finally, this Convention gave the Bank of France power to purchase bills and short term securities for the account of such foreign banks of issue as had opened current accounts

<sup>82</sup> *Op. cit.*, p. 21. These arrangements were all provided for in Art. 1-5 and 7 of the Convention between the government and the Bank. Art. 6 and 10 were part of the series of arrangements that provided for the disposition of the Russian bills.



with it, to guarantee such bills and securities, and to rediscount them (Art. 9). It thus opened the way for the French side of inter-central bank cooperation in the stabilization of the exchanges by allowing foreign central bank operations in the French market similar to those conducted by the Bank of France in London and New York and under similar central bank control. It gave the Bank of France a small measure of initiative in the open market.

Articles 6 and 10 of the Convention between the government and the Bank of France, the Convention between the government and the Caisse d'Amortissement, and the Convention between the Bank of France and the Caisse d'Amortissement jointly provided for the exchange of 5,930 million government bonds held by the Bank, representing advances to Russia, for non-interest bearing three month bonds of the Caisse, and for the allocation to the Caisse of designated revenues for the service of these bonds, including the profits on silver coinage.

Article 3 of the Convention between the Bank and the Caisse explicitly granted a further limited open market power to the Bank. It provided that the Bank should have the right to sell these bonds in the open market "in order to influence the volume of credit and to maintain control of its circulation," and to repurchase them before maturity.

### *The Technical Heritage*

These new arrangements had a profound significance for the subsequent history of the international gold standard. Their salient features in this respect may be summed up as follows:

- 1) The withdrawal from the Bank of France of the right to purchase foreign exchange and to issue notes against it placed the Bank of France in a strategic position with respect to gold imports. As long as it was possessed of 'excess' gold reserves it could purchase foreign exchange and issue notes against this 'excess gold,' thus producing the same effect as if the gold exchange standard still prevailed. It could also re-

frain from such purchases of foreign exchange. If it did so while the French balance of payment was favorable, large increases would accrue to the foreign exchange holdings of private French banks, and the effort of these banks to restore their working balances abroad to their customary relationship to other assets would strengthen the French exchanges and lead to gold arbitrage transactions of the ordinary type. By adopting the purely passive attitude of awaiting the presentation of gold at its counters and purchasing this gold as required by law, the Bank of France could, under these circumstances, accumulate gold on a large scale.

2) Large gold imports could be viewed by France with calm, if not with satisfaction, for they did not represent grave danger of inflation. For in France the small use of checks made possible the absorption of a large amount of gold with a relatively small pyramiding of the superstructure of bank credit, and relatively small additions to the internal means of payment. Gold imports on a large scale would not inaugurate inflationary forces, which, under a differently organized banking system, might have tended to check the gold inflow through their influence on interest rates and prices. If, after the transition to the gold bullion standard, France continued to fail to employ permanently abroad that portion of her international credits available for investment abroad, this homely and familiar phenomenon of French financial organization was certain to be raised suddenly to a position of extreme importance in the whole operation of the decentralized international gold standard system.<sup>88</sup>

3) The new relations between the government and the Bank of France eliminated from the French economy two sources of internal deflationary pressure that had been operative during the period of *de facto* stabilization. The government no longer withdrew notes from circulation by accumulating in its deposits with the Bank of France deposits received by the Treasury from the public, and it no longer permanently with-

<sup>88</sup> Cf. Hawtrey, *op. cit.*, pp. 36 ff.

drew notes from circulation that had been received as part of its general revenues, by using them to repay advances at the Bank of France. However, the assignment of special revenues to the Caisse d'Amortissement was bound to continue to build up Treasury balances at the Bank of France as long as the reduction in the floating debt did not proceed *pari passu* with the receipt of revenue earmarked for that purpose. This, in fact, proved to be the case for some months after stabilization. A technical factor therefore remained in the French money market well calculated to force French private banks to bring gold to the Bank of France for the replenishment of their balances, or looked at from the other point of view, to prevent gold imports from expanding the circulation.<sup>84</sup>

4) Furthermore, the peculiar organization of the French savings bank system produced a 'circuit flow' of notes from the savings banks to the Caisse de Dépôts and from thence to the rentier and to the savings banks again, and a lock-up of notes held by the Caisse de Dépôts against its liabilities. Both would increase with an increase in French savings.<sup>85</sup>

5) If, in spite of the forces tending to minimize the internal effects of large gold imports into France and the desire of the Bank of France to strengthen its position, considerations of an international character should lead the Bank to endeavor to reduce gold imports, the extreme limitation of its open market powers deprived it of a major weapon for so doing. It could not, by open market purchases of securities, offset the drain upon the note circulation resulting from the accumulation of government deposits and thus eliminate a powerful motive for gold imports; nor could it by the same means so reduce interest rates as to encourage foreign borrowers and discourage foreign lenders and thus lessen the pull of the franc on the exchanges.

6) The Law of June 25, 1928 was silent concerning the treat-

<sup>84</sup> Cf. Thomas Balogh, 'The Import of Gold Into France,' *Economic Journal*, Sept. 1930, pp. 442-60, especially pp. 448-52.

<sup>85</sup> *Ibid.*, pp. 450-1.

ment of the stock of foreign exchange already held by the Bank of France, but its intent was interpreted as requiring the Bank to dispose of additions to its foreign exchange holdings accruing after the law was passed through the maturing of foreign exchange forward contracts. The maturing of these contracts—amounting to over 9 milliard francs—meant that immediately following June 1928 part of the French favorable balance of payments continued to be remitted in the form of acquisitions by the Bank of France of foreign exchange against which notes were issued. It prolonged in fact the technical situation of *de facto* stabilization. The decision not to retain these added foreign exchange supplies led subsequently to the sale of a part to the government, reducing government balances at the Bank, but adding to the power of the Treasury in the foreign exchange markets, and the conversion of the rest into gold. This conversion was postponed until the first half of 1929, and brought France into the world market for gold at the height of the final phases of the American stock market boom, not because of the then existing composition of the French balance of payments, but because of the technical completion of the transition decreed in June 1928 from the gold exchange to the gold bullion standard.

7) Finally the Law of June 25, 1928 was not interpreted to mean that the Bank of France could not continue to hold, including in that phrase the right to replace maturing items, the foreign exchange actually acquired before that date. This meant that the French pull over the world's gold supplies was not compulsorily increased by conversion of pre-stabilization as well as post-stabilization acquisitions of foreign exchange. On the other hand, no legal compulsion was placed upon the Bank not to sell its exchange, and as long as it was held, it gave the Bank of France a great power in London, New York, and other markets, and a large potential supplementary call upon gold over and above that accruing from the current favorable balances of French international accounts.

## CHAPTER 16

### *The Consolidation of the Gold Standard in Germany, 1924-1928*

Like the position of France after the de jure stabilization of 1928, the relation of Germany to the international gold standard after 1924 cannot be adequately described under conventional rubrics such as the gold bullion or gold exchange standard.

#### The Four Major Principles of Post-War Stabilization as Applied to Germany

In Chapter 12 it was shown that the German stabilization program of 1924 embodied, in addition to the settlement of past debts, four great principles of post-war stabilization theory:

- 1) the direction of foreign capital to capital-poor countries
- 2) the adoption of measures of gold economy
- 3) the determination to safeguard the independence of central banks
- 4) the resolve to stop inflation.

The application of these principles to Germany, a world economic power of the first order, highly industrialized but denuded of free or working capital and subject to an extraordinary external political debt, was unique in gold standard history. In the practical test of German life all four principles changed in meaning and relative importance.

#### *The Principle of Attracting Foreign Capital*

The greatest weaknesses of the purely internal German currency stabilization of the winter of 1923-24 were that it did

not directly provide foreign resources to support the mark or the means of replenishing the depleted working capital of Germany. The introduction of the rentenmark was the agency through which the fact of a shortage of working capital was first disclosed to business and agriculture. It was followed by a depression which disclosed the true intensity of the demand for liquid funds as well as the difficulties of the German banking system in meeting it. Consequently the Reichsbank was obliged to meet the first shock of this depression, but the expansion of its credits threatened to develop into a new inflationary movement fatal to the stabilization plan. This was checked by the credit restriction of April 7, 1924, the third of the great refusals of credit which were the technical basis for currency stabilization in Germany. In consequence, the underlying weaknesses of German banks and enterprises, as disclosed in their new balance sheets, once more made themselves felt in renewed depression.<sup>1</sup>

The great strength of the Dawes Plan, *as a stabilization measure*, was that it did attract foreign capital to Germany, and therefore for the time being solved the German balance of payments problem, supported the reichsmark, and gave Germany liquid capital for the development and reorganization of her productive powers. The long run economic significance of these capital imports for Germany has been summarized by J. W. Angell at the close of his book, *The Recovery of Germany*. Writing in 1929, he surveys the history of the preceding years as if standing in mid-stream of an economic process requiring a quarter of a century for its fulfilment, to which the four years of capital imports initiated under the Dawes Plan were only an introduction. In the course of his discussion of German foreign trade he says (pp. 355-6) :

“. . . it is extremely unlikely that a lasting surplus of the neces-  
<sup>1</sup>Cf. Ch. 12, *Political Economics*, 1919-1924; also C. T. Schmidt, *German Business Cycles* (National Bureau of Economic Research, 1934), p. 28; references in this chapter to German business conditions are largely based on this monograph.

sary size [to meet reparation payments and charges on foreign capital] can be developed in the near future. A transition period, of perhaps 20 or even 30 years if things move slowly, must intervene. This seems the more probable when one recalls that Germany's exports, and indeed her production in general, are dependent to an unusually high degree on prior imports of raw materials and foodstuffs. Except at the price of diverting current production from the domestic markets to exportation, and thus reducing the domestic standard of living, exports cannot be increased without also increasing imports, though of course in lesser degree. Nor can imports be reduced without reducing exports much more than in proportion, except by lowering the living standard and except with respect to the narrow range of manufactured goods which fall in the import category. It follows from this that a sustained absolute increase in the volume of exportation can bring only a less than proportionate increase in these exports *relative* to imports. . . .

In this critical transition period, how can [Germany] make the large and sustained volume of payments to other countries which will be necessary?

Clearly she must continue to do what she has been doing since 1924. By the sale of securities and tangible property and the negotiation of short credits abroad, she must obtain in other countries the funds required to meet all the current foreign obligations which her own commodity and service exports are inadequate to offset. Even apart from the need of such capital imports to carry out her ambitious programs for further internal expansion, there is no other way in which the international deficit itself can be met. In other words, during these years Germany's capacity to *pay* abroad will be determined largely by her capacity to *borrow* abroad, or to secure the necessary funds from foreign countries in other ways. As time goes on, a steadily larger part of the total payments will come from her own production and sale of goods and services, but the critical remainder must be derived from further importations of capital."

Attraction of foreign capital on this scale and for such purposes was different from the attraction of foreign capital as part of a currency stabilization scheme. It was, it is true, a

difference in degree, but one so great as to constitute a difference in kind, for it involved immense economic problems concerning the development of the necessary markets for German exports and the sources of prolonged and large scale foreign lending.

Like all capital imports, this inflow into Germany had to be mediated to the German economy through the German banking system, and the manner in which it was so mediated profoundly modified the other principles of stabilization; gold economy, the independence of the central bank, and the resolve to stop inflation.

### *The Principle of Gold Economy*

The legal form of the gold standard adopted by Germany in October 1924 was that of the gold exchange standard. The restriction, however, of the proportion of foreign exchange to gold in the composition of the legal reserve of the Reichsbank to one-quarter, and the very strict definition of the types of foreign assets that could form part of that reserve indicated that gold exchange was not expected to be permanently of much greater importance in the operations of the Reichsbank than it had been in pre-war days.<sup>2</sup>

The obligation to redeem its notes in gold or foreign exchange was suspended in the 1924 stabilization and did not in fact become legally binding until the Young Plan went into effect in 1930. In practice, however, the Reichsbank did redeem its notes in gold or foreign exchange upon demand from 1924 to 1930, but by its own operations it dominated the foreign exchange market and therefore controlled the conditions under which the right of redemption was exercised. Germany, in fact, continued, after October 1924 as before, to be a country with a pegged exchange. As part of the operation of pegging, the Reichsbank stood ready to buy and sell foreign exchange at the fixed price of 4.20 reichsmarks

<sup>2</sup> The average foreign exchange holdings of the Reichsbank from 1905 to 1913 were about 140 million marks or \$33.3 million (*Blessing, op. cit.*, p. 4).



to the dollar until August 23, 1926. Thereafter it bought and sold at prices determined in part by market fluctuations but it retained sufficient control to fix the limit of those fluctuations. Dr. Bruins has described the attitude and practice of the Reichsbank toward the redemption of its notes during these years:

"As regards delivery of gold, although it was not yet legally bound to exchange its notes into gold or *Devisen*, the Reichsbank constantly maintained during this period the standpoint that, if the development of the rates of exchange should bring about a legitimate demand for gold, it would not hesitate to make it available. This principle was enunciated several times, *inter alia* in the annual report for 1926. As a matter of fact, such gold deliveries never took place as the Reichsbank satisfied the demand for foreign currencies by delivering *Devisen* at a price under the gold export point. Whenever replenishment of the *Devisen* stock proved to be necessary, the Reichsbank itself carried out the requisite export of gold to foreign countries. The Bank, for instance, acted in this way in the spring of 1929 and also during the past few weeks."<sup>3</sup>

In establishing this control over the foreign exchange market the Reichsbank was directly aided by the Dawes Loan which added to its foreign exchange and enabled it to reconstitute its gold reserves. Other forms of capital import into Germany indirectly but powerfully influenced the Reichsbank's position in the foreign exchange market and contributed directly to building up a great volume of bank deposits in Germany.

When after stabilization German business and agricultural enterprises began to state their balance sheets in terms of gold marks, many had practically no capital other than their physical equipment. In order to carry on current operations they had to borrow either from German banks or abroad. The lending power of the German banks was, however, very restricted. This was revealed by the reconstitution of their own

<sup>3</sup> C. W. J. Bruins, 'The Movements of Gold into and out of Germany since 1924,' *Selected Documents of the Gold Delegation* (League of Nations, 1931), pp. 16-7.

balance sheets. The total assets of 399 private incorporated banks were 31,176 million marks on December 31, 1913, while on January 1, 1924 the total assets of 500 private incorporated banks were only 4,044 million reichsmarks.<sup>4</sup> Very high interest rates at home were inevitable under such conditions, and the alternative of borrowing abroad was not open to all borrowers. There was, therefore, a remarkable shrinkage in the number of business enterprises in Germany during 1924-26. Many German public bodies and strong enterprises did however succeed in borrowing abroad under the joint stimulus of high rates at home, an intense need for capital, and renewed international confidence in Germany. The successful borrowers were then in a position to purchase goods abroad with their newly acquired foreign exchange or to bring it to German banks for reichsmark deposits. The banks themselves were able to offer high interest inducements to foreign depositors, who were attracted to Germany in large numbers—so large that in 1928 foreign deposits were 45 per cent of the total deposits of all German commercial banks. In addition the German banks began to arrange new acceptance credits abroad for financing German foreign trade, and even, under the form of reimbursement credits, for the provision of work-

<sup>4</sup> Madden and Nadler, *International Money Markets* (Prentice-Hall, 1935), p. 364. The principal assets and liabilities of these banks are given in the *Statistische Jahrbuch fuer das Deutsche Reich* for 1929 as follows:

*Some Balance Sheet Items of Private Incorporated Banks (millions of reichsmarks)*

<i>Assets</i>	<i>Dec. 31, 1913</i> <i>(399 banks)</i>	<i>Jan. 1, 1924</i> <i>(500 banks)</i>
Checks and Bills	3,743	227
Due from Banks and Bankers	965	784
Securities	1,320	275
Loans and Current Accounts	10,209	1,360
Long Term Loans	12,237	145
<i>Liabilities</i>		
Capital	4,158	1,131
Surplus	986	268
Creditors	10,708	2,208
Acceptances	2,637	8

ing capital within Germany. From all these sources the German banks' holdings of foreign exchange and the deposits of the borrowers and of foreigners were increased. Part of this foreign exchange was retained as a reserve against foreign deposits.<sup>5</sup> Part was sold to importers whose accounts were charged, the total effect of the foreign borrowing and the payment for imports being to offset the deflationary effect of the latter (cf. Ch. 4). Part of it was sold to the Reichsbank to help provide for a steady increase in the note circulation from 1924 to 1928, and to build up the reserves of banks as a basis for new credit extensions. Private borrowing abroad thus strengthened the reserves of the Reichsbank, but as long as the central institution continued to hold the exchange within gold points, the private banks were in a position to reverse this process by buying foreign exchange from it when the reichsmark was weak.

This situation meant that the Reichsbank was brought into possession of a fund of foreign exchange whose size was a function first, of the amount of foreign exchange accumulating in the hands of German banks as a whole—that is, of the German balance of payments; second, of the decision of these banks concerning the proportion of this total they wished to hold as working balances abroad. The decision as to what portion of this fund would be imported into Germany in gold was in the first place a function of the size of the legal reserve the Reichsbank decided to hold. Up to 1927 this was less than it would have been if the Reichsbank had decided to convert all its foreign exchange either into gold or exchange available for cover, for on December 31, 1924 it held 1 milliard reichsmarks and on December 31, 1925 500 million reichsmarks in foreign exchange outside its legal reserve. In the second place, the amount of gold imported was a function of the proportions in which the Reichsbank wished to hold gold and foreign exchange in its legal reserve. When the Reichsbank was rapidly gaining foreign exchange be-

<sup>5</sup> Madden and Nadler, *op. cit.*, p. 396.

tween October 1924 and the end of 1926, it pursued a steady policy of strengthening its reserve and bought just enough gold to maintain the legal proportion. When in 1927 it was losing foreign exchange it kept the gold in its reserve and parted with devisen. When gold began to reach Germany again in 1928, the previous proportion was not restored. Until 1928, moreover, all gold imports were made by the Reichsbank which was free to choose the market from which they were to be taken.

The demand of Germany in the world's gold market after 1924 was thus only an indirect reflection of its total balance of payments position. It was modified as to amount, timing, and distribution by a series of commercial and central banking decisions within Germany.

#### *The Principle of the Independent Central Bank*

The inflow of foreign funds into Germany contributed to the strong position of the Reichsbank in the foreign exchange market, but only at the cost of weakening its position in the home market, for it gave German banks a means of access to central banking credit that was independent of Reichsbank control. When faced with the choice of borrowing from the Reichsbank at high rates or borrowing more cheaply abroad and selling foreign exchange to the Reichsbank, banks and industrial concerns took the latter alternative. This was especially true up to August 1926 when no exchange risk was involved in reversing the operation. When foreign markets lost confidence in Germany and foreign funds were withdrawn the Reichsbank could make its rate effective by rationing credit and forcing would-be borrowers to bring to it part of their foreign exchange; but when foreign funds were flowing to it the Reichsbank lacked the means of offsetting the resulting increase in its credit and thereby making its rate effective. Its own funds available for operating in the market were limited, partly because the clearing balances of the commercial banks were smaller than before the war; partly because,

for some years after stabilization, the large public funds of Germany were not effectively concentrated at the Reichsbank where their administration could be coordinated with credit policy;<sup>6</sup> and partly because of the application to Germany of the Genoa principle of the independent central bank. The Dawes Plan restricted the advances of the Reichsbank to the state, and its open market powers in order to protect it from the demands of the government, but these safeguards also prevented the accumulation of a portfolio that could be sold in case of need to tighten the market.

### *The Principle of Stopping Inflation*

Under the Dawes Plan the Reichsbank had been made independent of the one influence that in all the immediate post-war discussions had been considered the single great threat of inflation—the covering of budget deficits by direct or concealed borrowing from the central bank by government. It had in consequence been deprived of adequate weapons against an inflationary influence of an entirely different sort—the creation of a vast superstructure of bank credit based on an inflow of foreign funds. This was not the inflationary threat of the immediate post-war days, but it was not new in the world's history after 1914. It had been dominant in the period of war finance itself in many countries, as shown in Chapters 3 and 6, in which the relation of war-time lending to the crisis of 1919–20 is suggested. The inflationary enemy in Germany during 1924–28 was of a similar character, and the dangers to which it exposed the world economy were equally great. The inflow of foreign funds into Germany after 1924, moreover, was a far less simple phenomenon than the international flow of war-time credits. Its division into long and short term credits, the unequal intensity of its flow, its sensitivity to changing psychological attitudes, and the geographical distribution of its sources all profoundly modified the influence it had on the German economy. It was re-

<sup>6</sup> For these aspects of the Reichsbank's position, cf. *ibid.*, pp. 382–7.

lated in a complex way to the periodical efforts of Germany to meet inflationary situations of quite different surface characteristics. These relationships can be brought out by a brief historical summary of some of its phases.

### The Conflict between Control of the Foreign Exchanges and Control of the Home Market, 1924-1926

C. T. Schmidt has summarized the characteristics of the inflow of capital into Germany in late 1924 and early 1925 in his *German Business Cycles* (p. 32):

"During the autumn of 1924 there were reports of contract after contract for loans and for sales of interests in business organizations. In addition, a multitude of unrecorded agreements were concluded and there were considerable sales of securities on the stock exchange to foreign capitalists. Furthermore, the increased discounting of bills of exchange and the acceptance of drafts by bankers in England and the United States added considerably to German borrowings abroad.

According to the Institut für Konjunkturforschung the total of foreign loans extended to Germany by the end of 1924 amounted to approximately 1,200 million Reichsmarks. Loans during the first four months of 1925 more than doubled this total. Although short-term foreign loans were discouraged by the Reichsbank and the financial administration, because of the dangers that would attend their sudden withdrawal, a large volume was extended."

This borrowing was a natural result of the shortage of working capital in Germany, and the limited capacity of the German banking system to extend credit as revealed by the new balance sheets. In combination with the Reichsbank's own limited desire and capacity to extend credit, this situation produced an extraordinary differential between German interest rates and rates abroad. Once confidence was restored the German banks found themselves in possession of an extraordinary deposit-attracting power,<sup>7</sup> and German public

<sup>7</sup> In less degree they possessed such a power before the war when foreign deposits were regularly placed in Germany to take advantage of relatively high interest rates. The dangers of this situation were revealed even then in

bodies and private enterprises were given an unusual capacity to attract foreign investors.

The first large influx of foreign funds relieved the tension under which the German economy had been laboring. The Reichsbank credit restriction policy was gradually relaxed. Deposits were built up at the commercial banks and loans became available for longer terms. Savings deposits began to accumulate. Stock exchange prices, which had been depressed after stabilization, rose, and the indexes of production and trade increased during the autumn of 1924 and the spring of 1925. Exports were increased,<sup>8</sup> but with reviving industry imports were increased more than in proportion and the trade balance was unfavorable. Unemployment was considerably reduced.

Foreign loans to Germany continued large throughout 1925, but after the initial inward movement many were issued to refund earlier short term advances. New foreign funds therefore declined in volume. The effect upon the German economy is thus described by Mr. Schmidt (pp. 36-7):

" . . . when foreign advances declined, or amounted largely to conversions of previous loans, German borrowers were unable to turn to supplies of domestic capital. The issue of stocks in the face of a weakened stock market was difficult, and the demand for bonds was so slight in 1925 as also to make their flotation inadvisable.

Enterprises that needed credit, therefore, had to resort to short term borrowing. Demands for funds overwhelmed the banks. The desire to preserve liquidity caused them to turn down fresh demands for money and even to call older loans, especially smaller advances. Banking policy was rather more lenient with larger debtors than with smaller. A restriction of credit advances to the larger organizations would at once have resulted in the abandonment of large projects and the dismissal of many workers.

time of crisis; for example, when 1 milliard French francs were withdrawn from Berlin during the Morocco crisis of 1911.

<sup>8</sup> The Macmillan Report was of the opinion that the mark was slightly undervalued by the stabilization of 1924 (p. 51).

Credit retrenchment, then, was made possible by recalling medium and small loans.

In the autumn of 1925, since it was almost impossible for industrial and commercial organizations to consolidate debts, they had to seek short term loans from the credit banks. As it became more and more apparent that repayment would be difficult, the banks, afraid of frozen credits, pressed for settlement and restricted further loans. This, of course, made the situation all the more tense."

During this depression, which reached its lowest point in February 1926 and was marked by declining production, increased unemployment, more business failures, and a check to the decline in interest rates, Germany turned to rationalization of industry and to an effort to make herself more nearly self-sufficient in agriculture. Imports of raw materials and semi-manufactured goods were reduced, but even so the trade balance continued unfavorable. A breakdown of the Dawes Plan seemed probable. Dr. Bruening, in his summary of his Lowell Institute Lectures, delivered in Boston in the winter of 1935-36, paints the picture of this period:

"By intensification of agriculture with the help of science [Germany] cut down imports to the detriment of countries living largely on their agricultural exports. At the same time industry was modernized, huge combines were founded to foster German industrial exports, and so by a surplus in the German balance of payments to be able to meet the reparation transfer. But these gigantic efforts led only to a very gloomy outlook in 1926. It looked as if the inevitable crisis in Reparations, at least as regards their transfer into foreign currencies, was bound to come only two years after the start of the Dawes Plan."

Relief from these economic stresses came in 1926 through a remarkable combination of events which was of first importance in determining Germany's relations to the international gold standard system, and therefore in determining its whole subsequent history. German internal recovery was promoted by the reorganization of industry which eliminated



most of the weak business units left over from the inflation. The factors leading to recovery usually present at the turn of a business cycle were also at work, and the internal credit position was eased somewhat by the final termination of the Reichsbank's credit-rationing policy in December 1925, and by a vigorous effort to fund short term internal credits, in which the aid of the Gold Discount Bank was enlisted.<sup>9</sup> The two factors mentioned by Dr. Bruening helped to turn an unfavorable into a favorable trade balance, and in this Germany was aided by French de facto stabilization which ended the long continued progressive depreciation of the franc.

Far more important, both for the development of the German economy and the support of the exchanges, than any of these factors were two dominating external influences—the British coal strike and the resumption of the inflow of foreign capital. It is difficult to exaggerate the effect of the British coal strike upon Germany. It led to new employment and optimism and gave the impetus for an extremely rapid acceleration of rationalization throughout German industry. In the coal fields old pits were closed and new ones opened with the newest machinery. The iron and steel industry profited directly and the feeling that enduring prosperity was finally within reach spread to all industry. The new and sustained outburst of activity obscured the fact that the prosperity was promoted by temporary causes and that the tremendous pace of rationalization was producing technological unemployment which increased production costs by raising local taxes at the same time that they were steadily being increased by the high cost of the borrowed money with which rationalization was financed. The industrial recovery encouraged optimistic views of public finance which ultimately led to increases in the salaries of civil servants to match increases in trade union wages granted by industry.

<sup>9</sup> The Gold Discount Bank in 1926 borrowed short term funds and bought 7 per cent agricultural mortgage notes of the Deutsche Renten Kreditanstalt; Madden and Nadler, *op. cit.*, p. 389.

The renewed inflow of foreign funds, which largely financed the accelerated rationalization, was itself the second major element in the German recovery. It gave the first impulse to the recovery from the depression of the winter of 1925-26. It made possible the funding of German debts and lightened the burden of German banks. It helped to reduce interest rates. The average rate for three months money in Germany for the entire year 1925, as given by Madden and Nadler, was 9.13 per cent and for 1926, 6.58 per cent, while the differential between German and foreign rates was 5.39 per cent in 1925 and 2.65 per cent in 1926. Domestic and foreign demand for German securities increased and stock market prices rose, and the capacity of the market to absorb new issues increased, though long term interest rates still remained relatively high.

For reasons already given the inflow of foreign funds, which produced this expansion of credit within Germany, left the Reichsbank technically out of touch with the market. The discount rate became ineffective as a weapon of credit control and the Reichsbank became aware that the true enemy to its independence was no longer the German government, but the dependence of Germany upon foreign capital for her economic development. In August 1926 it tried to regain part of its independence by ending the formal pegging of the mark so as to introduce an element of exchange risk into the operation whereby it was used as an agent in credit operations in which foreign lenders and German banks and industries were the principals, but this was not enough to restore its control over the domestic market.

From 1924 to 1926 therefore the Reichsbank found it difficult to reconcile its duty to control the foreign exchanges, to which it was bound by the Dawes Plan and to guarantee the performance of which it was subjected to foreign supervision, and its duty to control the domestic market, to which it was impelled by all the considerations of banking policy and long

run economic responsibility that underlie the institution of central banking itself.

### The Retreat from the Principle of Stopping Inflation, 1927-1928

During the first six months of 1927 German economic recovery became more and more widespread, but the inflow of long term capital from abroad was sharply restricted. This was partly due to the concentration of French funds seeking employment abroad in the hands of the Bank of France and their utilization in substantial amounts to repay credits in England and to buy gold. This diminished one potential source of long term capital imports into Germany. At the same time some restraint was exercised by prospective German borrowers abroad because the non-productive use of the proceeds of some of Germany's foreign loans and the growth of public expenditures were causing uneasiness in Germany. The main reason, however, was that it was becoming easier to borrow at home. The domestic capital market was reviving, and this revival was actively encouraged by the authorities. From December 1926 to June 1927 the exemption of German securities placed abroad from the prevailing 10 per cent tax on the yield of capital was withdrawn, and on January 11, 1927 the Reichsbank reduced its discount rate from 6 to 5 per cent in harmony with generally easier money rates in Germany.<sup>10</sup>

The improvement in the domestic capital market became pronounced in the spring of 1927 and had a rather complicated effect on the German balance of payments. While long term foreign borrowing was curtailed, foreign short term funds were attracted to Germany for speculative employment on the Bourse, and there was also a counter movement of short term funds outward on account of the fall in the interest

<sup>10</sup> Cf. League of Nations, *Course and Phases of the World Economic Depression*, prepared by Bertil Ohlin (rev. ed., Geneva, 1931), pp. 33-4; also R. R. Kuczenski, 'American Loans to Germany,' *Foreign Investments* (Harris Foundation Lectures, University of Chicago Press, 1928), p. 173.

differential. German money was seeking employment in London and Paris early in 1927, and German investments abroad were increasing. The net movement seems to have been away from Germany. At the same time the balance of trade became adverse because of increased imports incident to the rising activity of business. The reichsmark was consequently weak and was prevented from reaching gold export point only by large offers of foreign exchange from the Reichsbank's portfolio.

The Reichsbank did not allow these losses of devisen to have their full deflationary effects within Germany, but offset them by increasing its bill portfolio,<sup>11</sup> so that the speculative activity first financed by foreign funds was carried on by domestic credit expansion. This was an important but temporary phase in the progress of inflation in Germany. The outward movement of capital was not wholly without influence upon the German market. Combined with a continued domestic demand for capital, it soon reversed the downward trend in interest rates, and this in turn called forth a fresh inward movement of short term funds. At the same time speculative opportunities on the stock exchange attracted foreign purchasers of German securities. The boom conditions increased the danger of later sudden withdrawals of foreign investments and through their general influence on prices threatened to react unfavorably on the trade balance. The old dilemma of the Reichsbank, set forth in the preceding section, had to be faced in an acute form. Being unable to check speculation by drastic rate increases without further attracting foreign capital, the Reichsbank, in May 1927, brought about a sharp reaction in security prices by forcing the banks, by drastic credit restriction, to reduce their loans to the Bourse.<sup>12</sup>

<sup>11</sup> *Report of the Agent General for Reparation Payments*, June 7, 1928, pp. 69-70; cf. Schmidt, *op. cit.*, p. 36.

<sup>12</sup> Madden and Nadler attribute this action to more long run considerations, namely to a desire "to curtail stock exchange speculation and to prevent a rise in prices which would cause reduced exports and increased imports and

Neither the temporary reduction in the inflow of foreign funds nor the subsequent check to speculation on the Bourse seriously interrupted the development of the general movement of rationalization and industrial expansion in Germany. The demands of private borrowers and continued borrowings by public bodies still required more capital than the German market could supply. Interest rates continued high and conditions were still favorable for a revival of long term foreign borrowings and a continuation of the inflow of short term foreign funds.

This was a turning point for German finance, and therefore for the international gold standard system. The economic alternatives to the building up in Germany of an ever increasing credit superstructure upon an increasing but ever less solid foundation of borrowed capital were first, to stop the inflow of foreign credits both long and short, and second to fund a substantial portion of the short term credit already in existence. If the spurious prosperity induced by the optimistic view of the possibilities of rationalization following the British coal strike had not taken so deep a hold on the imagination of the German people, or if the Reichsbank had not offset in large part the deflationary effect of its losses of foreign exchange, it is possible that the crisis of 1927 might have forced a suspension of reparation payments under the transfer protection provided by the Dawes Plan. The actual course of events was that foreign capital began to flow into Germany again early in the summer of 1927. Abundant supplies of foreign exchange were offered to the Reichsbank, and there was no crisis in the Dawes Plan. In the light of subsequent events the fact that a major reparation crisis was not allowed to develop at this time must be regarded as a catastrophe.

During the first six months of 1927 credit in Germany, as measured by new capital issues and private bank deposits, actually increased rapidly. After a long delay, attributable to pressure on the foreign exchange of the Reichsbank" (*op. cit.*, p. 385); cf. Ch. 15, The Moreau-Norman Conversations of May 1927.

its unwillingness further to encourage the inflow of foreign funds, the Reichsbank finally raised its rate from 5 to 6 per cent on June 7, 1927 and on October 4, 1927 to 7 per cent. These increases, however, did not influence credits in general, which continued to expand throughout 1927 and the first half of 1928. During the latter part of this period Reichsbank credit was made available to the banks in the form of payments for gold and devisen, rather than through increases in the Reichsbank's portfolio of bills. Until the spring of 1928, when there was a recession to about the levels of early 1927, business in Germany, in the words of the Agent General for Reparation Payments, continued to display an activity "entirely characteristic of a period when large supplies of fresh funds were available for production and consumption."<sup>18</sup>

On October 20, 1927 the Agent General for Reparation Payments addressed a note to the Reich government complaining that the rising tide of public expenditure was giving an artificial stimulus to economic life and threatened to undermine the essential stability of the public finances. The efforts of the Reich to remedy this situation took various forms, chief among them intervention to control the foreign borrowings of states and communes. Such borrowing had, since 1924, been subject to the approval of the *Beratungstelle* and in October 1927 that office suspended its activities until it could review its policy. Not until May 1928 did it again approve applications for foreign loans, and then only in accordance with a carefully worked out general plan. Publicly controlled enterprises, however, still had access to foreign markets and no steps were taken by the Reich to curtail the foreign borrowing of German private industry and commerce. The short term foreign debt was larger in May 1928 than in December 1927, and more foreign loans were placed between these two dates than in any previous corresponding period.

<sup>18</sup> *Report of the Agent General for Reparation Payments*, Dec. 10, 1927, p. 92. This description applied to the end of 1927, but remained apt for the beginning of 1928.

The conclusion to be drawn from this record is inescapable. In 1927 and 1928 the stabilization principle of stopping inflation was applied in Germany in so intermittent and half-hearted a way as to constitute a retreat from the principle itself.

### The Approach of the Acid Test of the Principle of Attracting Foreign Capital, 1928

In 1928 the maximum Dawes Plan annuity of  $2\frac{1}{2}$  milliard reichsmarks was to go into effect, and with it the machinery of the Prosperity Index. This meant not only that an increased annual burden of 750 million reichsmarks would fall upon the German budget, already in a precarious position, but also that the surface prosperity of Germany would probably carry the Prosperity Index to a point where even greater payments would have to be made. Even under boom conditions such an increase in payments might have led to a breakdown in the Plan, or at least of its transfer possibilities.

These circumstances added great weight to the arguments advanced in his Reports by the Agent General for Reparation Payments in favor of a final agreement upon the total of reparation. If compensated for by putting the annuities in a form suitable for commercialization, some reduction in the annuities of the immediate future began to appeal to the creditors as possibly in their own interest. At the same time the German government was pressing for rapid evacuation of the Rhineland, and in August 1928 it was made clear to Stresemann by the French that the whole question of evacuation was inextricably bound up with reparation.

Both Germany and her creditors had strong reasons in 1928 to desire the negotiation of a final settlement. The general optimism of the time made it seem safe to envisage the dropping of transfer protection, especially if annual payments were to be reduced. The dropping of transfer protection, in fact, seemed to have certain positive advantages to the creditors. The Agent General, for example, held that transfer pro-

tection freed German officials from some of the consequences of their own acts while uncertainty concerning the total of the reparation to be paid removed the incentive to financial reform.

The general optimism also kept alive the conviction that Germany would eventually develop, with the aid of foreign borrowing, export surpluses sufficient to provide real and ultimate payment of reparation. This assumption was one of the greatest of all post-war illusions. In the summer of 1928 the first unmistakable signs of a new economic depression were beginning to appear in Germany,<sup>14</sup> and, though foreign loans continued, the sources of the inward movement of capital were actually beginning to dry up.<sup>15</sup> In addition, the most glaring weakness of Germany's international position—her continued large short term indebtedness—had not been remedied.

The inflow of acceptance credits had come largely from London and the temptation to use them more and more to provide working capital had been strong, and had not been resisted. The advances obtained from American banks had been largely in the form of deposits and other short term credits to German banks, and these had been reinvested by the German banks in long term commitments, including even municipal housing and similar projects. The dangers were obvious, and there is reason to believe that both English and American bankers and German borrowers were willing and even anxious to put part of these credits in funded form as early as the summer of 1927. Had credits then been refunded on a large scale the first shock of the withdrawal of foreign funds in later crises would have been much less. Purely economic considerations, however, militated against large scale refunding at a moment of exceptionally high interest rates, and in addition strong political motives prevented effective

<sup>14</sup> Schmidt, *op. cit.*, pp. 47-8; cf. also Ch. 25, The Acid Test of the Stabilization Principle of Attracting Foreign Capital.

<sup>15</sup> Cf. Ch. 22, The End of De Facto Cooperation by the Nucleus.



action in this field. The possibility that a future withdrawal of short term foreign funds might precipitate a crisis in the Dawes Plan and lead to a genuine solution of the reparation problem without any violation by Germany of the provisions of the Plan was distinctly attractive to some minds in Germany. The cooperation of the tax experts of all parties in the Reichstag in levying even unpopular taxes in order to make sure that a Dawes Plan crisis, if it developed, should not be laid to the door of Germany is to be explained on this ground.

It was therefore with all danger signals flying that Germany, in 1928, approached the acid test of the stabilization principle of attracting foreign capital.

#### Modification of the Principle of Gold Economy, 1928

In 1928, also, Germany completed, in the main, a transition from the gold exchange to the gold bullion standard. The various steps in this transition were technically significant in the development of the mutual relations of the center countries, Great Britain, France, and the United States. The final result had an important bearing on the relation of Germany to the whole international gold standard system in the last years of Experimentation.

As long as the exchange was pegged at 4.20 reichsmarks to the dollar, the recurring autumn weakness of sterling in New York had to be reflected in weakness of sterling in Berlin also, but when the Reichsbank bought gold abroad, it did not buy it in London.<sup>16</sup> With the abandonment of pegging on August 23, 1926 this diversion of German purchases of gold from the London market ended. When, in November 1926, sterling approached the gold export point to Germany the Reichsbank even encouraged a gold arbitrage movement from London by accepting gold in Bremen as well as in Berlin. Furthermore, when the reichsmark was weak early in 1927 the Reichsbank gave up not gold but foreign exchange. The reduction in its devisa portfolio at that time was about one milliard

<sup>16</sup>In 1925 the Reichsbank sold gold to the Bank of England.

reichsmarks. Of this half came from holdings of foreign exchange not counted as part of the bank's legal reserve.<sup>17</sup> This meant that the policy, closely adhered to when the Reichsbank's reserves were being built up, of maintaining the foreign exchange reserve at one-quarter of total legal reserves, was abandoned.

The renewed inflow of foreign capital in the summer of 1927 produced a great change in the foreign exchange market. The reichsmark rapidly gained strength and it looked as if Germany might again appear as a buyer in the London gold market. This, however, did not happen for over a year, largely because of the international conference of central bankers in New York in June 1927,<sup>18</sup> at which Germany was represented. At that conference questions bearing upon the relending to Germany of reparation payments, later elaborated as part of the plans for the Bank for International Settlements,<sup>19</sup> were discussed. Of more immediate importance to Germany was the decision to facilitate the redistribution of gold by diverting demand from London to New York. The adoption of a cheap money policy in America to promote this redistribution was an important factor in encouraging the flotation of German securities in New York and thereby strengthening the reichsmark in terms of dollars. Specifically, Germany's adherence to the program of protecting the London gold market was made manifest by a change in attitude, as compared to the autumn of 1926, toward gold arbitrage shipments. In his Report for December 1927 the Agent General for Reparation Payments wrote (p. 95):

"The decline of the dollar (from August, 1927, on) while it did not reach the point at which it would be profitable to buy gold in New York and bring it to Germany, did approach a point at which it would pay to convert dollars into sterling, buy gold in

<sup>17</sup> Bruins, *op. cit.*, p. 18.

<sup>18</sup> Cf. Ch. 15, The Moreau-Norman Conversations of May 1927, and Ch. 18, The Critical Decisions of 1927 in their Inflationary Setting.

<sup>19</sup> E. L. Dulles, *The Bank for International Settlements at Work* (Macmillan, 1932), pp. 10-2.

London, and bring gold to Germany. *That no such transactions took place* in any substantial sums was owing mainly to the fact that on October 18 the Reichsbank lowered its buying rate for gold from the statutory mint equivalent of 2,790 Reichsmarks per kilo of fine gold to 2,784 Reichsmarks, the lowest point at which it is legally qualified to buy gold."

Thereafter German demand for gold was diverted from London by the relatively greater strength of the reichsmark in dollars than in sterling, which was itself a byproduct of the international consultations of 1927, for it reflected the improvement of the sterling exchange in New York.

As a result of careful currency management Germany succeeded in remaining neutral in the gold markets of the world during 1927. Not until 1928, after it had been remarkably stationary for a year, did the gold stock of the Reichsbank begin to increase. It then appeared that the Reichsbank had once more changed its attitude. It allowed exchange rates to reach the gold import point, so that from then on gold began to reach it through the channels of gold arbitrage carried out by private banks.<sup>20</sup> Because of the faithfulness with which the Berlin exchange reflected the changing relations between the dollar and the pound,<sup>21</sup> the fact that Germany was buying gold in the cheapest market on ordinary gold standard principles, proved to be of great international significance. In the first half of 1928 Germany drew gold from New York, but with the weakening of sterling in the summer the position of the two currencies in Berlin was reversed. By that time London was no longer protected by an international gold redistribution policy, and a steady drain of gold from London to Germany became the most outstanding feature of the bullion market during the last six months of 1928.<sup>22</sup> During this period, however, French gold imports were suspended, for the

<sup>20</sup> Bruins, *op. cit.*, p. 16.

<sup>21</sup> This is admirably brought out in the charts opposite p. 20 of Dr. Bruins' report which is so freely drawn upon in this summary.

<sup>22</sup> Samuel Montagu & Co., *Annual Bullion Letter, 1928*, p. 6.

Bank of France was building up its foreign exchange balances by the maturing of forward contracts (cf. Ch. 15). At no time, therefore, before 1929, was the London bullion market subject to a simultaneous effective demand for gold from both France and Germany.<sup>23</sup>

The import of gold into Germany through gold arbitrage in 1928 also meant that the legal reserve of the Reichsbank was not restored to its former composition of one-fourth foreign exchange and three-fourths gold, and that the Reichsbank did not accumulate large non-reserve holdings of *devisen*. It meant, therefore, that the next unfavorable conjuncture in the international position of Germany would be reflected visibly in a reduction of the Reichsbank's gold reserves. This was in accord with views expressed by Dr. Schacht in October 1926, but not reflected in Reichsbank policy in 1927, to the effect that gold exports, as compared with the delivery of *devisen* in the exchange market, have the advantage of revealing more clearly to the business community the dangers connected with the attainment of the gold point,<sup>24</sup> and that *devisen* represent a double utilization of credit and expose the central bank to a risk abroad as well as to the risk of its inland credits.

By the time the negotiations for a permanent solution of the reparation problem were begun in 1928, Germany had abandoned the stabilization principle of gold economy so far as that principle was represented by the gold exchange standard.

<sup>23</sup> For the importance for Great Britain, cf. Ch. 19, Bank Rate and the Defense of Sterling.

<sup>24</sup> Ch. 10, Establishment of an Apprehension Point.