

GOLD, UNEMPLOYMENT AND CAPITALISM

GOLD, UNEMPLOYMENT AND CAPITALISM

By

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TO
T. D. BARLOW
AND
MY OTHER FRIENDS
IN MANCHESTER

INTRODUCTION

I.

A WELL established tradition dictates, I think, an apologetic attitude on the part of a writer who ventures to confine within the covers of a single book some of those scattered products of his pen which are presumed to owe their existence to his own passing intellectual interest or to the pressing importunities of the flying moment. I recognize, indeed, the difficulty of distinguishing, particularly in the case of one's own past writing, between the merely ephemeral and the presentation, though it may be in summary form, of a point of principle or an analysis of fact, which may still validly claim attention after a lapse of time, either because it is still relevant in the light of after events or because it throws light upon the general evolution of an author's thought. The following eighteen essays and papers, which have been selected out of a mass of material some two or three times as large, have at least this claim upon the reader's attention, (that they deal with subjects which were not only important at the time at which they were written, but which have continued to be important, intellectually and politically, ever since) To some of the issues discussed the passage of time has added a significance and urgency which they did not originally possess. With one exception only, none of these papers is more than eight years old: the solitary exception—the first fruits of an interest in the problems of seventeenth century economic thought which the force of circumstances has prevented me from pursuing—deals with phases of thought more familiar than appears at first sight. For the wheel of thought has come full circle and the Mercantilist theories of employment which are examined in the earliest of these essays are but little removed intellectually from those which are the staple of political and economic debate to-day.

II

It is my friend and former teacher, Prof. Edwin Cannan, who has most strongly insisted on the influence exerted by the external course of events upon the development of English Economic Science and upon the turn given to the intellectual interests of particular writers. I am afraid that I cannot claim to be one of those strong minded and ardent students who devote themselves even from their undergraduate days to the mastery of a particular field of study and who allow neither the changing incidents of their own professional careers nor the pressure of objective circumstance to divert their attention from their chosen task. (My own training was primarily that of an economic historian, though the admirable wisdom of those who framed the regulations of the London degree in Economics has always prevented London historians from being ignorant of economics and London economists from being uncontaminated by contact with the actual facts of economic development. If the late Prof. Lilian Knowles tried to turn me into an historian, I was privileged to acquire, under the inspiration of Prof. Cannan, my first insight into the significance of the economic point of view, although I have never had the privilege of teaching economic history, and have only intermittently had the opportunity of teaching "pure economics". If to my contact with these two great teachers I can attribute my first interest in the problems of economic organization and the history of economic doctrine my first acquaintance with the fascinating problems of currency history and doctrine I owe to Prof. H. S. Foxwell, whose vast stores of knowledge have been so freely put at the disposal of generation after generation of students in London and in Cambridge. I must, however, confess that, much as I owe to the inspiration of my teachers, the bulk of the papers contained in this volume owe their appearance to the chances of my professional career and to the shifting circumstances of the last ten years. In 1923 I first began

to lecture at the London School of Economics upon the subject of banking: that led to my interest in the Federal Reserve System and the first of many happy visits to the United States. In 1926 I was honoured by being appointed Prof. Foxwell's successor and banking and currency problems have ever since that time been in the forefront of my mind. Membership of the Macmillan Committee and an official visit to Australasia were of course intimately connected with the same part of my University appointment. In 1930 the University of Manchester appointed me its Professor of Social Economics: it was at the time when the world depression was beginning to be intense, and when the relationship of the depression to the process of technological change and to tariff policy was becoming widely canvassed. The last two groups of essays in this volume owe their main inspiration to the course which public discussion and national policies have assumed in the last few years.

III

I do not feel that the later sections of this book call for any emendation or comment, though they deal, at any rate in part, with highly controversial matters upon which differences of opinion are not only possible but almost inevitable. Whatever the value of the views and opinions expressed in these sections, I am not conscious of any change of outlook on my part sufficiently profound to make it necessary to refer to it here. The situation is rather different in regard to the first section of this book, which deals with Monetary Policy. Here I am sensible of a change of outlook of some significance; and I venture to summarize my present attitude to the complex of issues involved.

Monetary polemics since the end of the war have gone through three stages: in the first period the main task on the practical side was to protest against the anarchic conditions of the time and to mobilize opinion in favour of a more orderly arrangement of the monetary affairs

of the world, i.e. in the first instance to secure a return to the international gold standard. The main pre-occupation of theory was to frame categories which would permit the phenomena of inflation to be treated as special cases of general principles; hence the contemporary stress on the theory of purchasing power parity and on the twin concepts of income flows and income velocity, i.e. upon the work of Cassel and of Hawtrey. Out of the discussions of this first period there arose a programme of reform of wider scope than the mere restoration of the gold standard, a programme which indeed made it doubtful whether the gold standard might not have to be abandoned. The three main points of the programme can be stated summarily. The object of monetary policy was to stabilize prices; the appropriate instrument of monetary policy was the Central Bank: the minor premise of the programme was that if the retention of the gold standard imperilled stability of prices, it was better to abandon gold and to purchase price stability at the expense of exchange stability. The third stage of monetary polemics is represented by a twofold movement; an attempt to provide a practical programme to meet the situation created by the world depression: on the theoretical side to take account more of the hidden than of the surface factors in the working of the monetary machine. Income flows and income velocity (i.e. the aggregate volume of purchasing power and the rate of turnover of that aggregate) began to be regarded as derivatives of a complicated situation involving the relations between the money rate of interest charged by bankers, the activities of the capital market, the habits of savers and non-savers and the volume of purchasing power made available at each successive phase of interaction between all these forces. Behind all these concrete phenomena of the monetary situation there stalks a ghost—the so-called Natural Rate of Interest, the existence of which is assumed: the *a posteriori* proof of the reality of the Natural Rate being furnished, if furnished at all, by the misbehaviour of the monetary

machine at certain times, this misbehaviour being explained as due to a divergence between Natural and Money Rates of Interest at given moments of time. From theories involving concepts such as these, two utterly divergent practical policies are being deduced at the present time and form the staple of debate between two powerful schools of thought.

This brief summary necessarily does injustice, of which I am acutely conscious, to the march of theory and to the brilliant writers who are engaged in the shaping of thought. It was imperative to say at least as much as the preceding in order that I may make clear how my own mind has reacted to the successive phases of opinion in the last ten years. From the beginning of my interest in these questions, I have been much more sceptical than many of my colleagues as to the practical possibilities inherent in Central Banking (first voiced in the essay reprinted here and written in 1924, *infra*, pp. 161-9 and repeated on many occasions since). But all instrumentalities are defective to a greater or lesser degree: and it has been only gradually that I have abandoned the view that the aim of monetary policy should be the stabilization of prices. What completed the process of conversion in my case was the failure of the Federal Reserve System to hold in check the boom of 1928-9, in spite of the fact that general prices showed a high degree of stability throughout the whole of that extraordinary period. The aims of monetary policy must be stated in more refined terms than those fashionable in the period 1925-9. It does not follow from what has been said that short-run violent fluctuations are not a great evil—they most certainly are, and the object of monetary policy should be to prevent the emergence of those conditions which entail such violent fluctuations as a consequence. The American experience has revealed the fact that approximate stabilization of prices is not inconsistent with the emergence of such conditions.

The conflicts of the moment are not concerned, however, except inferentially, with such long-run questions

as these, but with the issue whether prices should be made to rise by means of a certain type of monetary policy in the *immediate future*. This simple issue apparently leads, even in academic circles, to the most astonishing confusions of thought and even to accusations amounting to a charge of bad faith. Thus it appears to be supposed that anyone who denies that the universal abandonment of the gold standard and the inauguration of a régime of competitive exchange reductions, accompanied by public works expenditure, are the best means of overcoming the difficulties of the moment *necessarily* also believes that prices ought not to rise. It appears to be the case that denial of these propositions is held to be tantamount to adhering to one type of monetary theory, viz. that propounded in recent years by the Viennese School. It appears to be thought, in other words, that there is a real inconsistency between affirming the desirability of a rise of prices and affirming the undesirability of certain suggested means by which this rise of prices can be brought about. It is as if a physician were held guilty of desiring to prevent the cure of his patient merely because he differs from a brother doctor as to the best means by which to effect the cure.

For my own part, I have no hesitation in affirming that recovery from the depression will be accompanied by a rise of prices and that such a rise of prices is desirable. It is perfectly possible, in my judgment, to hold this view coincidentally with the further opinions (1) that the above mentioned devices for attaining a rising price-level are undesirable; (2) that a policy of "cheap money" in the sense of low bank rates of interest on new loans to industry and finance is perfectly consistent with their rejection, and (3) that the trade cycle is nevertheless mainly a monetary phenomenon, in the sense that relatively low rates maintained for too long a time during the upward phase of the cycle encourage investment which no longer pays when interest rates are finally forced upwards, so that, part of the previous investment having become unprofitable, the *de facto* situation

resulting is one of capital maldistribution. It is no part of the case against inflationary methods of reviving trade that they cannot achieve their objects, in the sense that they do not raise prices: of course inflation will raise prices in the long run. But it appears to me to be necessary to distinguish between those rises of prices which take place because business men believe that the wreckage associated with the turn of the tide from expansion to depression has been cleared away and price rises which take place merely because it is expected that the value of money will be driven down, irrespective of whether or not the mistakes committed in the previous boom have been corrected or not. Cheap money in the sense of new loans at low rates between willing borrowers and willing lenders, asked for and granted on a rational calculation of future profits, seems to me to be fundamentally different from the "cheap money" of the inflationists. It is only on the assumption that what maintains the depression is an *absolute lack of purchasing power* that pure inflation is justified; and I do not hold that this particular view is justified. Whilst I am by no means an adherent of the terminology or even of some of the tenets of the Viennese School, I do believe that they are right in thinking that in the course of upward movement of the trade cycle profound modifications in the structure of production take place and that monetary policy or theory cannot be negligent of this aspect in putting forward remedial measures. To carry the argument further, however, would be to contribute another essay to a book which some of my readers may find unnecessarily long. It only remains for me to express some personal obligations. To Mrs. A. Henderson B.Sc. (Econ.), I owe a debt of gratitude for unfailing assistance and advice which I find it difficult to express in words: without her aid many of these papers would never have been written. For permission to reprint the contents of this book I have to thank the Controller of H.M. Stationery Office, the Rt. Hon. S. M. Bruce, Resident Minister in London of the Commonwealth of

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GOLD

THE ECONOMIC SIGNIFICANCE OF "GOLD MALDISTRIBUTION"

I

It happens very frequently that a state or condition prominently associated with a situation regarded as undesirable is taken as the starting point of comment and discussion, without reference to the question whether, in fact, the state or condition referred to is in reality the initiating factor in the situation. The task of science in such a case is a twofold one: to examine whether the condition referred to is, in fact, the cause of any subsequent chain of events, and, further, given that the state or condition does initiate further consequences, whether it is not, in itself, a consequence of more remote causes. The difference involved in these two inquiries may be illustrated by, for example, the case of medical research. It is possible to pursue inquiries into the best methods of *curing* cancer, or it is possible to investigate the *causation* of cancer; if a disease can be prevented, this avoids the necessity of seeking for cures. Again, unemployment does, in itself, create further undesirable consequences, but if unemployment can be prevented there is no need to investigate alternative methods of relieving the unemployed. Applying these analogies to the present case, it becomes important to ask, not only whether gold "maldistribution" is a state or condition in the economic world capable of causing a chain of unfavourable consequences, but also whether gold maldistribution is, in itself, a consequence, in which case the problem of prevention must be treated from an altogether wider point of view.

¹ Reprinted from *The Manchester School*, 1931.

II

The use of the term "maldistribution" implies that, if the direction in which gold moved were different from what it actually is, and if the gold stocks of the world were thus differently distributed from what they actually are, the net world economic situation would be improved. But this improvement in the situation might come about either because the causes leading to the actual distribution have bad effects (of which the gold movements actually taking place, with all their supposed consequences, are part), and maldistribution ceases because these causes are prevented from operating in future, or because the gold movements themselves produce undesirable results, so that, if in any way the gold movements can be brought to an end, the undesirable results will cease directly. Current confusion on the subject of gold distribution is partly due to the fact that economists and practical men will not necessarily be in agreement as to the criteria by which desirable are to be distinguished from undesirable gold redistributions. But it is also due in part to the neglect by economic theory of the element of arbitrariness in any *de facto* scheme of distribution; and, lastly, to a failure on the part of practical men always to realize that, whilst there are arbitrary elements in gold distribution, there are also inevitable chains of sequences which make it impossible for the economist to accept the view that operating on the gold stock or the gold flow directly will be a cure for the situation in all cases.

III

The first great generalization on the subject of the distribution of the precious metals was Ricardo's: "Gold and silver having been chosen for the general medium of circulation, they are, by the competition of commerce, distributed in such proportions amongst the different countries of the world, as to accommodate themselves to the natural traffic which would take place if no such metals

existed, and the trade between countries were purely a trade of barter.”¹ As is well known, Ricardo denied in the same chapter on “ Foreign Trade ” from which this extract is taken, that the value of gold must everywhere be the same ; but that particular point is unimportant in this connection. What is relevant is that gold flows, under the circumstances envisaged by Ricardo, are always effects and not causes. The same remark necessarily applies to the position taken up in the correspondence with Malthus and in the later editions of the *Reply to Mr. Bosanquet*. Gold is only exported when it is the cheapest commodity : and export of gold is a proof that the currency is redundant : in a word, bullion exports are a cause, not the effect, of an unfavourable balance of payments, and even the failure of a harvest or the necessity of paying a subsidy to a foreign power are not, in the Ricardian view, direct causes of a drain of bullion, since those goods will always be sent in discharge of such indebtedness as are cheapest in the exporting area and dearest in the importing area, and bullion is not necessarily the cheapest commodity to send. As Professor Viner has shown, the Ricardian position that bullion exports are the cause, and not the effect, of an unfavourable balance of payments has not been the dominant tradition in English political economy. But whether one sides with Ricardo or John Mill on this particular issue, it must not be overlooked that there is a fundamental unity of idea behind both points of view ; in both of them gold flows are a response to the necessities of a price change. According to the dominant view, a shift in the balance of payments necessitates an alteration in relative price levels, and bullion will move until relative prices in the paying and the recipient areas are such, respectively ; as to enable the new excess of payments over receipts to be met by movements of goods. The Ricardian view is that, unless goods are cheaper as a means of remittance than bullion, bullion will flow and that very fact will make the balance “ unfavourable ”. But in both cases bullion

¹ *Principles*, in McCulloch's Edn. of the *Works*, pp. 77-8.

exports are an effect of causes more organically bound up with the economic situation as a whole. Maldistribution would result, not from allowing the bullion to move, but from attempts to prevent it from moving. It is true that, as bullion moves, "bank rate" is raised, but the legitimate defence for that action is not that it attracts short money and, therefore, delays the adjustment of prices, but that it *both* attracts short-term money *and* forces on a readjustment of prices. The failure of bank rate changes to bring about such results in the recent past, as well as the coincident failure of gold imports to raise prices in consequence of "gold sterilization", are points which will require separate consideration later on.

IV

Two further results follow from the general classical view: Countries cannot possess a gold stock *larger* than they are entitled to, nor can a country ever be *forced off* a metallic standard if it desires to adhere to it, for successive additions to the gold stocks of a country cause, directly and indirectly, a rise of prices, and gold losses similarly cause price reductions. The price rises in the first case and the price reductions in the second, will reverse the tidal movement of the precious metal; in the end no movements of gold will take place at all. From the standpoint of strict monetary theory, the correct distribution of gold is achieved whenever the price situation in all countries connected together by international trade is such that they settle their outstanding international balances of payment without gold movements. Gold movements which ultimately lead to this result *correct* maldistributions; gold movements which would have the effect of delaying this result *cause* maldistributions. But it is difficult to see how classical monetary theory could have ever found room in its analysis for the possibility of movements of this second kind. The international movement of the precious metals tended towards equilibrium; the "self-liquidating

character of drains" was the classical answer to the apprehensions of the mercantilists.

V

The first approach to modern doubts on this subject will be found, I think, in Fullarton's denial of the contentions of the Currency School that drains of bullion were self-liquidating. The theory that bullion exports diminished the circulating medium of a country and *therefore* reduced prices was inconsistent, he urged, with the existence of "hoards"—i.e. of Central Bank reserves, as we would put it to-day. This point brings us to the first of the possible ways in which the assumptions of the classical school may be negatived in practice; bullion shipments may be "offset" by credit expansion. If the position of a country's price level or of its balance of payments is such that gold or bullion exports are necessary, then to offset gold exports by further credit creation is tantamount to neutralizing the effect of such gold exports, so far as the domestic position is concerned, and increases the risk that further gold shipments will become necessary in the future. And if, in the importing country, gold is *also* offset by restriction in the volume of other forms of purchasing power, a second departure from the assumptions of classical doctrine takes place. For prices will not fall in the area whence the gold came, nor will they rise in the areas to which the gold flows. The aggregate volume of gold flowing may, therefore, be much greater than it needed to have been in order to restore the conditions appropriate to "natural traffic" had different canons of bank policy obtained in the areas under consideration. The *de facto* distribution resulting from the simultaneous adoption of these policies may be described as a "maldistribution" of gold in the sense that the economic necessities requiring *some* gold movement could have been fully satisfied with a smaller *net* movement if the policies pursued in both areas had been different. The gold movements taking place are effects,

and not causes, but among the causes which dominate the quantitative aspect are some which are arbitrary in the sense that they are *directly* modifiable by human will. The classical tradition tacitly assumed that each country participating in the international monetary system possessed a "normal" gold stock which, as it never changed, could be neglected, whilst increases in that stock led to an expansion of purchasing power and, therefore, to a rise of prices, while decreases led to a contraction of purchasing power and, therefore, to a fall in prices. If *all* countries pursued this policy, any increases in the supply of the precious metals coming from the mines would ultimately be distributed among them all in proportion to the previous sizes of their gold stocks, and no disturbance would result to the self-balancing nature of the system on this ground.

VI

It cannot, therefore, be denied that the economic world has been somewhat slow in appreciating the full consequences of the policy of gold sterilization which, when it was first discussed in its relation to Federal Reserve Policy, met with a great deal of praise. For sterilization undoubtedly enables a country for the time being to "contract out" of the consequences of gold imports, just as "offsetting" gold exports by credit expansion enables a country to evade the consequences, for the time being, of maintaining a price level too high in relation to that of other countries. But, whilst this possibility is important from the standpoint of inquiries relating to the limits of autonomous monetary policies under a gold standard, it is still more important from the standpoint of the conditions appropriate to the fruitful functioning of the gold standard internationally. The fact is that economic theory has been more concerned with the *relative* movement of prices than with the *absolute* level of prices, and has tended to overlook the fact that when a single country hoards, or a group

of countries are hoarding gold for the time being, the effect is to *delay* the attainment of international equilibrium. For, instead of prices rising in the gold-importing area, they remain stationary for the time being, and in those countries from which the gold came a proportionately greater pressure has to be exerted on local prices to produce parity. Thus, if at a time when the general economic conditions necessitate gold exports and imports, the importing countries decide to modify (in the sense of raising) their reserve requirements, this modification of reserve policy involves that international equilibrium will be attained at a lower level of world prices than would have been necessary if no such modification had taken place, *unless*, at the time when the gold-importing countries are modifying their reserve requirements in an upward direction, gold-exporting countries modify their reserve requirements in the opposite—i.e. in a downward direction.

VII

It appears at first sight as if the conclusions stated in the previous paragraph were inconsistent with those reached in paragraph 5, but this is not the case. In paragraph 5 it was urged that gold sterilization in one area accompanied by offsetting gold exports in another area, at a time when the international equilibrium is disturbed, involves a *larger aggregate volume of gold movement* in order to restore equilibrium than would have been required if gold imports had been allowed to raise the one price level and to lower the other. In the next section it is argued that a reduction in gold reserve requirements in the gold-exporting areas at a time of dis-equilibrium *and* of gold sterilization in the gold importing area enables equilibrium to be restored with a *smaller absolute fall in the price level* (though not with a smaller absolute amount of gold loss) than would have taken place if reserve requirements in the gold-exporting areas had not been reduced. Up to a point, therefore,

a choice can be made between greater losses of gold and greater strain on the price level. The limit comes when the policy of offsetting gold exports—i.e. allowing gold reserves to fall—is carried so far that the entire gold losses are compensated, for then equilibrium will not be attained at all. To bring the loss of gold to an end, prices must fall in the gold-exporting area, relatively to prices in the gold-importing area. There must be a shift in *relative* prices, but this shift can take place at different absolute levels of the associated prices.

VIII

This possibility of a choice between restoring equilibrium through larger aggregate gold movements, or by means of greater relative and absolute price changes, provides the key to much practical controversy. The choice is obviously easiest to make where reserve ratios are high at the moment when the gold drain begins, and where, also, the remuneration paid to the factors of production is elastic; it is most difficult where the opposite conditions prevail together. The traditional British policy has been to reduce the gold flow to a minimum—a policy which rested upon the two circumstances: that the gold stock was small relatively to the liabilities secured by that stock, whilst the remuneration paid to the factors of production was capable of alteration. But the choice is made more difficult to-day by the existence of several new factors in the situation.

IX

Owing to the rigidity of the cost and price structure, bank rate changes are unable to initiate, as easily as in pre-war days, a chain of events which ultimately leads to a fall in the level of costs, incomes and prices. On the other hand, a rise in bank rate easily initiates an inflow of foreign balances. From the standpoint of the Money Market, such an inflow has the effect for the time being of postponing the necessity of fundamental

readjustments of the cost and price structure ; it prevents a gold redistribution which might otherwise have been necessary. But it does so at a price : a withdrawal of balances accentuates the drain of gold, when this becomes necessary for any reason, and, by doing so, introduces psychological elements. For the drain of gold in its turn leads to doubts as to the safety of the balances, and thus causes a further drain. An extremely paradoxical result follows : the instrument which normally reduces the drain below what it might otherwise be, is the cause of an accentuated drain when gold movements have begun, for any reason, to assume proportions which upset "confidence". In order to prevent gold from moving, foreign balances are encouraged to flow in ; but once foreign balances are held it becomes more than ever necessary to prevent gold from moving, for if it does, the balances will move, and with them, a more than proportionate amount of gold will move also.

X

These phenomena, it may be argued, are aspects of the pathology of the gold standard, rather than manifestations of its normal working. The fact is that the normal working of the gold standard assumes a certain elasticity of the factors of production and their remuneration ; if this elasticity is not present, it produces an altogether novel state of affairs, with which the established economic doctrine, which assumes elasticity, is unable to cope. Given elasticity, it becomes possible to use foreign balances as a temporary method of adjusting the balance of payments, because under these conditions, it would also be possible to use other methods of adjustment. Given inelasticity, it is possible to use foreign balances as a method of adjustment, but the very causes which force reliance upon this method are also the causes which make it dangerous, since the ebb and flow of balances are subject to irrational influences. For if a centre is a large holder of foreign balances the movement

of gold to and fro ought normally to be larger in the long run (though not immediately) than if it held no such balances. But if this is not understood, such gold flows are themselves a cause of still further gold flows, as soon as they attain a magnitude greater than international opinion will tolerate with equanimity.¹

XI

To sum up. From the economic standpoint every gold movement which does *not* tend to produce equilibrium (though not necessarily *identity*) of international prices results in what is, from that point of view, a maldistribution of gold; but, equally, every device which *prevents* a gold flow which would otherwise tend to produce equilibrium of international prices results in a maldistribution of gold: The primary assumption underlying the concept of an international standard is that local conditions will prove adaptable to the working of the standard, and not that the standard will be adapted to the necessities of the local situation, for local necessities are not *necessarily* congruent with one another. From the practical standpoint the present position of the gold standard poses two problems: a more detailed investigation of the cases in which divergent local aims can be made congruent with the retention of the gold standard, and a search for methods and arrangements by which local aims, which are not only divergent from one another, but which paralyse the working of the international standard, can be eliminated. A study of maldistribution, in other words, leads directly to a study of those forces of international distrust and of national rigidity and inelasticity which threaten the continuance of the existing economic order in every one of its manifestations.

¹ The purely irrational character of such drains is revealed by the nature of the remedies applied to stop them. There is general agreement that if a loan is made to the gold-exporting country of very large dimensions, such a loan is hardly likely to be used. Further, the accumulation of gold resulting from such drains does not make for equilibrium and constitutes a clear case of "maldistribution". The use of extra-economic measures for stopping such a drain is, therefore, perfectly justifiable and causes no undesirable economic consequent

THE CAUSES OF GOLD MOVEMENTS INTO AND OUT OF GREAT BRITAIN, 1925-1929¹

I

THE general position of Great Britain is that, owing to her traditional economic and financial connections with South Africa and other gold-producing areas within the British Empire, which occupy such a large place in the aggregate world production of gold, she should act as one of the main distributors of gold to other parts of the world. It would, therefore, not be surprising that, of the gold imported into Great Britain, a large proportion should be subsequently exported on principles with which political economy has long been familiar. The characteristic feature of the last five years, however, has been that Great Britain herself has not been able to retain any proportion of the gold flowing to her from the South African mines or, indeed, from any part of the world. In other words, Great Britain has not been able to add to the stocks of the precious metals which she possessed before the return to the gold standard in April 1925.

II

This fact is clearly brought out whether one has regard to the statistics of gold movements in and out of the Bank of England or to the figures furnished by the British Customs Department. These two sets of figures do not coincide, because gold imported into Great Britain and sold in the open market is not included in the movements of gold in and out of the Bank of England, and, therefore, the former movements are naturally larger than the latter. The broad position is that, in the years 1925 to 1930, gold imports into the United Kingdom amounted to 1,334,882,000 dollars, whilst

¹ Report submitted to the Gold Delegation of the League of Nations, Geneva, 1931.

exports in the same period of time amounted to 1,389,486,000 dollars, resulting in a net export of 54,604,000 dollars. The position as revealed by gold movements to and from the Bank of England is substantially the same. In the period between May 1925 and December 1930, the movements of gold into the Bank of England amounted to £97,714,000, the movement of gold out of the Bank of England amounted to £114,194,000, leaving a net excess of gold outward of £16,480,000. Thus, the effect of the movements of the precious metal over the last five years has been to leave the gold stock of the Bank of England substantially unaltered. The average annual holding of gold, which in 1925 amounted to £146,000,000 has hardly changed in the interval. It is obvious, therefore, that, in the last five years, Great Britain has been unable to retain for herself any part of the accruing gold supplies, whether from gold-producing countries or from other areas.

III

A survey of the most important import and export areas will show in rough outline the causes to which these movements can be attributed. If the table of gold imports and exports presented herewith is studied, it will be seen that the supply of gold coming into Great Britain in the last five years can be divided into two main sources of supply. First comes a group of gold-producing areas (Transvaal, Rhodesia, West Africa). Secondly comes a group of countries which have been sending gold to this country for reasons which are obviously connected with monetary and economic disturbances rather than with the present position of their gold production. This group includes Australasia, South America, Russia and Spain.

If the areas to which gold has gone are studied, it will again be noticeable that they divide themselves into two groups. One group consists of those areas, India, Egypt and other Eastern States, which have been

absorbing gold for generations and which take gold regularly, although in fluctuating quantities, on grounds which are perfectly well known to all students of the subject. But, in addition to this group, there is a group of States, including particularly France and Belgium, Germany and the Netherlands, Switzerland and the United States, which have been taking in the last five years very large quantities of gold, a portion of the gold flow being based on grounds which cannot merely be explained away as part of the traditional pre-war system of distributing the world production of gold. In their case, in other words, other factors must be looked for besides the general principle that the world supplies of gold are distributed among the commercial nations of the world in accordance with their general economic and financial status. It is in connection with the flow of gold to these areas that the real problems of Great Britain in recent years emerge.

IV

A country upon a gold standard is powerless to prevent the movement of gold in the long run, given the fact that its rates of exchange with foreign countries reach the gold export point. The gold export point, as is well known, is not a fixed and invariable magnitude, but itself varies with the relative rates of interest ruling in different centres and with the time element and transport costs involved. The tendency to substitute, in the case of European countries, air transport for transport by rail has, in fact, meant that the gold points have become closer to one another, and that the money markets concerned lose gold more easily than was the case before the war. But these considerations throw no light upon the reasons why gold movements are ultimately possible. The central point in any discussion of recent gold movements must be taken by considering the forces which increase or decrease the supply of foreign exchange available in a given market. Whenever, for any reason,

the demand for foreign remittances exceeds the momentary supply, then, given an effective gold standard, the tendency will be for gold to move. Hence, all those factors which are capable of influencing the supply of foreign exchange available in a market must be taken into account.

V

The main features of the British domestic situation in the last five years are now fairly generally known. The most significant single element, in the long run, of the British domestic situation is presented by the tendency for wage-levels to remain rigid in the face of a continuous fall in the level of wholesale prices. This involves a margin between the prices at which manufacturers can afford to sell their products abroad and the cost at which these goods are manufactured. Even if, at the moment when Great Britain returned to the gold standard, equilibrium had existed between domestic costs and international prices, this equilibrium would have been destroyed by the subsequent disparity in the movements between selling prices and costs. But there is sufficient evidence to warrant the statement that, at the moment of stabilization—that is, the return to the gold standard—at the pre-war parity between sterling and gold, this disequilibrium was already in existence, and the tendency of the rapid decline of world prices in the last eighteen months has been, in this respect, to accentuate an already present disharmony of price levels.

Economic theory has long been familiar with the kind of consequences which are likely to result from a situation of this sort. The rigidity of wage-rates implies a level of money incomes and therefore of retail prices which are likely to attract imports. The exporter finds that he is faced with the alternative of either selling at a loss or of lowering his prices. In general, the tendency will be for exports to fall off and for imports to rise, or, at any rate, to maintain themselves above the level which

would not have been possible had money incomes in the United Kingdom generally been reduced. In other words, there is a tendency for the balance of international payments on this ground to fall into a state of relative disequilibrium.

But, as is perfectly well known, the position in Great Britain does not conform to so simple a pattern as this. Throughout English commercial history in the last fifty years, an excess of imports has been possible in consequence of the presence in the British balance of payments of a large credit item, due to the performance of certain services for foreigners and the receipt of large amounts on account of previous long-term and short-term investments in foreign countries. On the other hand, the pressure of the British balance of payments has been accentuated by the presence of large, new, long-term loans to foreign countries. Whenever a foreign loan is made, the tendency is to bring immediate pressure on the balance of payments, either through the investment of the proceeds of the loan in short-loan markets for the time being, pending the purchase of goods, or through the attempt of the borrower to transfer the proceeds of the loan via the foreign exchanges in those particular cases in which either this country does not furnish him with the kind of goods which he requires, or in which he can obtain the kind of goods which he requires more cheaply elsewhere than he would have obtained them in the United Kingdom.

The important question therefore arises whether, in view of the inelasticity of British costs, the effort to make large capital exports to foreign countries has not been the main cause of the failure of Great Britain to retain any part of the accruing supplies of gold. It has become fashionable in Great Britain to attribute the main part of the difficulty to the attempt to transfer to foreigners capital loans in excess of our ability to transfer them. It is argued that, if the country had not wanted to lend so much abroad, the balance of payments would have been adjusted without the pressure on the exchanges actually

experienced. The reason that this pressure exists, it is argued, is that the amount which individuals desire to lend abroad is a function of the rate of interest at home, and in foreign countries, whilst the amount which this country can safely transfer is a function of the price level; and the rate of interest in the capital market and Great Britain's ability to export at a competitive price are elements which stand in no direct connection with one another. It is argued that the main cause which has led to an attempt to meet the balance of payments by gold exports has been the excessive foreign lending of this country in recent years, or, rather, in order to prevent an excessive amount of gold exports, it has become necessary for the monetary authorities in this country to adjust the situation by measures intended to counteract the possible effect of excessive capital loans on the foreign exchange market and on the supply of gold. Since this country is lending too much, monetary policy has necessarily been directed to reborrowing from abroad the amounts which foreigners have been borrowing from us. Hence the monetary policy of Great Britain has been described as one of "lending long and borrowing short", and the policy of lending long and borrowing short has, in its turn, led to the maintenance of rates of discount higher than those which would have been necessary had less been placed at the disposal of foreign borrowers in the first instance.

This is a line of argument of great importance, both as regards the currency controversy in Great Britain and as regards an interpretation of what has been happening over the last five years. To test it empirically is difficult. Recent investigations by Sir Robert Kindersley and other authorities have shown that it is excessively difficult to arrive at a true estimate of the facts in the capital market, owing to the presence of such factors as sinking fund repayments, capital investments by foreigners in British industry, the transfer to foreigners of British investments in such areas as South America, and foreign subscriptions to new foreign capital issues in London.

Moreover, an investigation of the actual balance of payments shows that, over a period of time, the relationship between the excess of the favourable over the unfavourable items in the balance of payments is more closely related to the volume of foreign capital issues in London than is the case for short periods. The sum of the general credit balances on the British balance of payments for the period 1925-1929 amounted to £480,000,000; the volume of capital issues for foreign countries in the same period amounted to £576,000,000. The volume of capital issues was in excess of the credit balance available in the earlier part of the period, and was below the credit balances available in the latter part of the period. It might, therefore, very well be the case that arguments which were true to the period 1925-1927 are no longer true of the whole period 1925-1929.

From the standpoint of economic theory, moreover, the view that the amount which can be effectively transferred over the foreign exchanges is a residual element is one which requires much further investigation before it can be accepted. It essentially depends on the assumption that the exports of the United Kingdom are a fixed amount, with the absolute size of which the amount of capital exports from the United Kingdom have nothing to do. I question the correctness of the assumption that the difficulty of adjusting the balance of payments is due principally to the lack of relationship between exports of goods and long-term capital movements. The volume of exports might have been even lower without long-term loans, since, given a certain supply price for British exports, the demand for them would probably be less than it actually is, unless foreigners were lent the money with which to buy them. The difficulty of adjusting the balance of payments might, with equal justice, be ascribed to the growth in the volume of imports due to the higher level of money incomes permanently maintained in this country in the last five years. If it is argued that the actual volume of imports, however caused, would have been justified by the position of the

available excess on the balance of payments, a smaller volume of capital exports being assumed, this again seems to me to be a begging of the question, since we do not know what the excess on the balance of payments would have been in the absence of long-term loans. From the practical standpoint, it is perfectly possible that, in the long run, the volume of capital exports which we chose to make was consistent with the position of British exports, without it necessarily being true that the volume of capital loans at any particular moment was consistent with exchange equilibrium at that moment, without either a certain volume of gold exports or without a counterflow of short-term money into this market, induced by a temporary rise in the market rate of interest. My main objection to the analysis just discussed is that the situation has, in practice, been more complicated than this analysis would seem to warrant. To sum up the situation by saying that we have been lending long and borrowing short is to neglect the multiplicity of factors which have been at work in the adjustment of the balance of payments in recent years. Undoubtedly, short balances and long-term loans are part of the elements in this situation ; but it cannot be said that these are the only two items which require to be brought into prominence in estimating either the factors which have been making for disequilibrium or the factors which have had to be brought into play to restore the equilibrium after it had once been temporarily disturbed.

VI

In analysing the factors making for gold imports and exports from Great Britain in the last five years, it is clear from the figures of gold exports that the United States, France and Germany have been the three countries of greatest importance, although the nature of the British Customs statistics make it desirable, in estimating the net flow to each area, to include neighbouring States from which part of the supplies of gold may have actually

gone to the areas named. A detailed investigation of the figures in the Appendix will also show that the pressure exerted on British gold supplies by these various areas in particular years has varied from time to time; thus, in the case of France and Belgium, it is clear that pressure began to be serious in 1928, and culminated in the last two years. In the case of Germany, the pressure was very strong in 1928 and 1929. In the case of the United States, the pressure was greatest in 1925 and in 1929. In the case of Switzerland, it was greatest in 1925. Similarly, as regards the areas from which gold supplies have come; in those cases in which the movement is to be regarded as associated with currency disorganization or political necessities, the position has varied from time to time. Thus, the Russian supply was large in 1925, and again in 1928. The imports from Spain concentrated on 1928 and 1930. Australasian imports were very high in 1930 and appreciable in 1929. The excess of exports to South Africa in 1926-27 turned into a small excess of imports in 1928, which became very large in 1929 and 1930. But, quantitatively, the movements to France and Belgium, on the one hand, and Germany, the Netherlands, Switzerland and the United States on the other, outweigh particular movements in other directions, and a discussion of the gold movements out of the United Kingdom must primarily be a discussion of the lines of influence which have been emanating from these areas at particular moments of time. The general character of these influences is, of course, fairly generally known. First in importance is the movements of French funds into this country in the days of the declining franc in 1926 and the subsequent repatriation of these balances after the stabilization of the franc. In other words, Great Britain first benefited from the flight from the franc in 1926 and then suffered from the withdrawal of French balances in 1929 and 1930. How large the French balances in London were and are is a matter upon which no accurate information exists, and the degree to which the avoidance of recent gold

movements to France would have been possible is also a matter of acute controversy. In so far as the repatriation of French balances is associated with the reserve requirements of the entire French currency system, the problem is one which has direct reference both to the legal requirements under which the Bank of France is required to operate and to the views entertained by the high authorities of the Bank of France as to the amount of reserve which they think it appropriate to maintain. In so far as gold has been imported on private account into France for the purpose of increasing the reserves of the French credit banks in view of an increase in the volume of currency required by their customers—the currency so taken from them being obtained from the Central Bank by sale to it of the gold so withdrawn from London—again, both the legislation under which the Bank of France is governed and the policy of the French monetary authorities comes into account. It may also be the case that the drain of gold to France has been affected by the periodical blocking up of currency in connection with the operations of French public finance. On all these questions little seems to me to remain to be added to the admirable article recently contributed to the *Economic Journal* by Mr. T. Balogh.¹ One would like to add that the view that the mere fact that the French balance of trade is favourable is no disproof of the proposition that, had the French monetary authorities desired to check the inflow of gold into France, it would have been possible for them to do so; though this might have required, not only a change of view on their part, but also an alteration both in the legislation of the Bank and in the practices of the French Treasury, as well as an alteration in the attitude towards long-term capital issues on the part of the French investor.

It is exceedingly difficult to estimate the extent to which the movement of French balances has been influenced by purely economic considerations, such as the higher level of money rates in France during a portion

¹ "The Import of Gold into France," *Economic Journal*, September 1930.

of the time under consideration. In so far as the process of restocking France with gold was a necessary element in the attainment of general economic equilibrium in Europe, gold flows from London to Paris cannot be condemned, however much the continuance of the flow may be regretted, in so far as it has increased the difficulties for the London money market. The only question at issue is whether the restocking process has not been continued beyond the point dictated by considerations of convenience and stability.

The flow of gold to the United States, especially in the year 1929, is, of course, associated with the peculiar monetary and Stock Exchange conditions which prevailed in that country in the year 1928, and to a much more marked extent in the subsequent period. It has been shown very clearly in an article published in the *Midland Bank Monthly Review* for December 1929—January 1930 that, if the relative pull of money rates and prices in the two countries on the dollar-sterling exchange is examined from about June 1928, priority of importance must be assigned to the movements of relative money rates in the two centres; or, as the writer of the article puts it, the charts in which he summarizes his conclusions graphically “lend substantial support to the argument that, at any rate over relatively short periods, comparative money rates are a more powerful force than relative commodity price movements in determining fluctuations in the London-New York exchange rate . . . Only when, for some special reason, prices and money rates part company, is the superior short-term strength of money rates made apparent”.

The movements of short-money rates in the United States were, of course, in part an expression of Federal Reserve policy; but it is important, in my opinion, to take into account also those features of the situation over which the Federal Reserve System in the days of the Wall Street boom had no control whatsoever. The net effect of the rise of security prices was to check both American long-term loans to Europe and to increase the

volume of European capital seeking a temporary investment in American securities. It is difficult to see how this movement of long-term capital, or relatively long-term capital, could have been avoided by anything which was done by the Federal Reserve authorities; and there is some reason to suppose that, in estimating the net movement of funds to the United States, the investment of European money in call loans has been exaggerated, whilst the actual outright purchase of American securities by European investors has been underestimated. Nevertheless, a discussion of Federal Reserve policy in relation to the stock market situation is necessary. The Federal Reserve rediscount rate did not rise to 5 per cent until the middle of 1928, and then remained stable until the middle of 1929. During that time the call-money rate on the New York Stock Exchange rose from an average of 6.1 per cent to as much as 9.4 per cent before the rediscount rate rose to 6 per cent in August of 1929. It is arguable, therefore, that the direct influence of a high rediscount rate has been exaggerated, the call rate rising by something like 50 per cent, whilst the rediscount rate remained absolutely stable. In truth, if the Federal Reserve System is to be criticized for its policy during the boom, that criticism must take a somewhat more sophisticated line. As is well known, the Federal Reserve System attempted the task of bringing about discrimination against call loans. In so far as it was successful in so doing, it made the price of call loans higher than it would otherwise have been, and, by making it higher, it attracted a volume of funds from Europe perhaps disproportionately greater than would have been attracted had the level of call rates been lower, even though this lower level had been accompanied by a rise in the price of commercial accommodation somewhat earlier than this rise was actually brought about, partly because the level of call rates was mounting steadily upwards, partly because the Bank itself was raising the rediscount rate. Had the price of commercial accommodation risen earlier during the boom, it would

have undermined the foundations upon which the boom was built, in so far as steadily mounting business and industrial profits formed the justification for an upward movement. But the effect of the Wall Street boom on the European money market situation cannot be gainsaid. The effect was to attract both speculative and short-term funds, to bring immense pressure to bear on the foreign exchanges, and therefore under these conditions to inaugurate a régime of steadily rising Central Bank rates, each Central Bank in turn protecting, or trying to protect, itself against a loss of gold to its neighbours, a loss which it was quite unable to prevent if the situation as a whole is taken into account. When attention is directed to the German position, it must strike the spectator as astonishing that a country with large annual reparation payments to make should have been in a position to accumulate a large fund both of gold and foreign exchange at the Central Bank. The fact is that the German Central Bank reserves are "borrowed", in the sense that Germany has been a consistent long- and short-term borrower throughout the whole period under review, and this excess of borrowing over her annual reparations payments has enabled her to accumulate a stock of gold and foreign exchange. In the case of Germany, as in the case of France, the question may well be asked whether the actual size of the gold and foreign exchange reserves is not greater than the circumstances of the country really warrant. Let it be admitted that the temporary situation of the German balance of payments was such as to enable the Central Bank to accumulate these large stocks of foreign currency, the question still remains open whether, at particular moments, the discount rate was not too high, and whether the Central Bank could not have done something, by the purchase of open market assets, to reduce the price of short-term money in Germany and thus prevent the constant offer of short-term money to German financial institutions upon the basis of which the actual movements of gold exchange were based.

VII

It becomes necessary at this stage to ask what measures have been adopted by the Central Bank in Great Britain. The Central Bank must necessarily deal, in the first instance, with the facts of the money market with which it is in much closer touch than it is with the industrial and economic structure, in the wider sense of the term. When Great Britain returned to the gold standard, the impression prevailed, in consequence of certain passages in the report of the Cunliffe Committee, that the Bank of England would attempt to maintain a total stock of gold of not less than £150,000,000, and a great deal of alarm has, therefore, always existed in the City whenever the total gold reserve fell below this figure, as anticipations were entertained that a deficit below this amount would be automatically followed by a rise in the bank rate of discount. This interpretation of the situation has shown itself to be falsified by events, and Bank of England policy has been a very complicated and delicate one, containing many elements, ever since the return of the gold standard, and is not capable, therefore, of summary statement.

(1) At times when the position in the foreign exchange market was difficult, the Bank has resorted to an unofficial embargo on fresh capital issues. Such a policy was adopted in the autumn of 1925, when heavy gold losses were being experienced, though this was accompanied, for a short period in the autumn, by a reduction in the official rate of discount. Opinions on the expediency and wisdom of unofficial embargoes go very far apart, the generally prevailing opinion being that, in view of the increasing integration of money-markets all over the world, an embargo on fresh capital issues cannot, in fact, control the movement of securities, and merely results in a loss of profit to the London issue houses.

(2) At times, the Bank of England has departed from its traditional policy of not buying gold above the minimum buying price fixed by the Bank Acts, and has

gone into the market to compete with outside buyers for gold, thus practising a modified form of the gold premium policy and narrowing its "turn" on gold operations.

(3) At times also, the Bank of England has indulged in what it is now fashionable to call "hidden hand financing"—that is to say, at moments of pressure in the short-term market, when it has appeared as if open market rates would rise to the level of bank rate and thus force on the Central Bank a rise in the discount rate, the Bank has bought bills in the open market for the purpose of checking the rise.

(4) The Bank, in co-operation with the discount market, has also attempted to stabilize open market rates of discount by means of conversations and discussions with the members of the discount market itself. No details of these conversations have ever been published, and the extent to which the open market has been a managed one is therefore obscure.

(5) An inspection of the Bank return shows that the Bank has attempted, within certain broad limits, to stabilize the total volume of credit available to the English economic system by offsetting the gold losses by an increased holding of securities, and, at times when gold was flowing in fairly freely, offsetting the increased supplies of gold by a reduction in its earning assets. Thus, between the second quarter of 1926 and the third quarter of 1928, the deposits of the Bank of England varied only by four millions. This small variation in the aggregate deposits of the Bank was, however, accompanied by an increase of £38,000,000 in the reserve of the banking department, and by a reduction of £36,000,000 in the holdings of securities by the Bank. Similarly, between the third quarter of 1928, and the last quarter of 1929, the gold holdings of the Bank of England fell by £31,000,000, whilst the securities increased by £21,000,000, the deposits fluctuating only by £3,000,000. Again, between the last quarter of 1929 and the third quarter of 1930, the gold holdings of the Bank rose by

£19,000,000, whereas the securities had fallen by £22,000,000. The long-run intention of the Bank is, therefore, fairly clear; it is to maintain deposits at a fairly steady level, while adjusting its assets in either direction according as gold flows in or out. Over the whole period, since the return to the gold standard, however, there has been a tendency for deposits to fall, and to this extent it may be argued that the Bank of England has been pursuing a deflationary policy. That this policy has not affected the position in a more marked manner is due to the fact that the joint-stock banks have altered the ratio of their cash holdings at the Bank of England to their deposits, the average yearly ratio between 1925 and 1929 having fallen from 11.78 per cent to 10.77 per cent. The aggregate deposits of the joint-stock banks have, in fact, risen from a yearly average of 1,662,000,000 in 1925 to a yearly average of 1,800,000,000 in 1929, though the effect of this increase in the volume of deposits has been to some extent counteracted by the tendency of time deposits to grow at the expense of current account deposits. It must, however, be pointed out that this movement in the relative importance of time and current account deposits is itself an effect rather than a cause of industrial depression. It marks the slowing down of the industrial machine rather than initiates such a reduction. Apart from the troubled year 1929 and the period of readjustment at the beginning of 1930, the Bank rate has, in fact, been remarkably stable. A short period of uncertainty in the autumn of 1925 was followed by a stable 5 per cent throughout the whole of 1926, and a stable $4\frac{1}{2}$ per cent rate throughout nine months of 1927 and the whole of 1928. In assessing the relative importance of different methods of control, therefore, the significance of Bank rate can easily be exaggerated; the rate has been steadier than might have been expected, and the importance of alternative methods of control much greater.

VIII

Two issues of general significance remain to be discussed. Surveying the whole development in the international money markets in the last few years, the question arises, would things have been very different if the aggregate world supply of gold had been larger? Upon this it must be said that, looking at the situation from the purely British standpoint, the position of this country would not have been substantially altered unless, indeed, our monetary policy had been so adjusted that, whilst world prices were rising, British prices had been kept more stable. The new era in 1925 was begun with British costs not in equilibrium with world prices. Had our prices risen in precise accord with the rise of prices outside the country, the disequilibrium would have remained. Even had more gold been available, it does not follow that the situation would have been substantially different from what it has proved to be, unless the Central Banks of the world had allowed the accruing supplies of gold to affect the price-level. In other words, the argument that, in the last few years, the world has been suffering from an *absolute* shortage of gold is only valid in the assumption that, if the supply of gold had been actually larger, the Central Banks would not have sterilized the accruing supplies to the full extent. Given this, a larger supply of gold, although it might not have made the relative situation of the United Kingdom substantially better, would have reduced the burden of fixed charges and national debts, and might then have contributed substantially to mitigating the severity of the present crisis, in so far as that has been accentuated by the burden of large fixed charges of all kinds, including reparations and national debts.

The other question which suggests itself is whether a different policy could have been pursued by Central Banks with regard to their gold holdings; whether, in other words, a better gold distribution could have been achieved by co-operation between the central banking

authorities. So far as the absolute size of the reserve in particular countries engaged in restocking themselves with gold is concerned, a better understanding of the uselessness of very large reserves could probably have done something. On the other hand, it would appear that it was the fear of losing reserves rather than the desire to add to already existing reserves which, in the last twelve months before the crash in Wall Street, added to the difficulties of the world. In other words, it was the period of competitive raising of bank rates following on the gold movements towards the United States and France in the first two-thirds of 1929 which substantially added to the burden of interest rates during that period.

	1929		1930 (First seven months)			
	Exports.	Net.	Imports.	Exports.	Net.	
France ad 36	162,527	-160,461	1,369	108,348	-106,979	
Germany 03	92,991	-89,788	7	63,022	-63,015	
Netherlan 82	2,006	+ 12,376	19	356	- 337	
Spain and 4	359	- 355	19,468	148	+ 19,320	
Switzerlan	10,781	- 10,781	-	10,404	- 10,404	
United St						
America 09-	61,293	- 38,203	283	-	+ 283	
South Am 129	-	+ 39,129	15,156	-	+ 15,156	
British Ine	10,320	- 10,320	-	6,478	- 6,478	
Australia 4,603	-	+ 24,603	84,761	2	+ 84,759	
New Zealan 2,433	-	+ 2,433	115	-	+ 115	
Egypt	3,786	- 3,786	-	94	- 94	
Rhodesia 4,641	-	+ 4,641	3,045	-	+ 3,045	
Transvaal 4,954	-	+ 184,954	117,417	-	+ 117,417	
West Africa 4,216	8	+ 4,208	2,921	-	+ 2,921	
Russia	-	-	-	-	-	
British Mal	-	-	-	-	-	
All other co	1,003	- 32,431	883	11,066	- 10,183	
Totals	3,724	377,505	- 73,781	245,444	199,918	+ 45,526

	Yeastasia.	Rhodesia.	Transvaal.	West Africa.	All other countries.
1925	-	+ 10,410	+ 108,403	+ 5,937	- 28,209
1926	-	+ 9,842	+ 153,240	+ 6,257	- 69,650
1927	-	+ 5,958	+ 124,348	+ 4,685	- 24,518
1928	-	+ 5,280	+ 144,482	+ 3,368	- 12,175
1929	7,036	+ 4,641	+ 184,954	+ 4,208	- 32,431
1930 (Janu July)	4,874	+ 3,045	+ 117,417	+ 2,921	- 10,183
Totals	1,910	+ 39,176	+ 832,844	+ 27,376	- 177,166

BRITISH GOLD MOVEMENTS

(Thousands of dollars.)

Country.	1925.			1926.			1927.			1928.			1929.			1930 (First seven months).		
	Imports.	Exports.	Net.	Imports.	Exports.	Net.	Imports.	Exports.	Net.	Imports.	Exports.	Net.	Imports.	Exports.	Net.	Imports.	Exports.	Net.
France and Belgium	620	3,710	- 3,090	802	8,257	- 7,455	627	4,718	- 4,091	912	97,178	- 96,266	2,000	162,527	- 160,461	1,369	108,348	- 106,979
Germany	—	—	—	—	—	—	190	17,034	- 16,844	258	102,423	- 102,165	3,200	92,991	- 89,788	7	63,022	- 63,015
Netherlands	25,474	48,707	- 23,233	1,175	14,704	- 13,529	2,313	6,486	- 4,173	145	7,081	- 6,936	14,300	2,006	+ 12,376	19	356	- 337
Spain and the Canaries	—	—	—	—	2,099	- 2,099	—	7,445	- 7,445	9,733	199	+ 9,534	—	359	- 355	19,468	148	+ 19,320
Switzerland	—	25,269	- 25,269	—	4,242	- 4,242	—	6,213	- 6,213	—	13,493	- 13,493	—	10,781	- 10,781	—	10,404	- 10,404
United States of America	21,378	50,477	- 29,099	180	1,138	- 958	8,567	28,042	- 19,475	32,532	32,132	+ 400	23,000	61,293	- 38,203	283	—	+ 283
South America	—	—	—	168	—	- 1,375	2,017	6,959	- 4,942	1,166	1,074	+ 92	39,000	—	+ 39,129	15,156	—	+ 15,156
British India	—	64,885	- 64,885	—	1,543	- 12,818	—	—	- 12,462	—	—	- 10,770	—	10,320	- 10,320	—	6,478	- 6,478
Australia	—	—	—	—	—	—	—	—	—	—	—	—	24,603	—	+ 24,603	84,761	2	+ 84,759
New Zealand	—	—	—	—	—	—	—	—	—	—	—	—	2,433	—	+ 2,433	115	—	+ 115
Egypt	—	3,240	- 3,240	—	1,199	- 1,199	—	3,799	- 3,799	1,309	1,384	- 75	—	3,786	- 3,786	—	94	- 94
Rhodesia	10,410	—	+ 10,410	9,842	—	+ 9,842	5,958	—	+ 5,958	5,280	—	+ 5,280	4,641	—	+ 4,641	3,045	—	+ 3,045
Transvaal	108,403	—	+ 108,403	153,240	—	+ 153,240	124,348	—	+ 124,348	144,482	—	+ 144,482	184,954	—	+ 184,954	117,417	—	+ 117,417
West Africa	6,184	247	+ 5,937	6,293	36	+ 6,257	4,705	20	+ 4,685	3,384	16	+ 3,368	4,216	8	+ 4,208	2,921	—	+ 2,921
Russia	21,387	1,903	+ 19,484	12,349	5,144	+ 7,205	1,049	7,732	- 6,683	18,582	—	+ 18,582	—	—	—	—	—	—
British Malaya	—	8,038	- 8,038	—	7,752	- 7,752	—	3,452	- 3,452	71	1,810	- 1,739	—	—	—	—	—	—
All other countries	13,692	41,901	- 28,209	3,557	73,207	- 69,650	8,129	32,647	- 24,518	14,803	26,978	- 12,175	1,003	33,434	- 32,431	883	11,066	- 10,183
Totals	207,548	248,377	- 40,829	187,606	132,139	+ 55,467	157,903	137,009	+ 20,894	232,659	294,538	- 61,881	303,724	377,505	- 73,781	245,444	199,918	+ 45,526

BRITISH GOLD MOVEMENTS

(Thousands of dollars.)

Year.	France and Belgium.	Germany and Netherlands.	United States of America.	Switzerland.	South America.	British India.	Russia.	Spain and the Canaries.	Egypt.	British Malaya.	Australasia.	Rhodesia.	Transvaal.	West Africa.	All other countries.
1925	- 3,090	- 23,233	- 29,099	- 25,269	—	- 64,885	+ 19,484	—	- 3,240	- 8,038	—	+ 10,410	+ 108,403	+ 5,937	- 28,209
1926	- 7,455	- 13,529	- 958	- 4,242	- 1,375	- 12,818	+ 7,205	- 2,099	- 1,199	- 7,752	—	+ 9,842	+ 153,240	+ 6,257	- 69,650
1927	- 4,091	- 21,017	- 19,475	- 6,213	- 4,942	- 12,462	- 6,683	- 7,445	- 3,799	- 3,452	—	+ 5,958	+ 124,348	+ 4,685	- 24,518
1928	- 96,266	- 109,101	+ 400	- 13,493	+ 92	- 10,770	+ 18,582	+ 9,534	- 75	- 1,739	—	+ 5,280	+ 144,482	+ 3,368	- 12,175
1929	- 160,461	- 77,412	- 38,203	- 10,781	+ 39,129	- 10,320	—	- 355	- 3,786	—	+ 27,036	+ 4,641	+ 184,954	+ 4,208	- 32,431
1930 (January to July)	- 106,979	- 63,352	+ 283	- 10,404	+ 15,156	- 6,478	—	+ 19,320	- 94	—	+ 84,874	+ 3,045	+ 117,417	+ 2,921	- 10,183
Totals	- 378,342	- 307,644	- 87,052	- 70,402	+ 48,060	- 117,733	+ 38,588	+ 18,945	- 12,193	- 20,981	+ 111,910	+ 39,176	+ 832,844	+ 27,376	- 177,166

GOLD MOVEMENTS TO AND FROM THE BANK OF ENGLAND

(Thousands of £)

	1925	1926	1927	1928	1929	1930
January
February
March
April
May
June
July
August
September
October
November
December
Totals

Sum of deficits

—11,595
— 1,215
— 1,221
— 8,228

Sum of surpluses

+ 6,271
+ 11,088
—
—

—22,359

+ 17,359
Net excess of gold outflows:
£5 millions.

* To October 22nd.

UNITED KINGDOM GOLD IMPORTS AND

MONTHLY FIGURES FROM

(Millions)

	January	February	March	April	May
1925.					
Total : Imports ..	2.266	4.414	1.862	1.031	2.650
Exports ..	4.799	3.823	3.015	1.991	2.635
	(1 month)	(2 months)	(3 months)	(4 months)	(5 months)
Imports ..	2.266	6.680	8.542	9.573	12.223
Exports ..	4.799	8.622	11.637	13.628	16.263
1926.					
Total : Imports ..	4.525	3.453	1.290	1.478	3.840
Exports ..	2.448	1.563	2.620	0.717	1.408
	(1 month)	(2 months)	(3 months)	(4 months)	(5 months)
Imports ..	4.525	7.978	9.268	10.746	14.586
Exports ..	2.448	4.011	6.631	7.348	8.756
1927.					
Total : Imports ..	2.366	3.235	1.546	5.071	3.383
Exports ..	3.736	3.181	1.417	0.767	5.462
	(1 month)	(2 months)	(3 months)	(4 months)	(5 months)
Imports ..	2.366	5.601	7.147	12.218	15.601
Exports ..	3.736	6.917	8.334	9.101	14.563
1928.					
Total : Imports ..	4.118	2.677	1.292	2.417	3.852
Exports ..	2.235	3.957	16.152	0.605	1.130
	(1 month)	(2 months)	(3 months)	(4 months)	(5 months)
Imports ..	4.118	6.795	8.087	10.504	14.356
Exports ..	2.235	6.192	22.344	22.949	24.079
1929.					
Total : Imports ..	2.434	2.537	5.288	3.317	5.812
Exports ..	5.731	4.934	1.592	0.763	0.956
	(1 month)	(2 months)	(3 months)	(4 months)	(5 months)
Imports ..	2.434	4.971	10.259	13.576	19.388
Exports ..	5.731	10.125	11.717	12.480	13.436
1930.					
Total : Imports ..	8.569	8.006	7.862	8.783	9.327
Exports ..	3.308	7.002	2.636	3.047	22.562
	(1 month)	(2 months)	(3 months)	(4 months)	(5 months)
Imports ..	8.569	16.575	24.437	33.220	42.546
Exports ..	3.308	10.310	12.946	15.993	28.555

EXPORTS FROM AND TO ALL COUNTRIES

TRADE AND NAVIGATION REPORT

of £.)

June	July	August	September	October	November	December
5·620 1·616 (6 months) 17·843 17·879	8·932 3·271 (7 months) 26·775 21·150	2·803 2·702 (8 months) 29·578 23·852	0·834 2·737 (9 months) 30·412 26·589	5·413 10·176 (10 months) 35·825 36·765	3·506 8·542 (11 months) 39·331 45·307	2·179 4·368 (12 months) 41·461 49·675
3·309 1·002 (6 months) 17·895 9·758	4·009 1·277 (7 months) 21·904 11·035	3·877 1·840 (8 months) 25·781 12·875	2·494 1·031 (9 months) 28·275 13·906	3·476 4·369 (10 months) 31·751 18·275	3·814 5·053 (11 months) 35·565 23·328	2·986 3·824 (12 months) 38·547 27·128
1·734 1·988 (6 months) 17·335 16·551	2·686 1·246 (7 months) 20·021 17·797	4·412 1·188 (8 months) 24·432 18·985	1·722 1·569 (9 months) 26·154 20·554	1·259 0·971 (10 months) 27·413 21·525	3·085 4·461 (11 months) 30·498 25·986	1·949 2·167 (12 months) 32·405 29·060
8·152 1·317 (6 months) 22·508 25·396	4·923 1·939 (7 months) 27·431 27·335	4·943 4·147 (8 months) 32·374 31·481	3·952 5·804 (9 months) 36·326 37·286	3·252 9·370 (10 months) 39·578 46·655	4·574 8·628 (11 months) 44·152 55·283	3·656 5·240 (12 months) 47·808 60·524
4·333 8·220 (6 months) 23·721 21·656	4·639 20·647 (7 months) 28·360 42·303	3·450 12·181 (8 months) 31·900 54·484	3·761 8·483 (9 months) 35·661 62·967	5·875 5·506 (10 months) 41·536 68·473	7·448 5·721 (11 months) 48·984 74·194	13·427 3·378 (12 months) 62·411 77·572
2·825 4·245 (6 months) 45·371 32·801	5·065 8·292 (7 months) 50·436 41·093	4·973 4·395 (8 months) 55·409 45·488	4·590 4·160 (9 months) 59·999 49·649	(10 months)	(11 months)	(12 months)

BALANCE OF PAYMENTS, UNITED KINGDOM

From Board of Trade Official Estimates (February). Overseas Loans; Estimates of Statist 1910 to 1926; Midland Bank, 1920 onwards.

(Millions of £.)

	1907	1910	1913	1920	1922	1923	1924	1925	1926	1927	1928	1929	1930
Merchandise (including Silver):													
Net imports	127	145	132	380	176	208	337	398	463	386	352	382	
Gold:													
Net imports	6	5	14	—	—	—	—	—	12	4	6	—	
Net exports	—	—	—	44	10	13	13	8	—	—	—	16	
Balance of Visible Items	133	150	146	336	166	195	324	384	475	390	358	366	
Government Transactions:													
Net receipts	—	—	—	—	—	—	—	—	4	1	15	22	
Net payments	9	9	12	7	5	25	28	11	—	—	—	—	
Shipping Freight:													
Net receipts	85	90	94	340	110	133	140	124	120	140	130	130	
Overseas Investments:													
Net income	160	187	210	200	175	200	220	250	285	285	285	295	
Short Interest, Commissions, etc.:													
Net receipts	25	25	25	40	30	30	60	60	60	63	65	65	
Other Services:													
Net receipts	10	10	10	15	10	10	15	15	15	15	15	15	
Balance of Invisible Items	271	303	327	588	320	348	407	438	484	504	510	517	
General Balance	138	153	181	252	154	153	83	54	9	114	152	151	
Overseas Loans	89	189	198	60	135	136	134	88	112	139	143	94	

Notes.—Export or credit figures in ordinary characters. Import or debit figures in italics.

ADDENDUM III TO THE REPORT OF THE COMMITTEE ON FINANCE AND INDUSTRY, 1931 (THE MACMILLAN COMMITTEE)

INTRODUCTION

(1) I desire in this note to express my views upon the present situation and upon the various proposals which have been put forward as cures, or at least as palliatives, for the evils complained of; further, to present some observations upon certain of the problems which fall directly within the Terms of Reference and have already been touched upon in the Report of the Majority of the Committee.

(2) It is common ground that the difficulties with which we are contending result from the accentuation of the pre-existent local depression of trade and employment through the world depression, which, beginning in the second half of 1929, has now lasted for nearly two years without showing any marked tendency to come to an end. The disequilibrium between prices and costs, which was a special characteristic of this country before the world depression, has now become a world phenomenon. But the fact that disequilibrium has become general means also that the degree of disequilibrium in this country has now grown cumulatively greater than it was before.

THE LOCAL SITUATION

(3) It is obviously impossible for this country, by any special action it can take by itself, to cure the world situation; although as a country which is one of the two largest creditor nations, with a capital market upon which a large part of the world habitually relies, with a Central Bank enjoying great international authority and prestige, and with a population with a high per capita volume

of exports and a high per capita consumption of internationally traded goods, we are in a position powerfully to influence the course of world events, even if the allowance is made for the special disabilities under which we are labouring. Our duty in this connection would seem to be a twofold one: to abstain from action which, if generalized, would result in making the world situation as a whole worse than it was before, and to follow policies which, whilst benefiting ourselves, will also help to alleviate the world situation. Apart from all other considerations, therefore, and considering solely the world situation, to embark upon a régime of tariffs and to refuse obstinately to face the question of costs are both undesirable. For to adopt the first will undoubtedly encourage a general tendency to further economic isolation on the part of other countries, thus impeding the recovery of world trade; whilst to refuse to face the second issue will lay us open to the charge that we are seeking the co-operation of other countries in obtaining a rise in the world level of prices because we have neither the will nor the ability to take the steps necessary to bring us into line with what is taking place elsewhere. We must be in a position to convince other countries that we are not dependent on their goodwill to save us from difficulties which, however mistakenly, they believe to be largely of our own making, before we shall be in a position to represent to them successfully that co-operation in the field of credit is a necessary part of the process of recovery. The mischief will not stop at this point, however. By one means or another, the world, as a whole, will climb out of the present depression, as it has recovered from previous ones. If recovery takes place in the outside world without any definite steps towards international co-operation having been achieved, it is certain that they will then become impossible for a long time to come; for it is not in periods of prosperity that efforts of this kind are likely to be inaugurated. And our moral and economic position alike may be permanently injured; our moral position by our failure to convert the rest of

the world to our way of thinking ; our economic position by our failure to make the adjustments necessary to accommodate ourselves to changes in the world as a whole.

THE WORLD SITUATION

(4) As far as the world situation at the moment is concerned, two solutions are presented for consideration. It is urged on the one hand that a concerted effort should be made to raise the level of prices ; it is urged on the other that the way out of the present impasse is to reduce costs.

It is argued by some of those who support the first solution that it is impossible to solve the problem of a depression in any other way : for a reduction of costs cannot result in anything else except an endless sequence of changes, in the course of which prices first fall, to be followed by falling costs, which in their turn result in prices falling again, requiring a further fall in the level of costs and so on. Thus the only result of the process is a cumulative fall of prices, which has merely the effect of increasing the burden of indebtedness and all other fixed charges, and does nothing to revive industry and employment.

It is argued by some of those who support the second solution that concerted efforts to raise the level of prices by means of additional credit-creation are not in any case likely to be made. Secondly, that a period of falling prices and depressed trade brings with it a necessary process of elimination of unsound borrowers and undertakings whose disappearance is necessary for a revival of sound business and of confidence in borrowers—a process of weeding out which would be delayed if plentiful credit were immediately available. But the longer the process is delayed, the greater will be the liquidation necessary when, at long last, further credit-creation proves unavailing to prevent the collapse of unsound institutions. Thirdly, it is argued that the process of credit-creation, if successful, involves the danger that revival may take place upon a scale and with a rapidity

that may make it imperative quickly to withdraw this additional quantity of credit. But in the face of violent opposition by the business classes this necessary policy of subsequent contraction may prove impossible, and the overstimulation thus given to the upward phase of the cycle may be followed by an even worse collapse than the one to overcome which the policy was first attempted.

(5) Neither set of contentions appears to dispose conclusively of the policy against which it is directed, and there seems to me to be no necessary inconsistency in the simultaneous application of both policies. To demonstrate that if costs are cut there will be a revival of trade is not tantamount to a demonstration that, therefore, the process of revival should be accomplished *solely* by this means. To demonstrate that a process of credit expansion would in the end revive business is not the same thing as proving that exclusive reliance should be placed on this method of attacking the problem. For it may well be that difficulties which would manifest themselves if only one method were employed may be absent if both are utilized.

(a) The reluctance to admit that a reduction of costs will alleviate the situation resulting from the present universal maladjustment between prices and costs springs from a confusion between a reduction of costs and an effective destruction of purchasing power. The argument upon which this reluctance is ultimately based can be stated as follows. Money costs represent income accruing either to wage earners or others taking part in the processes of production, and in the form of income, therefore, constitute the purchasing power from which flow the receipts accruing to producers. If costs are reduced, therefore, it follows that purchasing power is diminished, and the relationship between receipts and costs remains unaffected. At the lower level of costs, receipts will still be insufficient to cover costs, just as they were at the higher level of both costs and receipts.

(b) But the fact is that a reduction of costs is not necessarily tantamount to a proportionate reduction in

aggregate receipts, because, so long as the costs remain above prices, unemployment ensues. It follows, then, in spite of the fact that what is paid out in costs reappears later in the form of receipts, that the aggregate volume of receipts is less than it would have been if costs had been lower and unemployment had been less.

Again, given the present level of prices and costs, production, it is freely admitted on all hands, results in losses to the entrepreneur. A redistribution of the present proceeds of industry, such that more of the proceeds would accrue to him, and less to the other factors of production, would not reduce the *existing* volume of purchasing power, but would induce him, by additional orders for raw material, plant and labour to expand the volume of output and of employment, though it might admittedly, so long as the aggregate volume of employment had not been appreciably affected, change the nature of demand somewhat through changes in the distribution of the proceeds of industry. But the mere fact that unemployment was falling would restore to the industries producing consumption goods part of the demand which they might have temporarily lost. It would not be true to argue that such an impulse to the expansion of production would be held up by the impossibility, at the new level of costs, of finding the volume of purchasing power, in terms of money, necessary to sustain it. For if prices and costs are in adjustment, the *de facto* volume of purchasing power available must always be sufficient. But it is not difficult to see further that once given the emergence of profits to the average entrepreneur, a series of repercussions in the field of credit-creation are likely to take place which will remove the danger (if any) that the expansion of production and employment will be checked by insufficiency of purchasing power. For entrepreneurs are more willing to borrow, and bankers more willing to lend, in a period when profits are emerging than in a period when industry as a whole is sustaining losses. It may be argued, therefore, that the adjustment of costs to prices is the necessary

preliminary to the inception of monetary processes which will initiate an upward movement of prices, and thus assist such adjustment in those portions of the field of production where it has not already taken place.

(c) The view that an adjustment by means of a fall of costs, rather than by means of a rise of prices, is objectionable, not because it fails to achieve its object but because it would increase the burden of debt charges, requires separate consideration. If prices remain permanently at a lower level, the purchasing power of debts will increase considerably; as they will equally increase if the reduction of costs takes the form of increasing efficiency. But if the adjustment of prices and costs results in increasing employment and output, the real burden represented by debt charges upon output as a whole may still be a smaller one than it would have been if the adjustment had not been made. For, if the adjustment had not been made, the debt charges would have had to be met out of a smaller dividend. Moreover, as has just been argued, it by no means follows, once prices and costs have been brought more closely into line than is now the case, that a low level of prices will be permanently imposed upon producers. Purchasing power has not been destroyed but only redistributed; and a revival of activity will, partly in virtue of the banking repercussions associated with it, partly in virtue of the direct effects produced by increased trade, help to raise the price level. There is, therefore, no reason to suppose that an adjustment of costs to prices must involve a level of prices permanently as low as that now existing; not that, even if it did, considerations relating to the burden of indebtedness would be a final reason for refusing to make the adjustment, *if no other solution were possible*.

(d) On the other hand, it is impossible to deny that the process of adjusting costs to prices is one which necessarily involves much hardship, and individual inequality and difficulty, and raises such far-reaching issues of social stability, that, if it could be avoided, even if only in part, by cheap money and credit expansion, very weighty

arguments would have to be advanced to justify inaction on the part of the banking authorities. The argument that it may later be necessary to retrace the steps taken and to deflate credit in order to avoid over-expansion at that stage, cannot be considered a sufficient reason against present action. For, in all probability, the process of recovery from a depression so severe as the present one will be slow, and ample statistical and other material is available for the guidance of the monetary authorities, nor will the technical forms, which any repressive measures (which may indeed subsequently prove necessary) would have to take, present any unusual features. In these circumstances the case against present action, *on these grounds alone*, cannot be considered conclusive, though I would agree that the dangers apprehended are by no means entirely imaginary. Nor, in my opinion, can the argument that some liquidation of weak positions is a necessary part of the process of recovery be pressed too far. For, as the depression continues, the circle of weak borrowers becomes wider and wider; for the losses sustained as a consequence of the depression gradually undermine the position even of those who were originally entirely creditworthy. To assert so much is by no means to deny the truth that in the upward phases of every cyclical movement of trade some branches of production and some sources of supply become over-developed, and that additional credit creation cannot overcome the difficulties associated with the position of such industries and areas. All that is contended for here is that efforts to prevent the general situation from deteriorating too markedly should not be withheld because such efforts will be unable to solve the special difficulties associated with particular cases. To attempt to prevent prices from falling further is not "inflation" but an effort at stabilization.

(6) Thus the short-run problem must be attacked, in my judgment, both from the side of cost-reduction and of credit policy. The important issue from the standpoint of this country is the price level which will

ultimately emerge as the result of the policies actually pursued. It would be unwise to calculate upon a price level being reached, even if recovery takes place now, which would restore the precise relationship which existed, before the events of 1929, between the level of British money incomes and prices and those of the outside world. Even this relationship was an unsatisfactory one. From the standpoint of this country, then, a still lower level of outside costs and prices would mean an intensification of our problems, and this makes the task of suggesting remedies still more difficult than it would in any case be.

THE ECONOMIC POSITION OF GREAT BRITAIN

(7) It is impossible to judge between the merits of the various alternatives which lie before this country without some previous consideration of its economic position. If all the available evidence pointed unambiguously in a single direction, choice between alternatives might be easier. But, unfortunately the position is not so simple; the evidence available allows no such unmistakable inferences to be drawn.

(i) It would be an error to assume that there has not been a substantial increase in productivity during the last decade and unjustifiable to argue that the general economic position is one of unrelieved gloom. On the contrary, unnecessary apprehensions on these grounds are entertained both at home and abroad, and the widespread impression to the contrary which has been allowed to prevail has itself been a factor of some importance in aggravating the undoubted difficulties of recent years. It appears from the evidence submitted to us that the index of output per head rose between 1924 and the first quarter of 1930 by as much as 13 per cent (manufacture and mining combined) whilst aggregate output rose during the same period by nearly 10 per cent, and in manufacturing industry alone by 13 per cent. General considerations, moreover, warrant the assumption that considerable improvements in productivity must have

taken place. For, though a large part of the explanation lies in the change in our favour of the terms of trade, owing to the extraordinary fall in the prices of food and raw materials and the reduction in the *net* volume of our foreign investment, the paradox of a rising standard of life coinciding with unemployment both for capital and labour upon a considerable scale throughout the last decade would otherwise be inexplicable.

(ii) In spite of the known difficulties in transferring labour from one occupation to another, it is well known that transfer on a considerable scale has in fact taken place, with the result that the proportion in different industries has shifted markedly. Moreover, whilst between June 1924 and August 1930, the numbers of unemployed in all insured industries rose from 1,085,000 to 2,119,000, the numbers seeking employment rose from 10,430,000 to 12,094,000. The numbers actually in employment at the later date were thus 600,000 in excess of those employed at the earlier date, in spite of a doubling of the volume of unemployment.

(iii) Though the volume of our export trade in 1929 was still below what it had been in 1913, nevertheless it is not the case that particular branches of British export industry have shown no elasticity. The contrary impression which has grown up is due to the fact that in 1913 so large a proportion of our total exports of manufactured articles were concentrated in just those groups of commodities which have suffered severely since, so that, if a weighted average of all exports is taken, the total still falls considerably below that of 1913. But this conceals the important fact that, in other directions, the volume of British exports in 1929 was above that of the last pre-war year. Thus it appears from the calculations of Professor G. W. Daniels¹ that, taking the volume of trade in British exports (articles wholly or mainly manufactured) as 100 in 1913, the volume in 1929 was only 86·1. But out of the twenty groups

¹ *Recent Changes in the Overseas Trade of the United Kingdom*. Manchester Statistical Society. November 1930, Table VII, p. 17.

comprised within this rubric, twelve showed an increase over 1913, eight showing a decline : the latter apart from the Miscellaneous Class including Cutlery, Machinery, Manufactures of Wood and Timber, Cotton and Woollen and Silk Yarns and manufactures and apparel : whilst other groups (including even Iron and Steel and manufactures thereof) had either maintained their position or in some cases had substantially improved it.

(iv) Nevertheless, there are other aspects of the situation which are not so encouraging, and which require to be taken into consideration before final judgment can be passed.

(a) The fact that the terms of trade have shifted in favour of this country has meant that we have been able to buy our imports of food and raw materials on cheaper terms, i.e. to obtain the same or a larger volume of such goods at less expense to ourselves in terms of the volume of exports. This necessarily reacts on the volume of employment in the exporting industries, other things being equal. But what is true of this country *vis-à-vis* of countries producing foodstuffs and raw materials, is equally true of all other industrial nations and does not therefore serve fully to explain why the rate of growth in our exports should have fallen behind those of our leading competitors. The recent investigations of Mr. Loveday have shown that some of the conventional explanations, particularly the handicap imposed by an appreciating currency, fail to account for this phenomenon, since other countries which have undergone the same monetary experiences have expanded their trade more rapidly than we have.¹

Moreover, if it is argued that our older, staple export industries have suffered from the effects of changes in demand which lower prices for our exports could not have prevented, it must be borne in mind that this is only part of the truth. For competition between articles is, partly at any rate, a matter of price, and lower prices might have prevented, e.g., part of the substitution which

¹ A. Loveday. *Britain and World Trade*, especially pp. 152-171.

has been going on between different fuels. Moreover, part of our export markets have been lost to new competitors producing the same article, e.g., cotton goods, and in this case, at least, it is clear that comparative prices must have played a considerable role.

(b) Again, even before the world depression began, the volume of unemployment was in the neighbourhood of one million. It is known that the figure does not represent an unchanging army of individuals crystallized out of the main body of wage-earners and unable to find work, but largely represents a body of persons sometimes in employment and sometimes out of employment. Moreover, absence of adequate training or of natural aptitude, housing difficulties and the like causes of immobility between employments (including the psychological and other effects of unemployment insurance) make it impossible to argue simply from the fact of unemployment to the fact that existing levels of wage-costs are necessarily too high to enable the expanding trades to absorb the whole of the labour available at the existing level of selling prices. But, since it is probable that with lower wage-costs a lower level of prices could have been established, and therefore a lower level of demand could have been tapped, there is reason to suppose that *part* of the failure to absorb unemployed labour must be connected with the level of British costs. How much of the continuing volume of unemployment can be explained on this ground alone it would be difficult to say, but in my opinion it is a considerable part of the whole. For a rigid level of costs not only fixes the margin of profitable exploitation of *existing* industries at a point different (and higher) than it would have been if costs had been lower, but also inhibits *new* industries from establishing themselves at all.

(c) Lastly, there is the undoubted fact that throughout the greater part of the period which has elapsed since the return to the gold standard the Central Bank has found the task of maintaining the international parity of the pound sterling a difficult one. The difficulties with which

the Bank of England has been contending can be easily enough explained, if the fact is accepted that, at the time when the gold standard was restored, the then level of sterling prices, costs and money incomes was inappropriate to the parity chosen, and that, in the absence of a rise in world prices sufficient to diminish the disparity between world costs and British costs, the only alternatives open were to reduce British costs sufficiently, or to pursue a monetary policy which would offset the tendency to increasing imports and diminishing exports resulting from an unadjusted cost position. There is thus no difficulty in understanding the course of monetary policy in recent years. The easiest method of adjusting the money market position which arose from inelastic exports and rising imports, combined with the desire to invest abroad, was to maintain a level of money rates which would allow of the use of foreign balances as an equilibrating item.

It is true that the problem thus presented to the Bank of England was eased by the gradual improvement in the volume of British exports before the world depression began, and has been eased since by the fall in the world prices of food and raw material imports. Moreover the figures cited in paragraph 260 of the Report warrant the assumption that there has not been, in recent years, a *progressive* increase in our reliance on the method of equilibrating the Balance of Payments by taking up foreign balances, but rather the contrary. Nevertheless, the Bank is still faced with the task of preventing too rapid an outflow of the volume of foreign balances now held here: the level of money rates is still managed with this end in view, and the assumption that our monetary position would be more comfortable if the level of our costs permitted a greater elasticity in our export trade is not invalidated by showing that, so far as our short debt position is concerned, the dangers and difficulties of the position have been somewhat exaggerated in the past, and that, over a course of years, improvement had been taking place. But in so far as optimism is

warranted on this ground, and if the fuller information now available suggests that the precariousness of the position of the Balance of Payments has been exaggerated, one is entitled also to draw the inference that some of the emergency measures which have been put forward as means towards *improving* the Balance of Payments are perhaps not as urgent as they appear to some of my colleagues.

(8) The attitude to be adopted towards measures for overcoming the present difficulties must to a large extent turn on the assumptions to be made regarding the future developments of the economic position of this country. If the view is taken that factors intrinsic to this country make continued participation in world developments on the old scale impossible to us, or if, alternately, the opinion is entertained that the trend of world events is in any case such as to require a fundamental change in the direction of our productive efforts, more drastic modification of our economic institutions may be required than would otherwise be the case.

It is certainly one of the consequences of the increasing command over resources that all over the world the demand for direct services and for luxury goods is expanding more rapidly than the demand for the older staple products: a change which is indicated by the growth in all countries of the distributive trades, the amusement-industries, and so on. From the standpoint of the older exporting nations, such developments of demand involve both losses and gains. In so far as they can no longer rely upon the same proportion of the population finding employment in the traditional manner it implies immediate loss: in so far as these changes in demand imply alternative methods of employing populations within their own frontiers the loss is balanced by gain: for the growth of these industries everywhere implies that, provided the transfer problem can be solved, there is no reason to suppose that a failure of foreign trade to expand in the old directions means a permanent loss of well-being. Moreover, a failure of demand to expand does

not necessarily, in the case of the older industries, mean that the *absolute* scale of the industries concerned must *contract*. All that it means is that they will no longer expand at the old rate. Provided that there are not at work specially deterrent *local* influences, the shift in demand does not mean a present loss of employment, but only that, in the normal course of development, other industries and employments will gradually assume greater importance. And, as regards the newer industries producing luxury goods, the development of an export trade in these is stimulated by the very causes which explain the relative stagnation of the older staple trades, i.e., the emergence of new kinds of demands.

(9) Turning now to the case of Great Britain, the following conclusions appear to be warranted :

(a) The material prosperity of a country does not depend directly upon whether it is engaged upon manufacturing for export (thus obtaining indirectly the goods it requires for its own consumption) or whether it meets its own needs for goods by direct local production, but upon the productivity of its capital and labour. Thus a decline in foreign trade is consistent with increased prosperity, provided that increased efficiency means the replacement of foreign by home-produced goods at falling costs, and provided that demand shifts towards sources of satisfying wants which cannot be supplied from abroad (e.g., services).

(b) On the other hand, so long as world population and trade continue to expand, there is no reason to suppose that this country cannot continue as a great exporting nation, furnishing either staple products or new products, so long as our costs are upon a competitive level.

(c) Even if there are changes in the world situation disadvantageous on balance to us (and some unfavourable phenomena are certainly present) one-third of our workers in manufacturing industry are

still engaged in working for export. Any emergency measures which may be adopted for the purpose of reducing this proportion cannot possibly appreciably diminish the magnitude of the population so engaged *in the short-run*, whilst they might have serious repercussions upon that part of our foreign trade which under any circumstances we would require to maintain. And the *indirect* benefits which might be expected to follow from such measures, i.e., the stimulation of demand for products of many different kinds due to increased employment and production, would equally follow if the mass of unemployment in the export trades were reduced, e.g., by a reduction of costs.

(10) The nature of the problem which we have to solve is often misunderstood. It is not merely a question of providing alternative sources of employment at *any* standard of life: any amount of employment of a sort could be found by the simple expedient of cutting off all foreign trade. The problem is to find alternative sources of employment yielding (without adventitious assistance through subsidies or other transfer-expenditure) at least as high a standard of life to the mass of the population as was yielded by the old sources of employment. Whatever may be the case in the long run, I do not myself believe that this problem can be solved without the assistance of vigorous and flourishing export industries: or of industries capable, by their efficiency, of replacing goods at present imported by new domestic production.

SUGGESTED REMEDIES

(11) It is, I think, common ground that a failure of world prices to rise above the very low level which they have now attained—still more, a further fall—would, in any event, create a situation of great gravity for this country, both as regards the question of adaptation to the new level of costs elsewhere, and also as regards the continuance of the stream of income from abroad,

representing interest and sinking fund payments on its past investments. Something in the nature of the National Treaty advocated by Mr. Keynes and those of my colleagues who have signed Addendum I might then become almost inevitable, and the sacrifices of money-income called for from producers of all classes might have to be compensated by additional taxation on rentier and contractual incomes (or alternatively by revalorization agreements on the lines of those which have sometimes been adopted after a period of currency instability, so as to bring debts more into consonance with the altered value of money). There is no need to emphasize the great difficulties which would attend measures of this kind, but their immediate adoption is not in question. Some recovery of world prices is to be expected, and in so far as prices do recover, the margin of cost disadvantage to be overcome will correspondingly diminish. If it is admitted, on the one hand, that there might have to be an adjustment of the scale of money-incomes of so abnormal a kind as to require a special procedure, and if it is admitted, on the other hand, that some adjustments of incomes are "normal" in the sense of arising inevitably out of the changing conditions and circumstances of economic life, and therefore require no special justification, one is left with an intermediate region of adjustment, greater than the normal, less than the absolutely abnormal, which does require separate discussion. But until we have seen at what level of prices world recovery will take place, this intermediate region is necessarily indeterminate in magnitude. The alternatives before us are simple. We may attempt to adjust costs: or we may attempt by special devices to interpose a cushion between ourselves and the outside world, in the hope that thereby we may avoid, in part or in whole, the adjustments which might otherwise seem inevitable. Three other alternatives are also open to us: to do nothing at all, but deliberately await events, hoping that a favourable further turn of the tide may float us away from the dangerous rocks towards which

we are drifting: alternatively by some national action (if that be possible) to change the whole direction of our productive effort. Lastly, we may devalue or abandon the gold standard.

(12) If we do nothing at all but wait upon events we must face the danger, though not the certainty, of a cumulative loss of export markets, of growing lack of confidence in the economic strength of Great Britain as a consequence of continued large-scale unemployment, heavy fiscal burdens, and of what would be read by the world as our evident and acknowledged inability to overcome the rigidities and inelasticities of our economic and social system. We would not, in any case, have to face any sudden catastrophe, for so long as our foreign balances are not swept away by a sudden panic, the excess of our visible imports over our visible exports can be compensated by a gradual decline in the volume of our *new* foreign investments: a decline which would become inevitable if increased taxation reduced the margin of new saving through inability on our part to expand the national income. All that would happen would be that our economic strength would gradually diminish, and with the diminishing of that strength would go the hope of a progressive improvement of the standard of life of the population as a whole. What has just been said assumes no improvement in the world price level, and adjustment to that price level by all countries other than ourselves: a process which in any event involves the danger that our sterling assets in the shape of foreign loans will have suffered a substantial diminution in consequence of voluntary or involuntary default. For my own part, I do not believe it possible to sit still with folded arms waiting for something favourable to turn up.

(13) There is no reason to reargue here the case against a tampering with the standard of value. Independent and premeditated action on these lines would represent such a violent breach of national faith, and give such a blow to confidence that its ultimate consequences

can hardly be foreseen. That they would be of the gravest and most unfavourable kind, at any rate to a nation situated as we are, can hardly admit of doubt.

(14) National action to change the direction of our productive effort would have to take the form of a large scale development of Public Works, planned in advance to absorb a large proportion of the national labour force for perhaps a whole generation. As a contribution to our immediate difficulties such a plan suffers from the most obvious defects. So long as capital equipment and labour power are out of employment, and current savings are hoarded because of lack of confidence, it is, of course, true that national works are not impossible because they cannot be financed except at the expense of withdrawing resources from other possible avenues of employment. But the most urgent problem which we have to face concerns the export industries, and it is not easy to see how plans of national development would much assist these industries in the short-run. Development works of any kind will (i) absorb unemployed labour of *some* kind, (ii) give assistance to the constructional trades supplying material and equipment, (iii) indirectly stimulate demand for other labour through increasing the purchasing power of workers and employers engaged in the constructional trades and of the workers directly employed in the development work itself. But the indirect demand under heading (iii) will not necessarily be confined to home products, so that, to the extent that imports of foodstuffs and raw materials increase, no direct stimulus to home demand will result under this head. How much assistance will then be afforded to the capital and labour in the export industries must thus be very conjectural, depending upon (a) the rapidity with which plans can be developed, (b) the amount of work which can be set in hand within a given period of time, (c) the nature of the work undertaken, (d) the demand generated directly, and the proportionate distribution of this demand between home and foreign products, (e) the direct proportion of the demand

accruing to industries formerly engaged in making for export, (f) the transferability of labour and capital to take advantage of improvements in demand for goods other than those which they formerly helped to make. As a short-run contribution to the problem, I cannot believe that the policy of Public Works has much to offer to the *export industries*, in which, after all, the bulk of our unemployment is concentrated. As a long-run contribution to our economic problems, it raises other issues, both fiscal and economic, which fall outside the scope, however interpreted, of the present inquiry.

THE PROBLEM OF THE TARIFF

(15) It has, however, been suggested that a remedy lies within our grasp, which *can* be applied in the short-run, and from which, at any rate in one of its forms, much can be expected. It has been suggested that the imposition of a Customs duty (of say 10 per cent) upon all imports, accompanied by a subsidy upon all exports (also of 10 per cent) would (a) improve our balance of trade, (b) reduce the real burden of *all* the sterling costs of British industry, including fixed charges, (c) increase revenue, less, of course, the cost of subsidies. It would be equivalent in its effects upon *home-income* to a devaluation of 10 per cent in the standard of value, without raising any of the difficulties attendant upon a direct attempt at devaluation. Even if such a tariff policy proved impracticable, import duties would still be imposed, accompanied by aids to the export industries, similar in effect to, though not identical with, a direct subsidy. It has even been suggested that such a tariff, in the light of our present situation, is the ideal method of securing the optimum distribution of our national resources.

This last point, though of no great practical importance, would, if it were true, be of great scientific interest. I believe it to be invalid. A flat rate of import duty accompanied by a flat rate of subsidy on the f.o.b. value of exports would indeed make conditions even as between

the export industries and industries using home-produced materials and domestic labour, and selling in the home market. But it would *not* make conditions even as between the production of either of these classes of goods and the production of goods intended for home consumption out of imported raw materials: nor would it make conditions even between the first two classes of goods and the rendering of services, in so far as those who render services would have to pay more than before for raw materials and equipment without receiving a subsidy. (Are, e.g., ships built of foreign steel but owned by English firms on the British register to receive a subsidy or not?) But this point is of quite subsidiary importance as compared to the other issues raised.

(16) It is only as a possible solution of the monetary difficulties associated with the present emergency that I am concerned with this, or indeed any alternative, proposal involving the imposition of duties upon imports. As a suggested method of overcoming disequilibria associated with monetary difficulties the tariff suffers, indeed, from the fact that it is unable to remove the fundamental defect which is complained of, so that, unless it is constantly being adjusted to meet changes in the situation, its use as a monetary instrument is liable to create new difficulties of its own. Moreover, a review of history does not warrant giving the tariff a very high place as a method of relief from monetary distress. But neither *a priori* considerations nor historical example constitute, in our present circumstances, a sufficient answer to the case put forward by some of my colleagues.

I demur, in the first place, to the definition of this expedient as an emergency measure; one which can be dropped without difficulty when the circumstances which called it into existence have passed away. For such a tariff would tend to perpetuate those disparities between British and foreign costs to the existence of which it would, *ex hypothesi*, owe its existence. So long as these disparities lasted, retention of the tariff could and

would be urged as a method of defence, but so long as it was hoped that the tariff would remain, there would be no need to make the efforts necessary to overcome the disparities involved. It might, perhaps, be said that some recovery of world prices is to be expected and that, in so far as foreign money costs rose, the fact would become so patent that a widespread agitation directed to the removal of the duties would follow. But if a rise in world prices is to be seriously hoped for, within a measurable period of time, this very fact would be a decisive reason for avoiding (unless other grounds than the nature of the present emergency can be invoked) any measures which, once imposed, would involve, in the virtue of their very nature, their permanent retention. If a revival of world prices is not to be hoped for, the tariff ceases to be an emergency measure and would become an integral part of the fiscal and economic system of the country: the more certainly, the longer the period of time involved. Moreover, the tariff history of other countries shows with what tenacity a tariff is clung to, even when, to the eyes of impartial spectators, the industries calling it in aid are clearly able to do without its assistance. If the tariff does what it is asked to do during the emergency period, there will be a natural reluctance to part with so valuable an instrument: if it does not, it can be pleaded that failure to achieve success was due to the inadequacy of the tariff protection actually afforded. If the tariff is to be adopted at all, it is likely to be permanent.

But if anticipations in this respect are well-founded it appears impossible to suppose that Parliament and public opinion will be concerned mainly with the monetary (and supposedly temporary) aspect of the proposal. Discussion would turn, and turn rightly, upon the relative merits of the proposal, as compared with possible alternatives, as a permanent instrument of fiscal policy. What is recommended for a special and temporary reason would be attacked and defended on other and more far-reaching grounds altogether.

(17) I question, in the second place, whether a tariff would not result in a spurious equilibrium likely to cause a new series of disequilibria in the course of time. In general, the beneficial effects anticipated could only follow if the reduction in real costs were effective. An attempt to adjust the level of costs, especially wage rates, to the effect of a rise in the cost of living, would at once produce new disequilibria. But, apart from its intended effect in assisting British industry to replace competitive imports by British products (which would assist employment) it is claimed for the measure that it would help in reviving business confidence and the "spirit of enterprise". But in order that it should have these effects, it is not enough that it should create a temporary mood of optimism, to be dashed later on by the failure of the tariff to function as it was intended to do. If, as a result of the imposition of tariff duties, a sharp fall in the volume of competing imports takes place, and the volume of foreign investment is not adjusted to the change in the position of the Balance of Payments, gold would flow in freely, to be utilized to serve as the basis of an expansion of credit.

Thus, if the tariff is at all successful in achieving its objects, it seems reasonable to suppose that it would result in a temporary boom in home industries, and that, under these circumstances, a check would be given to foreign investment, at least for the time being. In the early stages of revival, the Central Bank might find it difficult to offset gold imports by sales of securities, for it would then be liable to be attacked for running counter to the policy of the Government of the day in restoring "confidence", and the anticipated effects upon the volume of credit are, therefore not only possible, but, under the circumstances, not improbable.

The money income of society would thereupon expand: especially if diminishing unemployment and rising prices led to a rise of money wages. Thereupon, at the new level of money-incomes (the tariff being supposed to remain unchanged) a new stimulus to imports and checks to exports is brought into being, and a new

disequilibrium between domestic and foreign costs is set up : to be followed either by the collapse of the boom or the imposition of a still higher level of tariffs in order to avoid the threatened breakdown of "confidence". I agree that the question can only be answered definitely by a comparison between particular, alternative projects. A slight measure of tariff protection would necessarily have slight effects. But this would apply to the beneficial, as well as to less attractive consequences to be expected from the imposition of import duties.

(18) Thirdly, I believe that the proposal for a tariff upon all imports accompanied by a subsidy upon all exports would prove hopelessly impracticable, and that the effects of any tariff which would be likely to be imposed would differ markedly from those which, it may be held, would follow from a flat rate of import duty accompanied by a flat rate of subsidy. My belief is not based merely upon the circumstance that, if such a flat rate tariff and subsidy were imposed, it would be met by countervailing anti-dumping duties in foreign countries and that, in order to avoid the danger of the application of such duties, equivalent advantages to the export industries would have to be devised, the subsidy being dropped in favour of such alternatives. I do not think that the technique of tariff-making is so little understood by foreign countries as to make it at all difficult for them to apply special measures against British goods, merely because we would attempt to grant our export trades concealed, instead of open, bounties.

The main object of the proposed tariff is not to collect revenue but to counterbalance the disadvantages of the British level of costs, as well as to keep out part of the existing imports of goods. But I feel that Parliament would not view with any great favour a scheme of tariff legislation which, whilst it would involve, in all probability, very considerable administrative expenses, would not have the advantages of leaving a large additional net revenue in the hands of the State. In combination with a subsidy, which would make an additional volume

of exports possible, the revenue aspect of the proposal is hardly worth taking seriously into consideration. But this would diminish the practical attractiveness of the proposal very much.

(19) The probability then is that the tariff as introduced would depart from the postulated simplicity of form and purpose contemplated. Though this is not the place to discuss at length the advantages and disadvantages of Protective Tariffs, it is not straying beyond the limits of the permissible to point out that the more complex and elaborate the tariff, the less can be predicted, in the absence of definite knowledge of what the concrete details are, of the effects of a tariff upon the position of the export trades. In considering the effects of the imposition of a tariff upon exports, it is not enough to take account of the direct reactions which might be expected to result, but attention must also be paid to the indirect reactions. Foreign goods excluded from the British market do not simply disappear; they reappear, in the guise of increased foreign competition, in neutral markets. The net increase in employment under all heads which will result from the imposition of tariffs is therefore likely to be smaller, and the damage to the export trades greater, than appears at first sight. The trade of the world as a whole, of course, is not a fixed magnitude, and it by no means follows that in the long run neutral markets will not be in a position to absorb both a greater amount of British goods and of the goods of countries directly competing with ourselves. But if this argument is valid, it is also valid to argue that an increase in the imports of manufactured articles into this country is not inconsistent with an increased demand for domestic products, in the long run, provided the productivity, and therefore the consuming power of the country, continues to increase.

THE PROBLEM OF COSTS

(20) The only alternative which has not yet been discussed is a reduction of costs. Since cost reduction

is inextricably mixed up with ^{and} question of wage levels, both absolute and relative, and with the question of the standard of life of the population, it is inevitable that this issue should be one which rouses some unintentional, and perhaps as much interested and calculated, misapprehension. I propose to set out the issue as succinctly as possible.

(a) The problem arises partly because we may not have increased our efficiency in the last ten years as rapidly as some of our competitors; partly because we had not, even before the world slump, entirely overcome the disadvantages attaching to the choice of ratio at which we returned to the gold standard; partly because world prices have fallen heavily since. It is very natural that producers, both employers and employed, should resent the imputation that the whole of the problem of adjustment is due to faults originating on their side: that it is entirely a question of deficiency of organizing skill, and of productive capacity. But it does not follow that additional efforts and sacrifices may not now have to be called for.

(b) A reduction of costs is not necessarily tantamount to a reduction in wage-rates, still less of money incomes. What is required is a reduction of cost *per unit of output*, and such a reduction may be quite consistent with rising money incomes. Thus the workers may be right in insisting that a reduction of costs should not take place uniquely at their expense, through wage cuts and nothing else. Our methods of organization, salesmanship, the choice of leadership, etc., are all elements over which Labour has little direct executive control, but which are extremely relevant to the problem of cost reduction. Still, if costs are to be cut by improved organization and technique, it must be borne in mind that the Labour movement must contribute its fair share to the solution of the problem. Public attention is largely concentrated upon wage-issues, but there are other elements in the situation as well; insistence upon the maintenance of practices and regulations which have the direct effect

of keeping costs up. The Labour desires to cut costs and refuses to allow wages to alter, it must at least be willing to alter practices which increase per unit cost. It can hardly be asserted with truth that this has always been the case.

(c) If it is urged that "finance" must contribute its share to the burden of cutting costs, the answer is that through conversions and re-organizations the fixed capital involved does have its remuneration reduced, whilst the owner of equities gets nothing, or gets less, unless and until profits begin to re-emerge.

(d) It may be argued that, if the cutting of costs leads to a fall of prices, and British goods can again be sold at a competitive level, profits will not re-emerge, i.e. purchasing power will be destroyed and not re-distributed. But an increase of sales which permits of a reduction of overhead costs on the whole of the output may still be consistent with the emergence of profits.

(e) It is argued that not only labour incomes, but all incomes, have benefited, in terms of real purchasing power, from the fall in foreign prices relative to our prices. This is true, but if it is used as an argument against a possible reduction of wage rates, it is invalid. For the level of money wages may be too high to permit of full re-absorption in other directions. The gain through the alteration of the terms of trade in our favour involves a transfer of labour into alternative occupations, and, if it is to be absorbed in these occupations, labour may have to accept a lower marginal wage, because in those other occupations, there has *not* been a shift of the terms of trade in favour of the British seller.

(f) Whatever reduction of wages and salaries may ultimately prove to be necessary, it by no means involves an equivalent reduction in the standard of life. A 10 per cent wage or salary reduction is not equivalent to a reduction of real income of as much as 10 per cent, even if other costs do not fall.

(g) If no wage and salary reductions take place and unemployment expands, a point must come when

working-class purchasing power as a whole will be less, given a certain combination of employment at given wage rates plus unemployment at a certain rate of unemployment pay, than it would be if wages and unemployment were both lower.

(b) There is nothing in the fact of wage or salary reduction which implies that wages and salaries can never be raised again: or that an immediate wage reduction implies a *permanent* lowering of the standard of life of the bulk of the population. The standard of life of the world, and of particular areas, is governed in the end by productivity, and there is every reason to suppose that, highly organized as the Labour Movement is almost everywhere in the modern world, successive increases in productivity will be reflected in a rising standard of life, as has indeed been the case throughout the modern industrial era.

(i) The view that a reduction in the price of British exports due to wage reductions would be nugatory, because such reductions would simply force on equivalent reductions elsewhere, is not in accordance with the facts. Such wage reductions as are taking place—some at least on a scale which suggests that not all the organized workers in the country are entirely beyond being appealed to in these matters—have followed and not preceded reductions elsewhere. Moreover, it is not necessarily the export industries themselves which should suffer any reduction of wage rates, but the ancillary and sheltered trades whose wage rates and standards have been maintained at the expense of the standard in industries less able to protect themselves.

(21) There is no reason to suppose that this country has exhausted the possibilities of rationalization, using that word in the largest sense; and it may very well be the case that, in order to push on as fast with rationalization schemes as the urgency of the situation requires, intervention by the State, both in the way of arming an industry with statutory powers and by way of guarantee, may be required. But—even in the absence of a catastrophic

alteration of world prices—such schemes may not prove enough; and some alteration in the scale of wage rates may be necessary. Those who do not wish to see wage rates reduced, or who think it impossible to do so, in the main urge measures which will have the same economic effect—the imposition of a general tariff. Indeed, unless the tariff does have this effect, it will not be a solution of that aspect of the British economic situation which concerns the members of this committee.

(22) It is true that a tariff, *if successful in reducing the standard of life all round*, would hit classes of the community who would not only not be affected unfavourably by a reduction of costs, but who would gain from such a reduction. That wage-earners should dislike wage reductions at a time when it can be plausibly argued that the rentier gains is no doubt perfectly natural, even though the economic depression has much reduced the value of investments in industry, and even though among the ultimate beneficiaries from the rise in real value of the National Debt are the working-class members of Trade Unions, Friendly and Building Societies, etc., owning blocks of War Loan. But the problem confronting us is one which cannot be settled on emotional grounds alone. The difficulties in the way of special taxation of the rentier are very great. But it is clear that any considerable reduction in the money value of the National Income must involve increased direct taxation to meet debt charges, unless a successful large-scale conversion operation can be undertaken in the near future. Such increased taxation (the basic rate of Income Tax having already risen in recent years by 12½ per cent) will fall in the main upon rentier and contractual income, and constitutes an offset to any increase in non-working-class well-being due to reduction of prices and costs, which would not, if money wages fell, accrue to those dependent upon incomes from labour.

(23) In the course of the last decade we have become, as a nation, highly sensitive to considerations of equity as between class and class. At the same time, partly

in consequence of our desire to translate our ideas of equity into practice, our economic and social structure has become less fluid and less amenable to change. To sacrifice elasticity to equity is tolerable so long as, in the outside world, changes are not proceeding at so rapid a pace as to make adaptation on our part, even if only with a time-lag, ultimately impossible. It may be that we are now faced by a turning point in the history of the world price level, to which, in the end, the level of costs in the outside world will adapt itself. If this diagnosis of the situation proves to be correct, it would be out of the question for us to maintain a level of costs out of all proportion to costs elsewhere. It may, on the contrary, prove to be the case that the world is now in the trough of an unusually deep depression, recovery from which will bring with it a renewed rise of prices. It is too early yet to say definitely which of these things will happen : but it is clear that a world rise of prices would greatly mitigate the severity of the task which would otherwise confront us. So long as the present degree of uncertainty as to the future level of prices prevails, to defer action, in order to take thought, is perhaps legitimate. But to defer action simply because we are as a nation afraid of acting at all would be a confession of moral weakness, neither creditable to the traditions nor beneficial to the economic future of the country.

WHITHER THE POUND ?¹

It is a fairly safe conjecture to make that only a very small minority indeed of those professionally interested in monetary questions—whether as Treasury or Bank of England officials or as economists—could have foreseen last September, when Great Britain abandoned the gold standard, the present, to all appearance, very paradoxical state of affairs. There may have been rejoicing in the camp of the advanced Monetary Reformers that at last this country had shaken off its shoulders the Old Man of the Sea who was strangling the possibilities inherent in an autonomous monetary policy. There may have been, even in those quarters where belief in the gold standard was a prime article of faith, a certain measure of relief, once the mood of bitterness engendered by a sense of failure had passed away—relief at the prospect of at least temporary escape from nerve-racking responsibilities. But both sides would have concurred in thinking that the probabilities of the situation pointed, not only to some check to imports and stimulus to exports so long as the fall in exchange was not offset fully by a rise of prices, but *also* to a rise in the general price level and the cost of living, as well as to considerable uneasiness at home and abroad as to the future course of sterling. The paradox of the present situation lies in the circumstance that, whilst some of the favourable consequences to be expected from a fall in the gold value of sterling have actually manifested themselves, most of the unfavourable ones do not appear to have been produced. Unemployment has fallen, but, in spite of a reduction of nearly one-third in the gold value of the pound, prices at the end of 1931 were actually lower than they were at the end of 1930. The Board of Trade Index Number at the end of 1931 stood at 63·7, as against 65·5 twelve months previously,

¹ Reprinted from *The Nineteenth Century*, April 1932.

a reduction of 2·7 per cent ; the Food Index alone at 67·8, against 69·8, a reduction of 2·9 per cent. In February 1932 the Combined Index was still below the figure for the same month of 1931. The Cost of Living Index, which in July 1931 stood at 145, stood at 147 in February 1932, a hardly perceptible rise. How is one to explain these results ? Have economic laws ceased to operate, or are the statistics entirely misleading ?

A great deal turns on ascertaining the true explanation of what has been taking place, for the public's satisfaction with the results of going off gold is based in large part upon the fact that the rise of prices so freely predicted does not appear to have taken place. It is true that an important section of economic opinion holds that an ultimate improvement of economic conditions can only come about if prices do rise ; for only by this means can the burden of fixed debt resting upon the taxpayer and the industrialist be appreciably mitigated. But public opinion is not concerned with matters so far removed from its immediate pre-occupations. The General Election was largely won by appealing to the fear of inflation : by an appeal, in other words, to the desire to conserve the purchasing power of the pound. Events seem miraculously to have confirmed the wisdom of the choice made by the electorate : the pound still buys more than it did a year ago. But can this state of things continue, and what are the choices open to us to prevent public confidence in a paper instrument of exchange from being rudely shaken ?

The relations between the price level and the rate of exchange, given a paper standard, are complicated and require explanation before the statistical and other facts of the present situation can be dealt with. Under an international gold standard, so long as it is effectively maintained, the rate of exchange cannot vary except within very narrow limits. The result is that, if the price levels in two gold standard areas are markedly different, it is only by adjustments in these price levels relatively to one another that equilibrium can be brought

about. Goods will move from the low-priced to the high-priced area, and gold from the high-priced to the low-priced area—i.e. one country will have, for the time being, a favourable, the other an unfavourable, "ba'ance of trade". The method by which adjustment will be brought about eventually is through gold imports stimulating credit expansion in the one case, and causing credit deflation in the other, with the final result that prices will tend to rise in the one area and to fall in the other. The attainment of equilibrium conditions, however, is by no means automatic; to bring it about, the social and economic structure must be sufficiently elastic to enable wage rates and other money incomes to respond to changes in the volume of credit, and the volume of credit itself must be regulated in accordance with the inflow and outflow of gold. But this by no means invariably happens; in fact, one of the reasons for the breakdown of the gold standard in recent years has been the refusal of the responsible monetary authorities to *allow* gold movements to affect the credit structure to a sufficient extent. But, in any case, given a gold standard, adjustment comes about through variations in the relative price levels induced by changes in the volume of credit, such changes themselves being brought about through changes in the volume of gold held.

In the case of an inconvertible paper standard it is not the price levels which change in the first instance, but the rate of exchange. Suppose a country with a paper standard. Imports and exports of gold do not affect its price structure. If, at the rate of exchange ruling at a given moment, its price level is not in equilibrium with the price level outside its area, its exports will be checked and its imports stimulated if the rate of exchange results in its prices being abnormally high to the foreigner; or in a stimulus to exports and a check to imports if the ruling rate of exchange results in its prices being abnormally low to the foreigner. But the first situation results in an increased demand for foreign currency and so to a decline in the value of the country's

currency abroad, whilst the second situation results in an increased demand for the country's currency in foreign areas, which will lead to the foreign value of its currency rising. In equilibrium, the rate of exchange will be such as just to offset the relative differences in the price levels inside and outside the area. But equilibrium may take a long time to bring about if, before the rate of exchange has had time to adjust itself to the original position of the price levels, these price levels themselves alter.

If the general direction which the exchange rate ought to take, so that equilibrium can come about, is a downward one, the cost of imports is bound to go up, assuming foreign prices to remain unchanged. The cost of imports *ought to rise in order that consumption of them may be checked*. So far as such imports are competitive, demand will change towards home-produced goods, which have not yet risen in price. This will cause further activity in the industries producing such goods and may lead to an expansion of credit, through increased demand for bank loans. But if the volume of credit is expanded, prices will tend to rise again inside the country, thus necessitating a still further fall in the exchange before equilibrium is produced. Again, suppose the imported goods to enter into the construction of the cost-of-living index. If, as a result, wage rates are adjusted upwards, and if, in order to finance higher wage payments, employers borrow from banks so that the volume of credit is expanded, again the equilibrium rate of exchange will have to be lower than it needed otherwise to have been.

Equilibrium, again, may be delayed, not by any rise in domestic prices, but by a further fall in foreign prices. If British prices in terms of paper money remain unchanged, whilst foreign prices fall, what is the result? The cost of imports, at the ruling rate of exchange, will be less than if foreign prices had not fallen, but this stimulates their importation. But, relatively to foreign goods, British exports will be more expensive than they

were before foreign prices fell, and exports will consequently be checked. The rate of exchange will move against this country, in order to check additional imports and stimulate exports, but it will have to move *further away* than it needed to have done if foreign prices had *not* fallen. It is true that falling foreign prices enable us, in the circumstances imagined, to buy our food and raw materials more cheaply, and are so far to the good; but that fall also checks exports and necessitates a more far-reaching fall in exchange to overcome the disadvantage so resulting to the export industries.

A further complication arises from the influence on the rate of exchange of capital transactions. If France or the United States "call in" their balances now held by London bankers, these balances can only be effectively liquidated, from the economic point of view, by an export of goods or by a transfer to France and the United States of goods which inhabitants of this country might otherwise have consumed. Every other form of so-called "liquidation" of balances is only a transfer of ownership, but not a final wiping out of the debtor-creditor relationship. If, e.g., French sterling balances are sold to Dutch speculators in sterling, this transfer still leaves London a debtor on balance. Now, how can the additional quantity of goods necessary to effect a *final* liquidation be obtained? A further fall of exchange is necessary to check imports and stimulate exports, *over and above* the fall (if any) necessary to equilibrate the price levels. Such a fall will, of course, have the effect of making imported goods still dearer and our goods still cheaper to the foreigner. But it is only when the exchange and the price level in conjunction give such a bonus to exports and such a check to imports that exceptional capital transfers become possible. Such a rate of exchange which is lower than is necessitated by a direct comparison of prices is said to "under-value" the local currency. As soon as exceptional capital transfers cease the rate will improve, provided that, in the meantime, foreign prices have not fallen further, or local prices risen any more.

Complication upon complication, it will be said. But, unfortunately, it is considerations like these which govern the rate of exchange when a country is off the gold standard, and they form the necessary background to what has been happening since September, and to what will happen in the future.

What, then, explains the course of prices since September? In the first place, though prices are still lower than they were a year ago, they are higher than they were when we went off the gold standard. Part of the satisfaction with the present state of affairs is due to the choice of dates. The *Economist* index number (1927=100) shows that prices on September 18th, 1931, were 60·4, on December 30th were 65·8, and on March 9th, 1932, were 66·3, a rise of over 10 per cent. On the basis of September 18th, 1931=100, the complete index on March 9th stood at 109·8, and the index of seventeen primary products stood at 116·0, after having been as high as 120·9 on February 24th. The fall in exchange has thus already produced some effect upon our price level. That it has not produced *more* is due to a variety of circumstances. We are not the only country which has abandoned gold; on the contrary, practically the entire raw-material producing world is off gold. To the extent that the former premium upon sterling in terms of various currencies has declined, import prices in this country have risen, but the existence of paper currencies in the outside world has lessened our dependence upon gold countries, injured their exports and kept prices steadier here. In the next place, gold prices of primary products, after an initial rise from the middle of October to the middle of November, have fallen much below the September level. Thus the *Economist gold index* for the seventeen primary products stood at 94·7 on September 18th, rose to 103·5 on November 11th, and fell away again to 90·3 by the beginning of March. In the third place, trade has been and is depressed, and there are large stocks: under these conditions there is inability as well as unwillingness to raise prices to the full extent

of the fall in sterling; further, the fear of being charged with "profiteering" may have acted as a deterrent. Fourthly, the extent to which the cost-of-living index is directly affected by changes in the cost of imports is usually exaggerated; only about one-third of the index is directly so affected, and it so happens that about half the food imports are from countries not upon the gold standard, so that Professor Bowley has calculated that a 25 per cent appreciation of gold in terms of sterling would cause the cost-of-living index to rise by only 4 per cent. Lastly, and very importantly, the existence of a high bank rate and the general uncertainties of the time have prevented credit expansion, and, therefore, the beginning of anything approaching inflation.

The sterling cost of imports at any moment of time is, of course, the direct resultant of the price ruling abroad and the current rate of exchange. The current rate of exchange is in the neighbourhood of \$3.70 to the pound sterling, and there can be little doubt that at this level the pound sterling is considerably under-valued. The *Economist* index for the last week of February stood at 110.9 for Great Britain: the United States figures (the Irving Fisher index) stood at 92.4. On this basis £1 should be equal to \$4.05 approximately, instead of being worth nearly one-third of a dollar less. The under-valuation of the pound is to be explained in terms of the effort of holders of sterling balances to withdraw them, thus forcing exchange down, at a time when the disorganization of world affairs was in fact neutralizing the existing and very considerable exchange bonus to British exporters on their sales in gold currencies, and when, at the same time, the decline in the earnings of British shipping, the falling off of revenue from financial and commercial services rendered to other countries, and the cessation of income from past investments abroad were reducing the British capacity to pay for imports except by the current export of goods. For it must not be overlooked that one of the vital ways in which world depression is affecting this country is to reduce our income

from abroad—whether that income is derived from the rendering of services or the ownership of securities. The exchange market is having to adjust itself, not only to relative changes of prices, but to changes in the size of the national income and to changes in the net position of indebtedness on long-term and short-term account. Our assets are largely frozen, our liabilities are to a large extent quick liabilities, and, at the same time, international depression is reducing the inflow of current income with which we might in part have met any draining away of our foreign balances. So far as there is any speculation in the pound sterling, it was probably *à la baisse* until recently. Such speculation, whilst in the long run it must steady the value of sterling—for “bear” sales have to be covered by purchase—had for the moment also the effect of depressing the rate of exchange. The forces which thus combined to cause sterling to be undervalued are cumulatively very considerable. Any changes in the international situation which would increase the inflow of income, reduce the pressure to remove balances or reverse the direction of flow and stimulate buying orders, would improve the sterling rate of exchange, reduce the cost of imports (assuming foreign prices to remain unchanged), but would at the same time reduce the export bonus, in terms of sterling, which at present accrues to exporters in so far as they are selling in terms of gold. The abrupt upward movement of sterling in the first week of March caused great alarm on this very ground.

From the standpoint of British policy, both political and financial, the important matter is: What is going to happen in the future? From the purely economic standpoint, it must be emphasized, there is no problem in the sense that the exchange, freed from association with gold, cannot, in the long run, fail to find an equilibrium level. However severe the pressure upon the “Balance of Payments” through the falling off of income and the pressure to transfer balances, as well as through a decline in current prices abroad in consequence of world

disorganization, the rate of exchange can be relied upon to fall until imports are checked sufficiently, even if exports cannot be greatly stimulated. But the price we should have to pay might be a very low rate of exchange, so low (if world prices go on falling) as to cause prices to rise appreciably here. But a falling exchange, whilst a country is off gold, brings with it the danger of psychological reactions. The falling exchange may create alarm, leading to a further withdrawal of balances and therefore to the necessity for a further fall of exchange, which, under the conditions pre-supposed, ought to take place in order that consumption of imports may be checked. But if the imports are, e.g., foodstuffs, necessary for the existence of the population, it may require a very high price domestically, and a very considerable fall in exchange, before equilibrium is restored. It is true that, provided credit policy is rightly managed, a currency *cannot* "fall to pieces": the continental cases, where a fall in the external (exchange) value of the currencies preceded final collapse, were due to failure by the Central Banks of the countries concerned to take the appropriate steps. But the psychological aspect ought not to be overlooked, and, in any case, given the continued dependence of this country on foreign food imports, as well as the fact that a large part of our overseas investments is payable in sterling, a very low rate of exchange may prove disadvantageous to us, even apart from the influence it may have upon public opinion. The immediate manifestation of unrest in Parliament and the Press when sterling fell sharply in the late autumn of last year shows very clearly the political risk which may be involved in allowing economic forces to work themselves out.

Assuming that it is not desirable that sterling should go on falling, what are the natural economic conditions consistent with a cessation of the fall? First, as regards the price situation. Contrary to common opinion on this point, a continuously falling price level, whether gold or paper, in foreign countries does *not* mean, if our

prices remain stable, a ~~to~~ in exchange or even a cessation of the fall, or ultimate ~~no~~ absence of a rise, in the cost of imports. For, as ~~rise~~ ~~is~~ ~~explained~~, falling prices abroad render British exports less attractive, and the pressure to adjust both sides of the account will force exchange down and the cost of imports up. Again, it is not the case that rising prices abroad necessarily imply that our imports will cost us more *in terms of sterling*. For rising prices abroad, whether paper or gold, will increase the competitive strength of the British exporting industries, and the pressure to adjust both sides of the account through a falling exchange will relax—i.e., a rise of prices abroad enables the equilibrium rate to be higher than would otherwise be possible, and the cost of imports to be lower, in terms of sterling.

The second set of circumstances which have to be taken into account relate to those forces which result in an "under-valuation" of sterling, i.e., a depression of its value below the point justified by the relative position of price levels. If the international situation improves, if confidence in the political and economic stability of the country becomes strengthened, then the temporarily depressing influence of "bear" speculation will cease: the pressure to export to pay off balances will relax; the pressure to cut down imports through a falling exchange will also diminish, and the rate will improve, up to that point at which the exchange will equilibrate internal and external prices. It may even go up beyond this point, so that exchange becomes "over-valued," which would create grave difficulties for the exporting industries, and stimulate imports to the same extent that exports were depressed. It is not a "high" or a "low" exchange which matters, but a rate high or low relatively to the position of the internal and external price levels.

It follows from what has been said that Great Britain is still intimately interested in the fate of the world's price level. Any further fall of prices, by increasing the difficulties of the export industries, will more than

neutralize any beneficial effect which might be exercised upon the cost of imports. Because, although imports might be cheaper if the rate of exchange were maintained at a given level, it is difficult to suppose that the exchange will in fact be able to be maintained. It is true that at present, with sterling under-valued, exports are encouraged and imports discouraged, but this under-valuation may cease, and then the real difficulties of the situation will begin. For a period of rising exchange would, in the event of world prices continuing to fall, be followed by a new period of falling exchange, especially if, in the interim period, credit expansion were permitted and the British price level allowed to rise.

The equilibrium position of the rate of exchange must constitute, then, a major preoccupation of any British Government so long as we remain upon paper. On the course of world prices we cannot, in the main, exercise any influence, except to the extent to which British fiscal policy may embarrass foreign suppliers and thus cause their prices to fall, and to the extent to which the abandonment of the gold standard, by reducing the aggregate demand of gold, will ultimately help to lower its value, i.e., to raise gold prices. But these are only indirect influences, and not of major importance in so complicated a price situation as the present one. For the greater part, therefore, any influence which can be exerted by us upon the rate of exchange must be through operating upon our own price level or through the other factors which help to determine the rate of exchange.

We have the choice of allowing the rate of exchange to settle itself, however low the level to which it may fall, or of attempting to keep it from falling below a certain limit, in the event of world prices not recovering: for a rise of world prices, provided we prevented our price level from rising as quickly, would automatically improve the exchange. From the economic standpoint there is much to be said for allowing exchange to find its own level, for every attempt to keep it in the neighbourhood of a certain dollar value implies the reproduction of

conditions analogous to those obtaining under a gold standard. If the rate is not to be allowed to fall, other factors in the situation must be adapted to the exchange, and not the exchange to the other factors.

The alternative policies which could be adopted to prevent exchange from falling are really only three in number. It is possible to borrow abroad; it is possible to keep the level of British prices and incomes at such a figure that, even if world prices do go on falling, the exchange will not decline too far; lastly, it is possible to attempt to keep exchange up by a general restriction upon imports. The first of these alternatives is the one utilized during the period 1925-1931; it has the great disadvantage that it exposes the borrowing centre to panic influences unless the loans are formal, long-dated ones, not subject to instant recall. The two other alternatives can be summed up as the method of *Income Deflation* or *Tariff Inflation*. It is the latter policy which the National Government has chosen to adopt.

These phrases sum up, not merely alternative policies, but historic controversies, where roots reach back to the very beginnings of modern economic doctrine, and, although at the moment the country is to link up its fate with Protection, the intellectual battle involved has not by any means been decided. The important question is: Are these two alternatives real substitutes for one another? Can deflation be avoided and the exchange be protected by the use of tariffs? It must be understood that what is being dealt with here is not the advantages or disadvantages to *particular industries* arising from the imposition of a tariff, but the influence of tariffs upon the rate of exchange. How, in other words, do these various alternatives work out? Both are alike in this respect—namely, that, if the world price level goes on falling, a cumulative use must be made of them, in order to maintain a given level of exchange; i.e., neither instrument will yield its fruit without further application of the same remedy if the general price situation alters. So far as concerns the process of adjustment,

deflation, by reducing the volume of money incomes, prevents as much being bought at any given level of world prices and of exchange—i.e., it deters purchases, not by increasing the price of imports, but by decreasing the funds with which the imports are bought; that is, it makes the British a bad market to sell in by forcing prices down. At the same time, it stimulates exports, because, at the given level of exchange which it is desired to maintain, the cost of British exports to the foreign buyer falls; relatively to the level of foreign prices, the British cost and price level has been reduced: even if foreign prices are falling, the difference of price levels has been narrowed. Under a tariff the direct effect is to cause a lessened consumption of those imports, the price of which, plus duty, is higher than the cost of competing products in this country, though, if the articles made at home are made of imported materials, the *net* advantage is much smaller than appears at first sight, even if possible repercussions on credit expansion are neglected. If the articles cannot be made here and there are no substitutes, consumption will still be lessened in all probability, but not to the same degree. In the case of raw materials of production, destined to be worked up and re-exported, there will be lessened consumption unless a rebate is given on export, because the higher cost of the raw material will cut off part of the foreign demand for the finished product. In this case, clearly, the check to imports will be accompanied by—in fact *caused* by—a fall in exports. But even if raw materials of industry are excluded, the difficulty attaching to a use of the tariff as an instrument of exchange control lies in *all* cases in the repercussions upon the export situation. For since, in the case imagined, foreign prices are assumed to be falling and British prices have not, the higher level of exchange which the imposition of import duties may permit will not be offset by lower prices and costs in the country, with the result that exports will be checked and the maintenance of the exchange at the desired level will be imperilled. Moreover, the increased pressure

on foreign price levels due to intensification of competition abroad due to goods being excluded from the British market must tend directly to reduce the sale of British goods in neutral markets.

These conclusions may seem disappointing to those who have been taught to think that the abandonment of the gold standard emancipated this country from the pressure exerted on its economy by price changes in the outside world, and to those who find in the tariff a solution of all our difficulties. A free exchange can only help us if it is allowed to find its own level, and we are prepared to accept the results of a falling exchange on the value of imports and on the cost of living, etc. The tariff, in so far as it is successful in excluding imports and keeping up the rate of exchange, at the same time checks the growth of exports and thus increases the difficulties of the export industries. Imports may indeed be less than they would have been without the tariff, but this is not the same as proving that they will therefore be less than they would have been if the rate of exchange had been allowed to fall. Exports may not be less even with the tariff than they might have been without it, *given the same rate of exchange*, but this is not the same as proving that they will therefore be as great as they would have been if exchange had not been kept up. The fact is that this country is so intimately bound up with the world order that, whether we are upon gold or upon paper, whether we are Free Trade or Protectionist, our fate, it is clear upon reflection, is largely dependent upon the course of prices abroad.

BRITAIN AND THE GOLD STANDARD¹

SINCE Great Britain's departure from the gold standard on September 21st, 1931, the course of the dollar sterling exchange has revealed three major movements. It fell almost continuously till December, the average daily rate for that month being \$3.37 to the pound. From thence onwards it rose to a new maximum in April 1932, the average rate for that month being \$3.72. By July the rate had sunk to \$3.56. In August, September and during the first three weeks of October the rate showed considerable stability, the average for the whole of this period being about \$3.46. As this article is being written, late in October, the downward tendency has again been renewed.

Toward the end of the week ending October 22nd, Sir Hilton Young, a distinguished parliamentarian who was formerly a brilliant financial journalist, speaking as deputy for the Chancellor of the Exchequer at the Annual Bankers' Dinner, vaunted the intrinsic stability of the pound sterling and put an end to any hopes or fears that might have been entertained that the British Government contemplated an early return to the gold standard. His speech may have contributed to the subsequent weakness of the sterling exchange, in so far as it may have encouraged continental speculators to sell short and continental bankers to withdraw balances. It has certainly not met with even the shadow of criticism in the British press; on the contrary, it is certain that, in the present state of public opinion, a return to the gold standard would be highly unpopular. When, a year ago, sterling was falling there were certainly some voices demanding that "something should be done about it". It is significant that it was the rise rather than the fall of sterling which produced alarm in the spring.

¹ Reprinted from *Foreign Affairs* (New York), January 1933.

To appreciate this state of public opinion, it must be related to the past, both near and remote. Great Britain had been a gold standard country for a century before the war; it was, and is, the centre of international financial operations; the Bank of England had rendered yeoman service in restoring the gold standard in Europe in the period 1925-1929, and only recently supported a resolution in favour of the international gold standard at a meeting of the directorate of the Bank for International Settlements; finally, the present National Government was originally formed to save the pound from destruction and played upon the fear of inflation in the autumn of last year—in the opinion of many somewhat shamelessly. Any discussion of the possibility of Great Britain returning to the gold standard requires that account be taken not only of those factors in the domestic and world situation which may well make even a convinced supporter of the gold standard hesitant, but of those intangible, perhaps partly irrational elements of public opinion which no government can afford to neglect. I shall begin with these wider elements of opinion, because, at a distance, they are in danger of being overlooked.

The gold standard is unpopular, to begin with, because to it is attributed both the world depression *and* the peculiar difficulties to which Great Britain was exposed in the period 1925-1929; and in the formation of opinion the special difficulties of this country have played perhaps the greater rôle. When the gold standard was restored, the opponents of the step then taken (and particularly Mr. Keynes) pointed out that, if the old parity of exchange were restored, the gold cost of British goods to the foreigner would rise unless the level of British costs fell, and that there was grave reason to fear that British costs would *not* fall. In a word, there was a danger that the pound sterling would be permanently over-valued, unless either world prices rose (without a corresponding rise in British internal prices taking place) or the forces of rigidity within the British economic

system were overcome. If world prices neither rose nor British costs fell, the result would be a more or less permanent depression in the British exporting industries. In my opinion, whilst it would be unwise to say that the whole of the difficulties of, say, the British coal trade in the last decade are due directly to the re-imposition of the old parity, undoubtedly the currency situation contributed to the difficulties actually experienced by exporters. The trade unions feel that they were asked to consent to a wage reduction merely because of a currency policy forced on them by "financial interests". Employers feel that they had to consent to a fall in their export prices and, under the conditions of the case, a deduction of profits on the same grounds. A large part of British industry is therefore disinclined to return to the gold standard because it fears a repetition of the same difficulties in the future. As for the general public, it has appreciated the line of argument advanced in 1925 and subsequently sufficiently well to have the impression that it was the supporters, rather than the opponents, of the gold standard who failed in their predictions; and consequently it is unsympathetic to restoration of gold.

But the state of business opinion is also in part influenced by the somewhat irrational idea that a fall in the international value of the pound is necessarily favourable to British exporting interests, whilst a rise in the value of the pound is unfavourable: the alarm which was felt at the rise in the dollar value of sterling in the spring was due in part to this feeling. In other words, business opinion feels that the existence of a falling exchange also implies the existence of an "export bonus", whilst a rising exchange involves a tax upon exports. Now, in so far as the falling exchange merely registers the extent to which world prices are falling more quickly than British prices, and accurately measures the extent of the difference, a falling exchange does not yield a bonus, any more than a rising pound due to world prices rising more rapidly than British implies any impediment

to export. It so happens that the pound sterling probably has been "under-valued", i.e., the international value of the pound has been below its true value on a comparison of price levels, because in the case of Great Britain the exchange has been, and is, greatly influenced by financial movements which have only remote (if any) connection with the state of prices. There has therefore been a bonus on exports, which a rise in the exchange would imperil. Opinion in Great Britain does not recognize that the continuance of such an under-valued exchange, given a free exchange, is intrinsically unlikely, or that its existence is in itself one of the reasons for the continuous increase in the import "quota" and "anti-dumping" legislation of other countries. Public opinion confuses the advantages resulting from a free exchange with those resulting from a temporary position of the exchanges, and its desire to retain these temporary benefits leads it to refuse to assent to the disappearance of a régime under which they are possible, even if only temporary.

Thirdly, public opinion has learnt to associate the world depression with the existence of the international gold standard. I have to refer here to arguments which must be familiar to American readers: the two theses that the fall of prices is due to gold shortage and that it is due to gold maldistribution have become common-places even to the general public. It would be easy to exaggerate the *direct* influence of experts such as Gustav Cassel and Sir Henry Strakosch upon the movement of opinion, though their views have been given wide prominence in the press. Whereas the trained economist is inclined to describe the depression as a cyclical decline in activity, accentuated by abnormal political and economic factors, the "man in the street" now believes that the fall of prices is due to the fact that "there isn't enough gold to go round" and that what gold there is has been locked away by France and the United States. This maldistribution of gold, he has been taught to believe, is due to a failure on the part of other countries to "play

the rules of the gold standard game". Under these circumstances, he is naturally inclined to ask himself whether it is not better to stay where he is rather than risk any further disasters by linking up again with gold. In a more sophisticated form, this view is shared by many whose knowledge of the technical position is much greater. In any event, the position in the United States (which the public believes to be much worse than it is in Great Britain), and the growing difficulties of France (which have not failed to be advertised by the press), are negative reasons for refusing to budge. The retention of the gold standard in these countries has certainly not prevented the accentuation of local difficulties in the period during which Great Britain has been off gold.

Moreover, the country finds itself in good company. It is not as if Great Britain had been driven off gold whilst the rest of the world remained unaffected by the British action. On the contrary, a large part of the world is in the same plight as Great Britain, and the number of paper standard countries has been added to since last September. In the spring of this year, when the great gold drain from New York was taking place, there were not wanting voices in the City of London prepared to argue that by the autumn the pound would be worth six dollars. The wish was no doubt father to the thought: it is certain that there has been no general conviction that the gold standard will maintain itself even in those areas where it is still ruling. Moreover, although the Ottawa Conference did nothing to further the hopes of those who saw in it the formal instrument for creating an Imperial Currency Union (to which other countries might perhaps be eventually admitted), the public knows that the "Sterling Club" is co-extensive with a large part of the Empire. The public also sees that the maintenance of the gold standard on the European Continent has been accompanied by an ever-growing volume of exchange regulation and it is not convinced that other countries—for instance, Germany—may not ultimately be forced off. For these reasons,

there is an under-current of feeling that the flowing tide is with the paper standard rather than with gold, and opinion is not prepared to risk a return to gold unless there is more evidence than is at present available that Great Britain's return would be followed by Scandinavia, for instance, or by those dominions, e.g., Australia, whose immediate interest it is to see that the gold and commodity value of sterling should be kept low.

To these more remote considerations must be added the tangible facts of the situation. The immediate consequences of the departure from the gold standard have been on balance favourable and are certainly far removed from those which were predicted in the summer of 1931, when the struggle to maintain parity with gold was going on. At that time it was freely predicted that the abandonment of gold would lead to a drastic fall in the purchasing power of sterling, and the politicians, at any rate, played upon the fear of inflation with very considerable effect. But, for various reasons, the unfavourable consequences which might have been expected to accompany the departure from the gold standard did not materialize, whilst some of the favourable consequences did manifest themselves, though to a smaller extent than the optimists had hoped for. The fundamental reasons for the non-appearance of unfavourable reactions upon the cost of living were the continued fall in gold prices and the steady decline in the number of gold standard countries. Great Britain was in fact in a position to exert a *deflationary* effect upon the prices of all those commodities for which she represented an important market, especially at a time when import and exchange restrictions of all kinds were narrowing the world market to an unprecedented extent. Moreover, public opinion took no account of such price changes as actually occurred. Between September 1931 and October 1932 the *Economist* index number (September 18th, 1931=100) show two maxima. On February 24th the general index stood at 111 approximately, and on September 7th at 107; the index of primary products

on the two dates in question stood at 121 and 120 approximately. But the cost of living index barely moved and on balance has been falling; thus, the Board of Trade general index number was the same in August of this year as it was in August 1931. It must further be borne in mind that for a time at least unemployment ceased to increase, though this favourable symptom ceased after December 1931. The fall in the exchange undoubtedly benefited certain industries, primarily textiles; for a time the growing depression in shipbuilding and iron and steel was checked; and there was a sharp rise (partly seasonal, however) in the index of production. Moreover, the combined effect of tariff measures and a falling exchange was to cause (after a preliminary period of rising imports, due to anticipation of the duties which were later to be imposed) a sharp drop in the volume of manufactured imports: exports of manufactures maintained their position at a time when the general decline in world trade would have warranted one in expecting a decline. Thus the visible adverse balance of trade moved in a direction favourable to the country—and the fact that a cutting of imports must be accompanied by increasing pressure on such countries as Germany was overlooked in the general rejoicing.

These favourable symptoms lasted long enough to give renewed confidence in the outlook at home. After unemployment began to increase again (in May) other counterbalancing elements of satisfaction made their appearance. The creation of the Exchange Equalization Fund, coinciding as it did with the flight from the dollar, gave sterling an appearance of stability which was a necessary preliminary to the great conversion operations of the government. In estimating the situation, the fact that there has been in progress a great boom in gilt-edged securities must not be overlooked. In September of last year the index of gilt-edged securities stood at 97·9: it fell to 92·6 in October and has since recovered to 126·8.¹ Thus the rentier class and the bankers,

¹ Basis 1924 = 100. London and Cambridge Economic Service Index.

those sections of the population most likely to be scared by a falling external value of sterling, have seen their security holdings appreciate some 40 per cent, and if this result has been in part achieved by official propaganda and an embargo on competing issues, a saving to the Exchequer of £23,000,000 net and a sense that the "old country is not played out yet", as well as very handsome profits on current purchases of gilt-edged stocks, are ample compensation. The fact that bankers' deposits at the Bank of England are up some £18,000,000 and bank deposits are up by some £150,000,000—in other words, the circumstance that there *has* been some inflation which must sooner or later affect prices—is either disregarded or welcomed. Certainly it does not diminish satisfaction with the way in which events have moved.

I come now to the more narrowly technical reasons which prevent any great enthusiasm being displayed for an immediate return to gold, or even a return within a foreseeable time.

The first is the perfectly understandable reluctance to risk a return to gold unless it is certain that, if the return is decided upon, a new wave of international unrest will not drive the country off again. This issue is, of course, a different one from the quite narrow question of the choice of parity. There is universal agreement that, failing a drastic rise of world prices in which Great Britain does not share, a return to the old parity of \$4.86½ to the pound sterling is impossible—and there are not wanting distinguished authorities, such as Emeritus Professor Edwin Cannan, who assert that the very fact that we are not likely to be able to return to gold at the old parity is a decisive reason for not returning at all, since public opinion abroad will regard a devaluation of the pound as itself a reason for not trusting our intentions as fully as before. So far as the factors internal to Great Britain are concerned, the possibility of remaining upon gold, once the return is decided upon, is of course affected by the choice of parity, but this is not the factor which looms largest in the British mind. What does

loom large is the possibility of a new run upon sterling in consequence of circumstances over which the country has no control whatever. A decline in sterling, due to removal of balances, is by no means to be welcomed; but at least the shock to confidence due to the gold standard having to be abandoned is not, under these present conditions, one of the elements to be taken into account. So long as the volume of international short-term balances remains as great as it is, adherence to an international standard does undoubtedly involve dangers which are not contemplated by orthodox gold standard theory. The fear of being driven off gold by some sudden panic is a very real element in causing hesitation on this side.

The second element which leads to hesitation is the future behaviour of the price level. So long as Great Britain remains upon paper, a fall in the world level of prices will lead, in so far as British monetary policy is directed towards maintaining the pre-existent level of British prices, to a further fall in the external value of sterling. If the fall is not accentuated by speculative or financial pressure, the cost of British imports will not, therefore, rise and the foreigner will pay the same amount as before, in the aggregate, for British exports. Great Britain cannot, of course, expect to "contract out" of the direct consequences of a fall of prices on the volume of world trade and production, but she can escape the necessity of making the adjustments which other countries might have to be making to adjust the level of costs to the new level of prices. Without question, it is a fact that it is easier, in view of the traditions and the economic structure of the country, to allow the exchange to fall than it is to bring pressure to bear upon the level of costs. If, then, world prices were to go on falling and Great Britain were to return to gold immediately, the effect would be to cause the reinaugurated gold standard régime to be exceedingly unpopular both with the broad mass of the population and with the business world. For the return to gold would involve the necessity for

further wage reductions and hence would provoke new labour conflicts—at any rate in the exporting industries. Owing to the rigidity of the British economic structure, such a fall of wage rates would not necessarily communicate itself to the “sheltered” trades—those protected by the nature of the case from foreign competition, or those working primarily for the home market. But the disparity between wages in the export industries and those in the sheltered trades is itself a cause of labour unrest. Having had experience of just such a situation between 1925 and 1929, business opinion would naturally be hostile to a resumption of the gold standard if it were to imply the recurrence of a similar situation. The fact that Great Britain’s retention of a paper standard might in itself act as a deflationary factor, and that a return to gold might act as an element strengthening confidence and so lead to a rise of world prices, is of course overlooked by those who put forward this line of argument.

The third element in the situation is the position of the debt question. There can be no doubt that Great Britain’s capacity to pay has been influenced by the decisions taken at Lausanne: nobody supposes that Germany will ever resume payments or that the former Allied Powers are in a position to constrain her to do so. The resumption of payments to the United States would involve in any event a serious additional strain upon the budget, and might easily involve serious transfer difficulties. These difficulties have only a slight connection with those which popular opinion imagines are comprehended under the term: a country upon a paper standard which is allowed to fluctuate freely must, in the end, be capable of transfer, by allowing the exchange to fall sufficiently to encourage further exports and at the same time drastically check imports. But in a world in which tariff and quota restrictions are of great and growing importance, the fall in the rate of exchange necessary to force exports to a sufficient degree may well have to be very considerable, and such a fall—even allowing for a decline in world prices due to the pressure which Great

Britain can exert upon the areas supplying food and raw materials—might then have very undesirable repercussions upon the internal cost of living and standard of life. Opinion within Great Britain might not be greatly upset; but London is still a great international centre, and a rapidly falling exchange might lead to renewed distrust of sterling. From this point of view, the creation of the Exchange Equalization Fund has made things worse rather than better. For, whilst British opinion primarily regards the Fund as a means of preventing an undue *appreciation* of sterling, continental opinion pays equal attention to the use of the pound as a means of preventing undue *depreciation* of sterling. The removal of the "peg" in October is one of the causes of the *magnitude* of the fall in the external value of the pound which followed. It is natural that it should lead to rumours that the Fund is exhausted and to attempts to force sterling down by bear sales. The resumption of debt payments to the United States—assuming that nothing else happens—must exert a depressing influence upon exchange and make it in any case impossible to fix a parity point here and now. In any event, so long as we do not even know whether we shall have to keep on paying, and, if we do, what the immediate and more remote results are likely to be, the public and the government will not seriously consider the possibility of a return to gold.

This brings us to two other problems connected with each other and with the issues already discussed. The first of these is the budgetary situation, the second the position of the balance of payments. It is, of course, obvious that the budgetary situation is intimately affected both by the course of prices, the course of exchange and the amount to be paid in principal and interest upon the Anglo-American debt. When the financial statement for the year was presented to Parliament, no account was taken of the possibility of renewed payment upon the debt: on the other hand, the various conversion operations had not then been undertaken.

Savings upon the old 5 per cent War Loan will amount to a *net* sum of £23,000,000, equivalent at rates of exchange current as this is written to some 76,000,000 gold dollars. This is considerably less than half the annual instalment of 189,000,000 dollars due to the United States. Since the price level has on balance fallen rather than risen, the burden of additional taxation would not be merely a nominal one, but would involve an equivalent real burden upon the taxpayer. There is, fourthly, general agreement that it is out of the question to increase direct taxation upon incomes and upon estates. With a lower exemption limit and a standard rate of tax of 25 per cent, and with trade not visibly improving, the position of the government would be politically impossible if it tried to raise the level of the income tax. A recovery in world trade would swell the revenue from customs, now a more important source of taxation than before. Cheap money, if it continues, will help the government by reducing the cost of financing the floating debt. On the other hand, the resentment against the so-called "Means Test", by which an attempt has been made to keep down the cost of unemployment assistance, is growing apace and some concessions will probably have to be made. Apart from further reduction upon armaments—and unilateral disarmament is not really possible—the chances of economies in other directions are not bright. About as much has been accomplished in these other respects as is consistent with efficient government, and a dangerous agitation directed against the whole principle of economy in government expenditure is already under way. It is not to be expected that the government will risk a return to gold until the prospects of being able to balance the budget at the parity chosen become less obscure than they now are.

Finally, there comes the question of the balance of payments. On this subject the public mind has become thoroughly debauched in the course of the agitation preceding the abandonment of gold in the summer of 1931. The real problem in connection with the balance

is not the "balancing" of the balance (with a paper standard, the credit and debit items must be adjustable to one another), but the decline in the "invisible" receipts from abroad (interest, shipping earnings, insurance and financial earnings, and the like). The growing disorganization of the world economy (partly, of course, the direct result of British fiscal policy) imperils that proportion of the national income which is represented by receipts from overseas. The improvement in the *visible* adverse trade balance may in fact merely conceal a reduction in Great Britain's ability to purchase abroad, due to default and absence of dividends upon equities, the laying up of ships and the like. A decline in these *credit* items may involve, in order that the balance may be adjusted, a further fall in the rate of exchange. On the other hand, it will be borne in mind that long-period capital issues in the London money market on behalf of foreign countries are almost at a standstill, whilst the prices of foodstuffs and raw materials have fallen. These elements affect favourably both the *income* and the *capital* categories entering the total balance of payments. What is not known with any certainty are the movements of short-period capital. Here various items have to be balanced against one another: (1) the repatriation of British funds formerly held abroad; (2) the inflow of foreign moneys (speculative and for investment purposes) into London; (3) the outflow of British money to take advantage of low equity prices and high bond yields in New York; (4) outflow of foreign money and speculative sales of sterling due to profit-taking or anticipated further reductions in the external value of sterling. At the moment, the outflow is probably in excess—perhaps largely in excess—of the inflow; and if the New York Stock Market situation should improve in the future the outflow might increase. In any case, it is not yet apparent at what point sterling could be stabilized without the authorities at the Bank of England having constantly to manipulate the bank rate in order to encourage a flow of funds

inwards or outwards as ^{one} the equilibrating item in the balance of payments

Some of these problems—particularly the problem of the world level of prices—may become plainer as the result of the deliberations of the World Economic Conference. By next spring, also, the budgetary situation will have become clearer and some certainty may have been gained on the subjects both of disarmament and of inter-Allied debts. For the reasons set out above, it is most unlikely that anything positive will be said or done by the British Government in the immediate future on the subject of Great Britain's returning to gold.

CURRENT PROBLEMS IN INTERNATIONAL FINANCE¹

I AM very conscious of the fact that lecturers on this endowment have in the past been chosen on the ground of their personal distinction, and I cannot hope to address you with that particular qualification ; but I can claim at least this, that at no time in the history of Australia did those eminent men have to discuss problems more immediate and more urgent than those which form the material of what I have to say this evening. What I want to discuss I have labelled *Some Current Problems in International Finance*, but what I really want to deal with are the problems which arise, and have been arising in the last ten years, out of the peculiar monetary organization of the modern world.

Now it has long been held up against economists of all schools that they are unnecessarily abstract in dealing with the problems of life, and in particular of business organizations. If we have been abstract, it is nothing in comparison with the actual abstractness of the monetary systems of the modern world. We are all of us in a way the creatures of an illusion. We see around us, in Australia as elsewhere, magnificent cities and still more magnificent buildings. Wherever we go we are faced by the tangible and by the concrete, and we naturally think that a body of men who spend their time reducing these great realities to abstract ideas are not in touch with the realities which they describe. But that, ladies and gentlemen, is a complete illusion. The real world, the world which matters in modern business, is not the actual physical structure at all. The real world which matters in business, as in economics, is the balance sheet, which those physical structures actually represent. In other words, whether we like it or not, in every state

¹ The Joseph Fisher Lecture in Commerce, University of Adelaide, given in Adelaide, August, 1930.

of society in which money is used all those concrete phenomena—farms and farmhouses, and human beings, and buildings, and equipment of one kind and another—are in the final analysis plotted down in a balance sheet.

And that balance sheet involves a conception of a monetary unit. It may be the pound sterling, it may be that object of worship the American dollar, it may be the franc, or it may be the mark, but, nevertheless, whatever the particular symbol we care to employ in the modern world, the whole of the economic activities of mankind presuppose and rest upon a monetary symbol and upon a monetary system. Not only that, but all business, the business of the small peasant farmer, as well as the business of the greatest banking firm in the world, is based upon the assumption that these symbols have a certain stability of value; that is to say, that the local unit of money, whatever it may be, will purchase both over space and over time a certain fixed quantity of goods. If it does not do so, some very important consequences follow. All business, I repeat, the business of a socialist community as well as the business of an individualistic community, is based upon the inherent assumption that the standard of value and the unit of account represent over time and over space a certain fixed quantity of goods, or, if not absolutely fixed, at any rate fixed to the extent that their purchasing power does not vary very much over reasonable periods of time. If their value in terms of goods does alter very much over space and over time, all business, the largest to the smallest, becomes simply a gamble with the future value of money.

Let me begin, therefore, by making quite clear what an enormous significance all changes in the value of money have even to the humblest individual in any part of the world. We all of us have to make provision for the future, and that provision takes the form of setting aside out of our income, voluntarily or compulsorily, certain sums of money. Whenever you and I are invited by an insurance company to take out a policy on our own life, or for a fixed number of years, we are gambling.

unconsciously, and in some cases consciously, on the future value of money. I constantly keep worrying as to what the value of money is going to be in twenty years time, when some of my insurance policies begin to mature, whether the pound sterling is then going to buy a larger or smaller collection of commodities compared with what it would have bought when I took out that particular policy; and every banker and every business man who makes any investment, the return from which accrues over future periods of time, ought, although a large number of them do not do so, to take into account the fact that, as things actually are, he does not know what the purchasing power of money is going to be in the future. Most of the problems which form the content of modern international finance arise from, and are determined by, the instability of money in the past, the instability of money in the present, and the probable or possible instability of money in the future. I want to drive these points home if I possibly can, because you will not understand the preoccupations of modern finance unless it is perfectly clear that modern economic society rests upon a monetary foundation, and that this monetary foundation rests upon the almost unconscious assumption on the part of everybody that money is not going to differ in its purchasing power in the future very violently from the purchasing power of money in the past.

That is the first point. Now we may ask what happens if the purchasing power of the pound sterling, the dollar, or the franc, varies very much. What are the consequences of extreme instability in the purchasing power of money? In the last fifteen years, broadly speaking, the purchasing power of money first fell and then rose. Between 1914 and 1920, roughly speaking, the pound sterling and the Australian pound and all other units of account, bought each year less than they did before; and since 1922, particularly since about 1925, the pound sterling and all those other units of currency have been buying more each year than they bought the year before. Economists are only just beginning to be aware of the

fact that alterations in the purchasing power of money are perhaps the most powerful of all agencies of social change that one can possibly imagine, because until quite recently those alterations which they produce in the social fabric have not been completely understood. The way in which alterations in the purchasing power of money work themselves out is simply this, that any change in the price level produces a most profound change in the distribution of the social income of mankind. In producing changes in the social income of mankind it completely upsets the equilibrium of social classes and the equilibrium of social institutions which are in existence at any particular time.

These changes in the purchasing power of money can take one or other of two forms. As I said, up to about 1920 the purchasing power of money was falling. Each pound of one's income bought less and less, which is the same thing as saying that the price level was going up. Since 1920 each pound of one's income has bought more. Of course, the speed with which each pound of one's income bought more has varied in different parts of the world, and I may mention in passing that the increase in the purchasing power of the pound in Australia has been very much slower than the increase in the purchasing power of the pound in almost any other part of the world, and a great many of your problems at the present time are derived from the fact that alterations in the purchasing power of the unit of account outside Australia have been proceeding much more rapidly than they have been inside Australia. But that is by the way. The point merely is this, that since the outbreak of the Great War, the unit of account—the pound sterling, or the dollar, or the franc—has never in any two succeeding years bought even approximately the same quantity of goods. What follows? In periods in which the purchasing power of a particular currency has risen, the distribution of the national income alters in favour of those particular groups, and of those particular institutions, that have fixed rights in terms of money. If I

am a bondholder at a time of falling prices, I get the same quantity of money, and each unit of my income buys more than it did before. If I am a bondholder in a period of rising prices, each pound that I get buys less than it did before. Now, if you make the enormous assumption, because it is an enormous assumption, that the real things which are produced remain the same, whether prices are rising or whether they are falling, it is easy to see, is it not, that in periods of rising prices those particular people who have fixed income rights of any kind suffer, and in periods of falling prices those people who have not got fixed income rights suffer. Economists express that by saying that in periods of inflation, in periods in which the price level is rising rapidly, the recipients of fixed incomes suffer, and that in periods of deflation the residual recipients of income suffer, that is, all people without definite legal right to a fixed amount of income.

What are the ultimate social consequences of this state of affairs? We in Europe have been privileged to see an enormous economic experiment carried out upon a vast scale, because throughout the greater part of Europe, between 1919 and 1925, we saw the purchasing power of money falling literally not only from day to day, but almost from hour to hour. I have been in at least three countries in which one did not know at the end of the day what to-morrow's rate of exchange would be, nor, therefore, what to-morrow's purchasing power of money would be. Consequently what I am about to describe is no figment of the economist's imagination, because international economists are not allowed to possess imaginations. What I am about to describe are the actual facts, as they have been experienced by a whole group of European and extra-European countries. If the purchasing power of the unit of currency keeps on falling, which is the same thing as saying that if the price level goes on rising, you ultimately get to a state of affairs in which production breaks down completely. If you ask me why this is so, the answer is perfectly simple. If I possess something, namely, money, the value of which

is being reduced not only from day to day, but even from hour to hour, the time will come when I will refuse that money, or, what is even more important, the time will come when I cannot pass this money on to anybody else, when I cannot use it to go into a shop and buy anything with it, for the very simple reason that the shopkeeper will not accept my money, and will say: "Oh, no; I do not know what the future value of this money will be; I prefer to hold my goods, and, if you like, you can hold your money." When the stage comes where nobody is willing to accept the local currency, the productive system breaks down, because we live in an extraordinarily complicated world based upon the division of labour, based upon private property. If nobody is willing to accept local money the entire productive mechanism breaks down. But the same result will also follow, not only if money is constantly falling in value, but also if money is constantly rising in value. In other words, the ultimate effects of deflation are very much the same as the ultimate effects of inflation. Put yourself in the position of somebody who possesses a piece of property, the value of which rises day after day and hour after hour. The longer you wait the more valuable your property becomes. Under these circumstances you refuse to part with it as long as you can. In other words, if prices are constantly falling, production breaks down, because everybody says, "Prices are going to continue falling, and therefore I will not do anything until they have fallen some more." If everybody says that, no one can sell anything at all, and prices will go on falling; in which case the productive machine breaks down just as it broke down in the case of inflation. In the case of inflation it breaks down because no seller is willing to sell, and in the case of continuous deflation it breaks down because no buyer is willing to buy. In both cases the whole cash nexus of society entirely disappears.

Therefore, however unwilling one may be to face ultimate consequences, there can be no doubt whatsoever that violent changes in the value of money, either

upwards or downwards, do result in very considerable alterations in the distribution of the national income, and do result in inflicting very considerable damage to the entire productive machine. My friend and colleague on the Macmillan Committee, Mr. Keynes, once said that the average person divided the world up into little inflationists, who believe you should go on reducing the value of money, and little deflationists, who insist on raising the value of money all the time. He did not see why he should belong to either category. I have to face this problem from a rather different angle when I ask the question, "Which is ultimately worse, to go on constantly raising prices and reducing the value of money, or to go on lowering prices and raising the value of money?" I do not know, because I have tried to explain that the ultimate consequences of either are to destroy the productive machine. If you ask me to choose, as it were, between two hells, the hell of inflation on the one hand, and the hell of deflation on the other, I am not sure, being, I suppose, a little deflationist, that I would not choose deflation as the preferable hell to the hell of inflation. When the value of money is altered from hour to hour, *everybody* is insecure. When the value of money is rising, that is when prices are falling, at any rate the people who have got the money know they have a good thing, whereas in periods of rising prices people who have money know they have a thoroughly bad thing. The social consequences of inflation on the one hand, and deflation on the other, can be summed up shortly, perhaps rather inaccurately, in this way. An endless period of rising prices destroys two very important social things; it destroys the value of saving, and it destroys the worker's standard of living. On the other hand, deflation, if endlessly pursued, destroys the business man's chance of success, and thereby aggravates the problem of unemployment. In the country in which prices are constantly going up, what is the use of saving £100 to-day when it may be worth, putting an extreme case, only one penny to-morrow? That is perhaps exaggeration, but let me

remind you that the German insurance policy which was worth perhaps £50,000 in 1913 was in 1923 worth rather less than the one-thousandth part of an English farthing, because at that time the mark was being quoted, if I remember correctly, at something like thirteen billions to the pound. I never was a mathematician, and could never grasp what thirteen billions was, but it made the £50,000, which was the value of the policy in 1913, look rather small in 1923. Similarly, inflation must destroy the worker's standard of living, because wages in the modern world are paid in terms of money. If you have got an indefinite inflation it must end by destroying the desirability of saving and the desirability of working. On the other hand, if you have an endless deflation, no business man will go on producing; he will not produce something which is worth £100 at the beginning of the morning and only £95 by the end of the afternoon. He will much prefer to keep his capital intact in the shape of a bank balance and to dismiss his workmen. Consequently, if you have to choose, and these choices are sometimes forced on mankind, between inflation on the one hand and deflation on the other, you have to choose between the destruction of savings and the destruction of the worker's standard of living on the one hand, and the destruction of business enterprises and increased unemployment on the other. I do not know which is worse, except that I have a sort of feeling that in a period of rapidly rising prices all sorts of other things, which do not enter into the business man's calculations at all, are destroyed: the ability, for instance, of the middle classes to educate their children, the ability of civil servants to have anything like a decent standard of living. All these elements, which do not enter into the business man's calculations, are more affected in a period of inflation than in a period of deflation.

I hope I have made it quite clear that money is a very much more important element in modern economic life than is thought at first sight, and than was thought by all those middle Victorian economists who lived in a

period of great peace and prosperity, and used to say that money was only the disturbing veil which hid the realities from mankind. Money is more than that. It has an extraordinarily potent tendency both for good and evil in the national life of any particular country and in the international life of all countries taken together.

That brings me more directly to the problem I have to discuss ultimately this evening. Why is it that international finance is in such a difficult position to-day? There are certain people in my country, and in yours, whose conception of an international financier is that of a gentleman with a considerable waist protuberance, always smoking a very fat cigar, and wearing nothing but white waistcoats and diamond studs. That is not the international financier as you actually know him, or as you actually meet him. The international financier as you actually meet him is a very worried gentleman, who sits in an office with twenty-five telephones around him, receiving depressing messages from every part of the world. What is wrong with international finance at present? In the first place it is suffering from the economical and psychological effects of the period of extreme instability, which came to an end in Europe, and the rest of the world, roughly about 1925. I want to describe what these psychological and economic effects are and have been.

In the first place there is the problem of the liquidation of the accumulated balances in the international short loan fund. That seems very terrifying. It is, in fact, a very simple thing to grasp. When in the period in which the German mark, the Belgian franc, the French franc, the Italian lira, the Hungarian crown, the Austrian crown, and the currency of all the other European countries were melting before the eyes of the miserable populations of those countries, a few people began to realize earlier than the rest that they were melting, what did they do? They tried to escape from the consequences of the falling value of their currency by buying something which did not fall in value; and the

simplest thing to buy, apart from attaché cases and other things which they could buy in their local shops, but which they could not go on buying because the shopkeepers frankly refused to go on selling them, was a dollar note, the ordinary notes of the Federal Reserve System. In 1926 and 1927, for instance, the Federal Reserve System suddenly discovered millions upon millions of small notes returning as physical entities from the interior of Poland, Czecho-Slovakia, parts of Germany, and other parts of Europe. There took place what is nowadays popularly called a flight from the currency, and, in the particular case of the London money market, a flight from the currency was especially important in the case of our nearest neighbour, France. Between 1924 and 1926 the French escaped the consequences of their local inflation by refusing to return to France the proceeds of their exports to England and to other countries. They left these sums—very large sums—on deposit in London banks. The same thing had taken place in Holland and in Switzerland in the case of Germany. All of these countries had also accumulated large balances in New York. What was the result? As soon as these currencies became stabilized again, local populations started drawing some of these sums back, and, owing to the peculiar organization of money markets, you cannot withdraw immense sums from one money market to another without actually, if you have fixed rates of exchange, taking part of the proceeds in gold. It would take me too long to explain why, but it is so. Consequently the London money market in 1927, 1928, and particularly in 1929, when other things were happening as well, which I intend to explain, was faced with the enormous problem of the French balances, the so-called bad money, about which you will find every English banker complaining and grumbling at the present time. In other words, the first of the consequences of inflation from the standpoint of the London money market (I make no apology for mentioning London, because, after all, it is the centre of international financial machinery),

was the presenting to the London money market of a very difficult and serious problem, namely, what the Central Bank was to do if a single country had it within its power, as France certainly had it within her power, to withdraw something between a moderate £50,000,000 and £100,000,000 in gold at any particular moment. That is the problem of withdrawal, the liquidation of accumulated balances—balances which had largely accumulated as a result of previous inflation, and as a result, therefore, of an attempt to escape from the consequences of that inflation.

The second consequence of this period of extreme instability all over the world is something which I can describe only in technical language. The second consequence has been an exaggerated spread, as a technical banker would say, between short and long-period rates of interest. All over Europe you earn relatively little if you leave your money on deposit at a bank; but if you take your courage in both hands, and invest in a long term bond, you get proportionately more than you would have got in comparison with deposit rates of interest before the war. In other words, the margin between the deposit rates of interest paid by banks, and long period rates of interest paid by various governments, municipalities, and business enterprises has increased considerably over the last ten years. Why is that? It is a remarkable thing. It presents many grave difficulties to the financing of long period enterprises; but the fact remains that the spread between long period and short period rates of interest is much greater than it was before the war. That is a direct consequence of the psychological effects of inflation. Everybody in Europe outside the Scandinavian block, Holland, Switzerland and Great Britain has witnessed—actually physically witnessed—the savings of the community being literally wiped out: so far as those savings were expressed in terms of money. Naturally the temptation to anyone who has seen that is to say, “I will put my savings into such a form that I can convert it from money into something else at a

moment's notice." Now, a deposit payable within seven or fourteen days is the most liquid form of investment known to mankind, and consequently all the nervous investors of Central Europe have been deliberately piling up their savings in the form of deposits, and have been refusing to take up on the normal scale the long-dated, interest-bearing bonds of governments and municipalities, and other enterprises. If you read the reports of that highly gifted officer, the Agent-General for Reparations Payments, an American, you will find that he constantly points to the spread, the difference, between long period and short period rates of interest as one of the most difficult problems which German and French bankers have to face at the present time. This difference, this distortion of the rates for money in one department and in another, is entirely the consequence of psychological disturbances created by inflation in the past.

The third consequence of inflation is this: Nobody in Europe has forgotten the war; still less has anyone forgotten the period from about 1919 to 1925. What is the consequence? The consequence is that people are liable to be very panicky when anybody suggests that a little dose of inflation would not do us any harm. I remember the situation in Great Britain on the eve of the general election of 1923, when a certain Conservative Minister suggested that the situation was so desperate that it might be as well to see what the effects of a little inflation would be. What was the consequence? The consequence was that within twenty-four hours of the making of that speech every international banking firm in the world was beginning to withdraw deposits from London. They said in effect, "If you are going to inflate we shall take time by the forelock." That is not only true of bankers, who ought to know their business. Over large parts of the continent it is true of the average man and the average woman, who have been through the period when local money literally would not buy the same amount from hour to hour. The result is that the European money markets, and all the money

markets affected by Europe, are very sensitive to any suggestion of a movement intended to reduce the value of money; that is, to raise prices.

The fourth consequence of the inflationist period in Europe was one which was hardly suspected until it came to an end. The fourth consequence was to make very popular among European investors the idea that at all costs they had to invest their money in something which had a real value. The business man's way of expressing that is to say that they wanted to invest their money in something which gave them an equity in an actually existing enterprise. The most prosperous country in the world in the last few years has undoubtedly been the United States of America, and therefore the tendency has been for European investors to refuse to invest in the long-dated bonds of their own enterprises and their own bonds, and to put all their money into those American enterprises which seemed to yield an endless prospect of expansion and profitability. The New York Wall Street boom of 1926-29, which came to a very sudden and very disastrous end last October, was fed by the fears of the European investor, and by his desire to invest his money in a way which gave him a real, aliquot part of the ownership of some definite industrial enterprise. The Wall Street boom—you probably never heard of it in Australia, because you had one of your own—was not only caused in part by European conditions, in part it was caused by American conditions; but, however it was caused, it has in itself been a factor in creating some very serious problems, both for the money markets of Europe, and for the money markets of the rest of the world. In the first place, it accentuated the problem of the flow of international balances. There was a time in the early part of 1929 when anybody, by which I mean any bank, any investment trust, any insurance company, having an amount of over 100,000 dollars, that is to say, £20,000, could earn with perfect safety 12 per cent per annum by putting its money at the disposal of Wall Street. The New York Stock

Exchange has always said with perfect truth that no investor in call money to the New York Stock Exchange has ever lost a cent. In other words, you could at that time earn 12 per cent and get your principal back without any difficulty by simply calling it. What was the consequence? It was perfectly simple. Instead of the European investment trust, or the European insurance company, taking up, I shall not say Australian securities, but the securities of the Argentine, or of Brazil, or of some West Indian island, which was risky, they put their money into Wall Street, which was not at all risky. Consequently the whole equilibrium of international investment, which was already being affected by the peculiar mentality of the European investor as regards short and long investments, was being further accentuated by this enormous drain on the funds of the New York Stock Exchange. How it worked out was briefly this: All the time the American banks and American issue houses were taking up long-dated securities in various parts of the world; but it really makes no difference to the net result if J. P. Morgan lends 50,000,000 dollars to Canada, and Canadian banks and insurance companies lend 50,000,000 dollars to Wall Street, for in the end no money is being lent to Canada at all; in consequence of the enormous outburst of speculative activity in the United States the total quantity of money invested in sustaining the industry and the governmental equipment of the newly developing countries of the world fell off, and fell off very sharply. What consequences this had there I need not enlarge upon at this meeting. Let me go further into the question. From the standpoint of the banking systems the flow of funds to Wall Street had the effect of causing a drain of gold to the United States; and, when Central Banks lose more than a certain amount of gold, they are almost inevitably driven, under central banking practice, to put up their bank rates. What is the consequence of that?

It can be very simply described. In the years 1927, 1928, and the early part of 1929, all over the world raw

materials of one kind or the other, such as copper, zinc, spelter, wheat and cotton, were being financed by means of bank credits, etc. As soon as the money market rates rose, as soon as the banks were short of funds, they began to put a squeeze on all the various instrumentalities, which were preventing the prices of raw materials from being depressed by keeping a certain proportion of the aggregate world output of those things off the market, therefore producing the slump of raw material prices of all kinds, which has been a characteristic feature of the world in the last twelve months.

I come back to 1929, as being directly and inevitably associated with the reactions of the money markets of the world, to the great spectacular boom in New York in those three years. The consequences of the fall in the prices of raw materials is again a matter on which I need not enlarge to this audience. I may mention, however, that the fall in the price of raw materials has been accentuated by the fact that various countries—I shall not mention them—thought that they could keep up the prices of these things by valorization schemes of one kind or the other. Rubber producers, for example, thought that if they could only keep rubber off the market they would keep the price up, and copper producers thought the same thing. That sort of game is all very well so long as banks are willing to finance the pools, but, as soon as the banks are not willing to do so, the whole structure comes down with a tremendous thump. As everyone knows, the whole structure has come down with a tremendous thump during the last few years. Of course, that does not end the matter, as banks all over the world have been advancing to producers in anticipation of those prices being maintained. So you see that, just as when you throw a stone into a pond, the resulting disturbance stretches out in an endless series of ripples, so a stone thrown into the international monetary organization, in the shape of the immense Wall Street boom, has had repercussions of a most difficult and far-reaching character.

Finally, I want to draw your attention to one very important and significant consequence which has not in the least been realized either in this country or in others. Inflation in Europe had the very bad effect of destroying the average man's belief in the virtue of buying Government bonds. That is inevitable. The Wall Street crash has destroyed the average man's belief in the virtue of buying ordinary shares, because shares he bought last year at 100 are now standing in the neighbourhood of 40. Consequently the whole process of investment, on which, in the last resort, our entire economic civilization depends, is being held up in all countries at the present time by the destruction in the minds of ordinary investors of any faith in the virtues of investment, either in bonds or in ordinary securities. What effect that is going to have in the long run nobody knows, but at the moment it is exceedingly difficult to present a convincing case for investing in bonds, and it is obviously an exceedingly difficult thing to present a convincing argument for investing in ordinary shares, as the average man you talk to has had experience in both directions. He has either put money into pre-war German 3 per cents and got nothing out of them, or put it into United States steel, or something of that sort, and lost 50 per cent. He now asks what he is to do, and the answer is, Nobody knows.

That brings me back to the ultimate question which I want to discuss this evening. These money market problems are very fascinating, but there are ultimately more fascinating problems still. These questions are only facets, only sidelights, if you like, on a very much deeper problem still, the problem of what is going to happen to the purchasing power of money, and what is going to happen to the price level in the future. The price level at the present time is being affected by two rather dissimilar series of causes. There is first of all the backwash of the Wall Street crash. That is very serious. In 1928, and in the early part of 1929 I was in New York. Up to the end of August 1929, very few people indeed

believed me when I said the crash was going to come before Christmas. In 1928 and 1929 it is true to say that, although there was some, and perhaps very considerable, unemployment in the United States, unemployment as a national problem was hardly conceived by even the most pessimistic of American observers. Nobody knows how many unemployed there are in the United States to-day, but it is pretty safe to put the number down in the neighbourhood of 5,000,000 people. There are more than 2,000,000 unemployed in Great Britain, and nearly 3,000,000 unemployed in Germany, if not more. It would be fairly safe to estimate that the total number of unemployed workers all over the world at the present time, including Russia, is somewhere in the neighbourhood of 10,000,000 persons. That is a part of the problem of price level at the present time. We are face to face with one of the most serious and difficult of any of the economic problems we have had to face in the lifetime of any man now living. Part of it is backwash from the Wall Street crash, but some portion of it has to be associated with the general tendency of prices to slide downwards, which has been in progress since 1920. If anybody asks me what the future of prices is going to be I do not like to answer; I am not a journalist; I am an economist. However, I shall put it something like this. I say that, in so far as present world prices have been depressed in consequence of the Wall Street slump and its various sequelae, I am inclined to think that prices by, say, the end of 1931 will be somewhat higher than they are at the end of 1930. Nevertheless, 1931 prices will be lower than 1929 prices, and the general trend will be downwards. That is to say, there will be a bit of a recovery, and then the general trend will be to slide down again, because there are at work two entirely different sets of factors. The first is the backwash from Wall Street, and the second is the problems and difficulties which arise from the general gold and central banking position as it is in the modern world. I am surrounded by some brother economists,

and I ask their forgiveness for talking about reactions from the Wall Street slump, instead of saying, as I ought to say, in purely technical language that we are now suffering from one of the effects of a cyclical movement of prices. That is what I really mean. These cycles, of good and bad trade, existed in the nineteenth century, and presumably from all we know after the Wall Street crash, will go on existing in the twentieth century. Prices are, however, practically the result of the long period movement, the effects of which are slower. The short period movement varies between years of good trade and years of bad trade. I venture to express the opinion that, enormous as has been the amount of statistical work and economic study put into the elucidation of these cyclical movements of trade, although we know a great deal more about their details than we did before, we do not know a great deal more about their causes than was known in the middle of the nineteenth century. However, we do know that there are these two sets of factors: long and short.

For the remainder of this lecture I want to discuss possible remedies, not for the short period fluctuations, but for the long period fluctuations. I hope I may say one thing perfectly frankly to an Australian audience. Since I have been in this country, which is not so very long, I have noticed a distinct tendency to argue that a little amount of local inflation would not do Australia very much harm. I hope I may be permitted to say at least this about Australian problems, that local inflation in Australia will not help Australia in the very least, for simple reasons. In the first place, you remember the attitude of the man Dickens used to describe rather frequently, who used to take off his coat and announce in a very loud voice to all and sundry that when he had taken off his coat he was prepared to fight, but who never did fight. Why did he not do so? It was because the other fellow knew, of course, that he had not the faintest intention of doing it. If you take off your coat, and announce to all and sundry that when you get into office

or when your friends get into office, you propose to double the Australian note issue, you will not secure the slightest success when you do get into office, because unfortunately you have told everybody of your good (or bad) intention. If you are going to announce beforehand to every man, woman, and child in Australia, that, when you get into office, you propose to cut the value of money in half, everyone with sense is going to take very good care that his own particular property will be exempt from the consequences of cutting the value of money in half. You see, in the modern world, it is not very much use to talk about the bondholder and the international financier as if those persons lived in elaborate palaces in Park Lane, Fifth Avenue, or anywhere else. If you announce that you are going to inflate, what is the consequence? It is that everybody who has any sense—and a large number of people who have no sense like to follow their neighbours—will escape from the consequences of inflation by converting their holdings of money, which will fall in value if inflation takes place, into something which will rise in value in the event of inflation occurring. Now, of course, the simplest way by which you did that in the good old days of European inflation was that you went to an innocent banker and bought dollars, and you paid for them two or three months afterwards when the value of your local currency had gone down. Those were the people who used to be called "Valutaschweine", or speculators, in the German press, the people who speculated in exchange. Of course, you may say to me, "Well, Australian bankers are not going to sell exchange to weak-kneed persons of that sort, who try to convey money out of the country; Australian bankers are going to pursue a policy of rectitude." That will not save you in the least, because no one has yet been elected to Parliament, even in Australia, by saying that if I have £100 I may not use that £100 either to buy wool, wheat, or what not. On the first day you announce beforehand you are going to inflate, people will escape by withdrawing deposits

from the banks, and using the proceeds of those withdrawals to buy goods in Australia. In other words, the price level will rise before you have inflated, and, if that is so, you have either to inflate a great deal more than you intended to do, or, if not, you cannot inflate at all. In other words, if the people know you propose to lower the value of money, you cannot lower the value of money by *fiat*. As far as I can observe, the inflationists in Australia have been so busy explaining what they propose to do, when they have the chance, that everyone has been forewarned from the beginning. It seems to me that inflation in Australia would be a very risky and a very dangerous expedient. You are, of course, a great many miles away from the nearest land. I do not know how far you are from New Zealand, but everybody in this country appears to forget New Zealand. You are, at any rate, a great deal further away from the other great centres of population than any other part of the world, but that does not save you from being a part of the world. If you are going to depend in the future, as in the past, on the great international money markets to supply you with part of the capital you require for the further equipment of this country, you cannot possibly inflate; and, if you ask me why, the answer is simply that the psychology of European and American investors is such at present that if you announce your intention to inflate on the one hand, and borrow on the other, they will, in fact, have nothing to do with you. Therefore, although I say that the little dose of inflation which some people recommend in this country has a very attractive air, I believe that its ultimate consequences would be fatal, not only to the stability of Australian banking institutions, but fatal to the ordinary progress of this country in every direction. That is all I want to permit myself to say on the subject of your own local problems.

Let me get back to the wider problems. What can the world do as a whole to prevent this instability in the purchasing power of money? The problem of prices is

primarily a problem of how to manage the gold standard. In its essence, looking at it as an economic problem, it is simple enough. The gold problem rests upon the three following foundations. In the first place you have a certain visible volume of gold production. Every year the gold mines of the world turn out so much gold. If the price level falls, as it is falling now, the quantity of gold which can be turned out goes on increasing. If it rises, the quantity of gold goes on falling, but ultimately gold production is governed, as various critics of the gold standard state, by the chances and fortunes of nature over which no man has any control. On the other hand, there are two other elements in the situation, over which human beings have some control. One is the industrial consumption of gold in such things as dental fillings, ear-rings, and other impedimenta of that kind; the other is the consumption of gold in Eastern countries for the purpose of hoarding. If people were to give up wearing gold as ear-rings, or using it as dental fillings, and if the Eastern potentates ceased to keep the cellars beneath their palaces stocked with gold, there would be so much more gold for the third use, which is monetary. Before the war gold was actually in circulation as an everyday part of the stocks of the world, but in the modern world the only monetary use which gold possesses is to be stacked in the cellars and vaults of the various central banks of the world. The quantity of gold which the central banks need keep against their liabilities is a matter over which the central banks, taking them altogether at any one particular moment of time, have complete control. In the modern world, in which gold is no longer in circulation, all central banks would recognize that the whole of the gold which they possess is required only for one reason, namely, to settle those temporary deficits in the international balances of payments which sometimes arise. If you have a panic in Australia, in England, or the United States of America, you do not meet that panic by the banker unlocking all his vaults and throwing sovereigns over the counter.

You meet the panic in the modern world by paying out notes of the central bank, and you cannot do it in any other way. You want the gold for one purpose, and one purpose only : if French creditors of the Bank of England, for instance, demand payment of their indebtedness they can be paid in gold at a moment's notice ; or, if the London money market is on balance a debtor to New York, the only real function of the gold reserve of the Bank of England is to enable the bank to ship gold to New York at a moment's notice. In other words, the gold stocks of the central bank have one purpose, and one purpose only. There are certain people who think that unless the bank holds a certain amount of gold its notes will not circulate. That is absolute nonsense, because during the war they circulated perfectly freely. The only function that gold reserves serve in the modern world is as a medium by which you can settle temporary deficits in the balance of payments.

But very important consequences follow that. If you look at the balance sheets and the constitution of the majority of the central banks in the modern world, you find they are required to keep a certain minimum reserve ratio against liabilities. For instance, the Federal Reserve System is required to keep actually in gold against any note issue a minimum of 40 per cent, and against deposits 35 per cent ; but, in fact, if ever there were an internal panic in the United States, it would be met, not by paying out gold over the counter, but by paying out more notes. The only reason why the Federal Reserve System wants to keep all that is in case it has to make payments, or in case the American money market as a whole has to make payments, to other parts of the world. It does not require it for internal purposes, but for international payments.

Upon these very simple facts we economists rest the whole of our case for the international functioning of the central banks in the sphere of monetary regulation. We say that if only they will adjust the value of credit to the price level, instead of adjusting the price level to the

value of credit, they can exert a pressure in the direction of stabilization. You may ask how can they do it. They can do it by not worrying if they happen to hold only 25 per cent of gold against the liabilities, instead of 35 per cent. In other words, as the price level falls, you work it back towards a position of greater stability by increasing the volume of credit against a given gold basis. That is the only way in which the central banks can affect the problem ; but, if they were to do it, it would affect the problem in the shortest possible way.

Why do they not do it ? The answer to that is a very complicated one. Let me indicate two reasons at least why this is not so easy as it looks at first sight. In the first place, there is a very large number of central banks in the world, and some of them are governed by persons of very much less economic intelligence and foresight than others. It is no use grumbling about that, but the fact remains that the degree of intelligence possessed by central bankers is not evenly distributed amongst all of them. There are some of them, like the governor of the Bank of France, who think that it is the aim of a central bank to accumulate, in the course of the financial year, more gold than is actually produced in the year, and available for addition to the monetary stock. If you have that kind of central bank, it is quite clear it is no good for economists to go around preaching the virtues of disgorging the quantity of gold you possess. If all the central banks behaved like the Bank of France, you simply could not attempt co-operation at all. In the second place, even certain central bankers who possess a high degree of intelligence, and are friendly towards other countries, are responsible to populations not so highly educated as themselves. One of the difficulties of the modern central banking world is to secure the co-operation of the Federal Reserve System with the rest of the world in a combined and definite way. This reflects no discredit, say, upon the directors of the New York Reserve Bank, who are assisted by a highly competent economic and statistical staff, who are perfectly normal

and well-educated human beings. Unfortunately, they are surrounded by hordes and masses of voters, who are neither intelligent nor highly educated, and who very strongly object to what they would describe as the entanglement of the Federal Reserve System with the nefarious complications of European central banking. So long as the average middle-western voter holds this opinion we are not likely to get very much further with co-operation. If all central banks were agreed, it is not clear that the population which surrounds the central banks would fall in with the views which the central banks desire to express, and the policies they would desire to carry out. Therefore, although it is as clear as daylight that the problem of the stabilization of the price level can only be achieved, if it is going to be done at all, through the intimate co-operation of the central banks of the world, we think it is not clear as yet that we have reached a stage when central banks can effectively co-operate to secure this particular end.

Even if you had the whole of the central bankers of the world unanimous on this particular subject there is still one difficulty to which I want to draw your attention—the last of the many difficulties to which I have drawn your attention to-night. You can, as an international group of central bankers, do your best by the expansion of credit—in other words, by the reduction of reserve ratios, by the reduction of bank rates, the purchase of securities in the open market, and what not—to increase the volume of credit, and therefore raise the price level, but it would be mere affectation to pretend that this is not a process which may take much longer than people think. For instance, the New York slump is already eleven months old. It came at the end of October 1929; nevertheless, in spite of the fact that every central bank in the world has been pushing its bank rate down ever since, and that bank rates are still falling, prices are still falling too. In other words, there is a time lag in these things, and it is sometimes of very long duration. In other words, again, you have not only to face certain

technical difficulties of co-operation between the central bankers, but you are face to face with the difficulty that you must not expect a very intricate, a very highly integrated and complicated modern economic system, to respond to the efforts of central bankers as easily as a modern liner responds when you turn the wheel a little bit one way or the other. If economic life were as easily adjustable as that, it would be a highly delightful and very satisfactory thing; but, unfortunately, economic systems are much more rigid and less amenable to direct control than one would think at first sight. I am convinced in my own mind that the problem of prices, if it is going to be solved at all, must be solved by the agency of central bankers; but I am bound to admit that the process of solving this particular problem is much more heartbreaking than it appears at first sight. For all these reasons it is just as well that there has been created one agency, which, in the course of years, certainly not in the immediate future, certainly not in the next twelve months, but in the long run, may help to overcome some of these difficulties. That is the institution that was created under the last definitive reparations settlement, namely, the so-called Bank for International Settlements at Basle. The Bank for International Settlements, in the first instance, was created to take the place of the old reparations machinery, by which Germany transferred reparations to her European and her American creditors; but the Bank for International Settlements contains the germ of a very fruitful institution, namely, it contains implicitly the idea that the central banks of the world should have for themselves a central bank with which they should all bank. Just as the commercial banks of a country, by banking with their central bank, can economize reserves, so, if all the central banks of the world were to keep their entire gold stocks with the Bank for International Settlements at Basle, in the end they could practise a highly desirable and highly useful economy of gold reserves. Of course, I need not conceal from you that we are very far from the

day when the Governor of the Bank of England, and particularly the Governor of the Bank of France, will be willing to transfer the whole of their gold reserves to the keeping of a new institution in Swiss territory. There is the germ of a new international central banking order in the creation of the Bank for International Settlements, but it is only a germ. Meanwhile, the Bank for International Settlements serves a highly desirable purpose, because it represents a private meeting place for the heads of the various central banking institutions all over Europe. One of the difficulties connected with getting conferences of central bankers together is that everyone begins to ask, Why do they want a conference at this particular moment? And at once you have a renewed wave of uncertainty and unrest; but through the creation of the Bank for International Settlements the heads of the central banks can meet at Basle, and nobody takes too much notice. Of course, astute journalists all over Europe invent explanations of what central bankers say and do; but, in the course of time, everyone will accept it as a perfectly normal thing that, once a month, or once every two months, Mr. Norman and the President of the Reichsbank should go to Basle and discuss the affairs of the Bank for International Settlements. To sum up, the problem of prices has not been solved. Even the problem of how to tackle the question has not been solved; but we have done two things in Europe. We are beginning to see the way in which the problem of prices must be solved, and we are beginning to understand the kind of machinery which will help us to solve it.

AMERICA

THE PRESENT POSITION OF BANKING IN AMERICA¹

ON November 10th, 1924, the Federal Reserve System celebrated the ending of its decade of active life. Its prestige in Europe is so high, the resources it commands are so great, the services it has rendered to the American nation have been so loudly, if not always, perhaps, sincerely trumpeted, that it is difficult for the European investigator to adjust himself to the reality, and to accept the fact that if the last ten years have solved some problems of American banking, as many more remain to be solved.

Pre-war writings have familiarized Europeans, as well as Americans, with the outstanding evils of the situation as it was then conceived. The inelasticity of the note issue, the concentration of banking funds in New York and their employment on the Stock Exchange, the many thousands of banks operated under many different systems of law, the cumbersome and expensive collection system, the rigid reserve requirements and the periodical suspensions in times of crisis—above all, and as cause of many of these difficulties, the absence of a bill market and of adequate re-discount facilities—these were the defects which occupied minds of reformers: defects which the Federal Reserve System was called upon to remedy. To discuss the present position of banking in America is to discuss the extent to which these defects have been removed, and the degree to which American banking has adjusted itself to the novel conditions of the post-war world.

(I) THE BRANCH BANKING CONTROVERSY

Fear of the future of the Reserve System, belief in individualism, the conflict of State and Federal legislation, have combined in recent years to push to the front the whole issue of branch banking.

For years the greater relative progress of the banks and trust companies organized under State laws, as

¹ Embodying the substance of a lecture delivered at the London School of Economics on February 25th, 1925.

compared with that of the National Banks organized under Federal law, has been one of the marked features of the American banking situation.² The causes of this relative decline must be sought in the restrictive legislation governing the position of the National Banks, which may be regarded as part of the price paid for the privilege of note issue, which, before the coming of the Federal Reserve Banks, was exclusively theirs. Something has been, and can be done to free the National Banks from restrictive conditions,³ but, nevertheless, the future of the National Banks, though they benefit by the greater prestige they enjoy, is not entirely assured. But since the National Banks are compulsorily members of the Federal Reserve System, whilst the State Banks and Trust Companies are not, a steady decline in the relative power of the National Banks is not a welcome phenomenon in the eyes either of the Federal Reserve System or of the Comptroller of the Currency, under whose official supervision they stand.

In recent years⁴ the growth of branch banking systems in various States has been employed very skillfully in the campaign for the strengthening of the position of the National Banks. The combined effort of Supreme Court decisions, the opinions of the United

² Between 1900 and 1923 the deposits of the various types of banks, exclusive of saving banks, increased as follows:

	National Banks.	State Banks.	Loan and Trust Cos.
1900 ..	million \$ 2,458	1,266	1,028
1923 ..	million \$ 13,964	11,118	6,822

The figures relating to State Banks are not entirely free from exaggeration, owing to some Savings Bank deposits being included, but the trend is unmistakable. See also the discussion in the *Report of the Comptroller of the Currency for 1924*, pp. 12-15.

³ The Annual Reports of the Comptroller of the Currency form a useful guide both to the legislation actually passed and to that recommended. In particular, in recent years, National Banks have been given, in addition to extended charters, certain powers relating to loans on real estate, acceptance and trusteeship, powers to act as insurance agent or broker or agent in making or procuring loans on real estate, the opening of foreign branches, and consolidation. See *National Bank Act as Amended and other Laws relating to National Banks*, Washington, 1923. The McFadden Bill, on which see below, carries this liberalizing process a good deal further. See *Financial and Commercial Chronicle*, January 1st, 1925, p. 282.

⁴ On the whole issue discussed in the succeeding paragraphs see *Reports of the Comptroller of the Currency*, 1923 and 1924; *Federal Reserve Bulletin*, December 1924; *Hearings before Committee on Banking and Currency, House of Representatives on H.R. 6855*, Washington, 1924; H. P. Preston, *Recent Developments in Branch Banking in Am. Ec. Rev.*, September 1924, and further detailed references below.

States Attorney-General, the regulations of the Comptroller, and the provisions of positive law, have been to allow a restricted number of National Banks to possess branches in the true sense of the word, to allow the opening of so-called "additional" offices within city limits in States where branch banking is otherwise permitted, although the operations to be carried on at such offices are definitely restricted,¹ and, finally, to prohibit branch banking to National Banks in general.

Legislation might take the form of generalizing the right of National Banks to open branches. But such a general right would conflict with the fact that in a larger number of States branch banking is prohibited also to State banks, whilst in other States, permitting branch banking in some form, the nature of the branch banking so sanctioned is by no means uniform. Further, there is widespread opposition to branch banking in the United States,² not only among the general public, but also among the so-called "unit-bankers" in those States in which branch banking is permitted. Extremist opinion would like to see no branch banking anywhere, moderate opinion would like to see some liberalizing legislation passed in favour of National Banks, without

¹ "Operations of additional offices of national banks established under these regulations shall be confined to the receipts of deposits and the payments of cheques and other such routine or administrative functions.

"No investment in bonds or other securities for the account of the bank shall be made at any such additional office.

"No loan or discount shall be made to any customer . . . through any such additional office that has been authorized at the central office and no general authority . . . shall vest in any officer . . . at such additional office any discretionary authority with reference to making such loans or discounts."

² The basis of the opposition is partly the fear of "monopoly", partly the belief that branch-bank systems involve restriction of facilities to growing but small communities and small but growing business firms. Local knowledge and initiative cannot be united with monopolistic and centralized banks, and the result of competition between branch and "unit" banks simply results in the former acquiring "the larger and, from the narrow banking standpoint, the desirable business of the town," by "offering lower rates of discount and higher rates on deposits than local conditions would ordinarily justify, which in the nature of the case would probably be withdrawn as soon as the independent unit banks of the town were finally eliminated." "Branch banks skim the cream and the unit banks are left with skimmed milk, the result being that the unit banks have gone out of existence." "One of the monopolistic influences exerted by the branch banker is the ability to secure, by the payment of higher salaries, the transfer to other points of the efficient employees of the unit banks." Extracts from *Rep. Compt. Currency*, 1923, p. 11.

strengthening the general tendency towards branch banking, whilst the State branch bankers are prepared to equalize conditions between State and National Banks, but are naturally unwilling to see anything done which would interfere with what, in their opinion, is the natural trend of economic evolution.

In the last eighteen months the Federal Reserve System has had to take part in this controversy. It is known that the Board is divided in its attitude towards branch banking and, in any case, intervention involved the danger that, should its stipulations restrict the rights of State-member banks, defection of member banks with branches might take place. In November 1923,¹ the "Committee on Examinations" of the Board reported that "the unlimited extension of the practice of branch banking will give to banks operating under liberal State charters such competitive advantages over the unit banks which are members of the Federal Reserve System, as to impair materially their usefulness, if it, in fact, does not ultimately result in their extinction". Making use of its power under Section 9 of the Federal Reserve Act to regulate conditions of entry into the system, the Board finally issued a new Regulation H of April 7th, 1924, by which the opening of new branches by applicants for membership was made dependent on the approval of the Board: branch bankers already members were made subject to the same conditions by Section V of the Regulation.² This policy brought the Board into conflict with those who saw in it an attempt to override State rights by administrative decree.³

¹ Report reprinted in *Rep. Compt. Currency*, 1923, pp. 13 et seq, and *Fed. Res. Bull.*, December 1923, pp. 1255 et seq. For Regulation H, *v. Bull.*, April 1924, pp. 279-81.

² The Board's basis of policy was defined thus: The Board "will as a general principle restrict the establishment of branches, etc. . . . to the city of location of the parent bank and the territorial area within the State contiguous thereto . . . excepting in instances where the State banking authorities have certified and the Board finds that public necessity and advantage render a departure from the principle necessary or desirable."

³ *v. G. V. McLaughlin*, State Superintendent of Banks N.Y. State, "Relationship of State Banking Systems with the Federal Reserve System," a speech delivered at the Twenty-third Annual Convention of the National Association of Supervisors of State Banks, Buffalo, July 1924.

In 1924 an attempt was made to solve the problem by the passage of the so-called "McFadden" Bill, which, in an amended form, has since passed the lower House of Congress. Apart from other, but not unimportant matters affecting National Banks, these banks were by Section 8 to be allowed, in those States where State banks had branch banking rights, to open branches within municipal limits. Further, the Federal Reserve Board was to refuse admittance to any applying bank after the passage of the measure, unless it relinquished its extra-municipal branches opened after the passage of the measure, and no member bank was to be allowed to open a branch "beyond the corporate limits of the municipality in which such bank is located" (Section 9). State banks with branches might convert themselves into national banks and keep such branches, even if extra-municipal, as were established before the passage of the Act, but they were to relinquish those which they might have established outside municipal limits after the passage of the Act.

The Bill in its 1924 shape failed to pass, and it was in any case not sufficiently drastic to please the extreme opponents of branch banking. They desired the rights of branch banking to be conferred only on National Banks situated in those States which *at the time of the passage of the Act* allowed branch banking to State banks. The effect would be to perpetuate the existing limitation on National Banks in those States which up till now do not allow or provide for branch banking, whatever may happen to State banks in such States in the future.

At the Chicago meeting of the American Bankers' Association in 1924, the opponents of branch banking were successful in getting a motion in favour of an amended McFadden Bill unanimously carried.² In its amended form the rights of National Banks to open branches and the rights of applicants to membership

² *Financial and Commercial Chronicle, A.B.A. Convention Section, October 18th, 1924, pp. 111-13.*

to possess branches are limited by being confined to certain States only, i.e. those which at the time of the passing of the Act specially permitted branch banking. The Bill, with these so-called "Hull amendments" incorporated, was carried in the House of Representatives on January 14th, 1925, by a vote of 172 to 65.¹ The Bill is now before the Senate and whether finally passed or not, is sufficient evidence of the kind of feeling against an economic development which had commended itself, on the whole, to the greater part of the civilized world. It is, however, by no means clear that legislation can check the integration of the banking system. The ultimate effect is likely to be only the extension of the so-called "chain banks". In 1922 the largest of these included a hundred and seventy-five banks.²

(2) PAR CLEARANCE³ AND INELASTIC NOTE ISSUES⁴

(a) If the grant, even if it is only of restricted rights, of branch banking to National Banks may do something to strengthen the basis of the Federal Reserve System, it must be confessed that in its fight to maintain the principle of par clearance, the System is faced by the hostility of the small bankers, especially in the South. The practice of making a small deduction against cheques presented for payment, and the further practice of paying such cheques not in cash but by a draft on a correspondent bank, thus gaining interest on the balance kept at the correspondent whilst the draft is outstanding—represent income which the small banks find it difficult to give up. Since they are not allowed to make an exchange charge against a Federal Reserve Bank, and since pressure can be brought to bear on them by presentation across the counter, the "par clearance" methods of the System are naturally unpopular in certain areas, and the System

¹ *Financial and Commercial Chronicle*, October 17th, 1925, p. 282, for details of the debate and the Bill.

² *Federal Reserve Report*, 1922, p. 6.

³ See particularly *Federal Reserve Board Report for 1922, 1923*; *Bulletin*, November 1924, p. 866; January 1925, p. 32, and Charles S. Tippetts, *The Par Remittance Controversy*, *Am. Ec. Rev.*, December 1924.

⁴ *Federal Reserve Bulletin*, December 1924, pp. 944 et seq.

is finding itself hampered by various decisions of the Supreme Court, which, whilst upholding the rights of the Federal Reserve Banks in some particulars,¹ expressly deny that the Federal Reserve System is *bound* to maintain a system of par clearance and at the same time uphold the validity of State legislation permitting the collection of exchange charges, though such charges cannot be levied against the Federal Reserve Banks.² Fortunately for the future of par clearance in the States, the recent attempt of a *National Bank* to obtain an injunction restraining the Federal Reserve Bank of Atlanta from deferring credit on items in course of collection, from handling non-member items and items on banks outside its district and from refusing to allow exchange charges on items presented by it on the plaintiff bank have been unsuccessful. As Professor Tippetts rightly points out, however, the ultimate chances of establishing an economical, universal clearing system depends less on legislation than it does in a vigorous support of the Federal Reserve System by enlightened business opinion: for it is the business world which ultimately bears the burden of collection charges.³

(b) On February 1st, 1925, the Treasury of the United States proposes to retire \$118.5 millions of 4 per cent bonds, of which a considerable part now serves as a basis of National Bank Notes, viz. \$76.7 millions. Of the total volume of bonds having the so-called "Circulation Privilege", i.e. serving as the basis for the issue of National

¹ Notably the right to present cheques for collection over the counter. Even if the maintenance of a system of par collection involves loss to the country banks, "Country Banks are not entitled to protection against legitimate competition. Their loss here shown is of the kind to which business concerns are commonly subjected when improved facilities are introduced by others, or a more efficient competitor enters the field." Decision of Mr. Justice Brandeis in the "Atlanta" case, cited *Federal Reserve Report*, 1923, pp. 296-8.

² Supreme Court decision in the so-called "Richmond" case. *Fed. Res. Rep.*, 1923, pp. 298-304, especially at p. 304: "The purpose of Congress . . . was to enable the board to offer to non-member banks the use of its facilities which it was hoped would prove a sufficient inducement to them to forgo exchange charges; but to preserve to non-member banks the right to reject such offer; and to protect the interests of members and affiliated non-member banks (in competition with the non-affiliated State banks) by allowing also those connected with the Federal Reserve System to make a reasonable exchange to others than the reserve." (Italics mine.)

³ *op. cit.*

Bank Notes, some 93 per cent are already used for this purpose. [\$739.8 millions out of \$793.2 millions.] The resulting reduction of notes is estimated by the *Federal Reserve Bulletin* at about 10 per cent of the outstanding National Bank Note circulation, and at less than 2 per cent of the total money in circulation in the country.¹

It is one of the curious features of the American currency situation that in spite of the existence of the elastic note issue of the Federal Reserve System, the volume of National Bank Notes outstanding should have risen considerably in recent years, notwithstanding the rise in the market value of the bonds and the consequent reduction in the profit to be derived from the note circulation based thereon. The intention of the founders of the Federal Reserve Act had been to retire the National Bank Note, and to replace them for the time being by "Federal Reserve Bank Notes", backed by the same classes of bonds as National Bank Notes are, the bonds to be acquired by transference from the National Banks or by purchase in the market: the transference from the National Banks to be voluntary on their part. This transference did not take place on a large scale, and the redemption of the 4 per cents of 1925 will represent the first real step towards unification of bank note issues in the hands of the central banking system.²

(3) THE GUARANTEE OF BANK DEPOSITS³

There is one aspect of American banking which the events of the post-war period have done a good deal to clear up. In a country of predominantly small banks, it is a fairly natural idea that the public should be protected against loss by the creation of a mutual guarantee fund to which all the banks should be made

¹ *op. cit.*, pp. 944, 947.

² On the whole question of the Federal Reserve Bank Note, see E. E. Cummins, "The Federal Reserve Bank Note" in the *Journal of Political Economy*, October 1924.

³ See in particular *Rept. Compt. Currency*, 1921, pp. 187-93; Robb, *Guaranty of Bank Deposit* (up to 1920); and Thornton Cooke, "The Collapse of Bank Deposit Guaranty in Oklahoma and its Position in other States" in *Quarterly Journal of Economics*, November 1923. For a very hostile and able attack on the whole principle, v. Laughlin, *Banking Progress*, chapter v.

to subscribe. In this way it would be possible to prevent a general distrust of the banking structure from arising through errors or default on the part of, perhaps, only a few banks. Just as in a country with large banks, the fear of what would happen if a single large bank were allowed to fail, forces banks to come to one another's assistance, so under the guarantee system a degree of mutual assistance can be forced on the banks from without. It is, in fact, the application of the idea of mutual insurance to banking.

The risks involved are fairly clear. It encourages reckless banking—for are not each banker's losses in part transferred to his competitor?—and it encourages a false sense of security among depositors, if the funds accumulated by the guarantee fund are insufficient to meet any heavy loss. If a single large bank were to fail, or if a large group of small banks were to go under, the funds might be insufficient. The alternative is to levy heavy contributions and this obviously discourages the banking profession and makes the banks unwilling to belong to such a system. When trade is brisk and bank failures are few, the idea will be popular, because it encourages deposits and costs little; in periods of depression, when failures are far from remote, the fund may easily be exhausted before all losses are met and the burden on the solvent bankers may be very heavy.

In certain States of the Union, the guarantee system has thus played a part in the constant conflict between State and National Banks, the relative proportion of the two types of banks depending in part on it. So long as the fund is piling up and losses are infrequent, new banks tend to be State Banks¹: when losses and contributions are heavy, the reverse is the case, banks deserting the State system and turning over to the National system. That the idea has at times tempted the Comptroller of the

¹ "The popularity of this legislation [in Oklahoma] was manifested in the liquidation and re-organization as State Banks of thirty national banking associations in 1908 and fifty-two in 1909. From 1910 to 1921 inclusive, fifty-one additional National Banks in Oklahoma liquidated for the purpose of re-organizing as State banks." Report cited, p. 187.

Currency can be seen from the recommendations in the Reports from time to time, suggesting a modified application of the system to National Banks, so far as individual deposits under \$5,000 are concerned.² The complete failure of the Oklahoma scheme (which has now been repealed), and its almost equal lack of success in other States³ in meeting the exigencies of the post-war crisis, has for the time being given a blow to the idea, from which it will take some time to recover. But in a country of small banks, in which public opinion is largely hostile to branch banking and thus antagonistic to one of the essential elements of sound banking, it would be rash to predict that the principle will not revive again. A rise in the standards of inspection maintained will no doubt reduce the danger to the funds arising from the bad risks assumed: stricter administration of the criminal law will work in the same direction.

(4) THE FEDERAL RESERVE SYSTEM AND THE FARMERS.

It requires only a very slight acquaintance with the currents of American opinion to discover that there is widespread hostility to the Federal Reserve System, based upon the view that the recent sufferings of the agricultural classes of the United States—now, happily, at an end, at any rate temporarily—were due to the deflationist policy of the Board in 1920-1. This "particularly dangerous and pernicious myth" as it is styled by Dr. B. M. Anderson, unfortunately received the endorsement of the politicians during the period culminating in the election campaign of 1924.³

² See e.g. *Report for 1919*, p. 152; *Report for 1917*, p. 24.

³ In Washington the largest bank in the system failed, the opinion of the Assistant Secretary of the Banking Board being that "the guarantee of deposits in this State had been 'tested and found wanting.'" In North Dakota in 1923 the losses facing the fund were between three and four million dollars; the fund possessed half a million, and the maximum permissible assessment "would not keep up the interest on the estimated liabilities." Cooke, *op. cit.*, pp. 128, 131.

³ See Dr. Anderson's vigorous "A bi-partisan myth—Federal Reserve Bank—Deflation of the Farmers." *Case National Bank Bulletin*, vol. IV, No. 4. For the whole controversy see, particularly, Beckhart, *Discount Policy of the Federal Reserve System*, pp. 454-502; Willis, *The Federal Reserve System*, chapters lxvi.-vii.

The invaluable *Hearings before the Joint Commission of Agricultural Inquiry*, especially Part 13, are out of print, and therefore not easily available, especially for European students.

Whether the action of the Federal Reserve Banks in 1920-1 should be condemned in principle or not, it cannot be established that deflation was more violent in the rural than in the non-rural sections of the country—on the contrary, the findings of the Joint Agricultural Committee of Inquiry of the United States Congress point to the opposite conclusion. Nevertheless, the last few years have witnessed constant attempts to alter the structure of the System so as to give more consideration to the supposed needs of agriculture, and though these attempts have been only in part successful, the long-run effects of the excited state of public opinion are likely to be unfavourable to the scientific and rational development of the System, so far as the following matters are concerned :

(1) The tendency for the System to become immersed in political controversies has of course been strengthened by the events of the last few years. A consistent policy obviously becomes very difficult if heated debates in Congress are to follow, and if the political parties inculcate the idea that a certain trend can be given to Federal Reserve policies by the action of the administration. Weighed against the evil produced by ideas of this kind, "the entry of political considerations of a controlling character in the selection of personnel"² is perhaps a secondary matter, for, provided the Board as a whole is left free to act as it thinks best, the pressure from the politicians on the Board cannot prevent the application of sound principles. It is the debauching of public opinion which is mainly to be feared.

(2) The agricultural conflict has also resulted in the extension of the principle of sectional representation. By an amending Act of June 1922, a sixth member is added to the Board, appointed for the purpose of representing agricultural interests. The position, by

² Willis, *op. cit.*, p. 1490. In November 1923 the Federal Advisory Council took cognizance of the attempts to influence the Federal Reserve Board "by political pressure and organized campaign, with the object in view of replacing tried servants of the F. R. System by others aspiring for their positions" and protested against such efforts. *Reports*, 1923, p. 467.

this Act, has been changed in a significant fashion. The original Act required the President in making appointments to the Board, to have "due regard to a fair representation of the different commercial, industrial and geographical *divisions* of the country". As the Act now reads, it requires the President to have "due regard to the financial, agricultural, industrial and commercial *interests*, and geographical divisions of the country". Thus the emphasis is transferred from geographical to economic divisions of interest. No doubt these coincide to some extent, but it is difficult to see how in future it will be possible to keep a representative of Labour off the Board and thus to strengthen the disruptive forces within it.

(3) The now existing body of legislation defining the classes of "eligible paper" bears all too clear evidences of sectional pressure. Experience and theory alike insist on the danger of a note issue being based upon illiquid resources, and, as a consequence, the constitutions of most central banks provide for the issue of notes only against paper of short maturity. Now the tendency of American legislation has been to expand the grades of "eligible" paper so as to increase the period of maturity. This tendency culminates in the new Section 13 (a) which was incorporated into the Federal Reserve Act by the Agricultural Credits Act of March 4th, 1923. It is now possible for a Federal Reserve Bank—subject, it is true, to the regulations of the Board—to "discount notes, drafts and bills of exchange issued, or drawn for an agricultural purpose, or based upon live stock and having a maturity, at the time of discount, exclusive of days of grace, not exceeding nine months, and such notes, drafts and bills of exchange may be offered as collateral security for the issuance of Federal Reserve notes", though paper with more than six months' security is not to be eligible "as a basis for the issuance of Federal Reserve notes unless secured by warehouse receipts or other such negotiable documents conveying or securing title to readily marketable staple agricultural products, or by chattel

mortgage upon live stock which is being fattened for market". Subject to certain restrictions, the paper of co-operative marketing associations was to be regarded as "issued or drawn for an agricultural purpose".¹

The proposals to add an agricultural member to the Board and to extend the maturity of agricultural paper had both been opposed by the Governor of the Board, Mr. W. P. G. Harding, now Governor of the Reserve Bank of Boston, though the second proposal was later agreed to by the acting Governor of the System.² I agree with Mr. Beckhart³ that "though the actual effect might be very slight the danger lies in the precedent established".

Apart from these modifications and the further not unimportant fact that in order to encourage small banks to join the system, the Act of March 1923 reduced the capital requirements for entry to 60 per cent of those which such a bank would require to become a National Bank in the place where it is situated,⁴ the same legislative instrument links up the Federal Reserve System with the new system of Intermediate Credit for the benefit of Agriculture.

It would be going too far afield to deal in detail with the new organizations which, beginning in 1916, have now been created for supplying the long period and intermediate credit needs of the American farmer. Suffice it to say that there now exist, in addition to the previously existing mechanism of agencies lending upon mortgages—Farm Mortgage Companies and Farm Loan

¹ Sec. 13 was also amended to allow of the discount (a) of factors paper "issued as such making advances exclusively to producers of staple agricultural products in their raw state" (up to ninety days' maturity); (b) of demand drafts drawn against the domestic shipment of "unperishable, readily marketable staple agricultural products", and secured by shipping documents. For the interpretation by the Board of the terms employed, see *Digest of Rulings of the Federal Reserve Board*, Washington, 1924. The power of interpretation possessed by the Board was almost from the beginning of the System used to favour the farmer by liberalizing the concept of "agricultural paper". See Reed, *Development of Federal Reserve Policy*, chapter vii.

² Beckhart, *op. cit.*, pp. 495, 499.

³ *op. cit.*, p. 500.

⁴ Federal Reserve Act, Sec. 9. But the capital must thence forward be annually increased by not less than 25 per cent of the net income of the previous year.

Companies, Insurance Companies and the mortgage loans of the banks—a new series of institutions, viz.¹

(1) Created by the Federal Farm Loan Act, twelve Federal Land Banks, a series of Joint Stock Land Banks and several thousand associations of borrowers, the so-called National Farm Loan Associations.

(2) Created by the Federal Farm Loan Act of 1923, twelve Intermediate Credit Banks and a series of National Agricultural Credit Associations. The function of the Intermediate Credit Banks is, broadly speaking, to finance the Credit Associations, as well as State Banks, Trust Companies, Savings Banks and other institutions.

The Federal Reserve System is allowed under Section 13 to buy or sell debentures or other obligations issued either by an Intermediate Credit Bank or a National Credit Corporation: just as under Section 14 of the Federal Reserve Act it is allowed to deal in such obligations as part of its open market operations. The Federal Farm Loan Act of 1916 had already, by Section 27, provided that the Farm Loan Bonds might be bought and sold by the Reserve Banks under Section 14. The bonds, debentures, etc., so bought and sold under Section 14, or bought and sold under Section 13A, are limited to a maturity of six months, so that, in effect, the degree of liquidity is greater than in the case of certain types of agricultural paper.

From what has been said, it will be seen that the view that the farmer has been neglected can hardly be substantiated. If there is any danger at all, it is that superabundant credit resources are being made available, the only effect of which will be to cause land to be capitalized at a higher figure, and to leave the competitive position of the farmer exactly where it was.

¹ At the close of business on December 31st, 1932, the Land Banks showed a balance sheet position of \$876.2 millions, including \$799.6 millions of net mortgage loans, and \$806 millions of bonds outstanding. At the same date the balance sheet of the Intermediate Credit Banks showed assets and liabilities of \$99.3 millions. The Joint Stock Land Banks showed assets and liabilities amounting to \$428.7 millions. See *Seventh Annual Report of the Federal Farm Loan Board*.

(5) THE "OPEN MARKET" POLICY OF THE FEDERAL RESERVE SYSTEM

In recent months a degree of attention has been paid to the so-called "open market" policy of the Federal Reserve System which the actual results achieved perhaps hardly justify. But before the technicalities of the method can be discussed and its achievements estimated, a word must be said about the use of the method of discount rate variations as a method of credit control. More than one factor is at work tending to diminish its importance.

In the first place, in view of the sensitiveness of the system to political charges, the use of the discount rate is too *spectacular* to be employed with safety. So long as the system runs the risk of being made the whipping boy of Congressmen dissatisfied with economic conditions, the system must avoid at all costs any association in the public mind of high discount rates and declining trade. The avoidance, where possible, of this method represents merely adherence to the principle of "safety first".

In the second place, no unanimity exists as to the precise relationship which should be maintained between the official discount rate and the rate charged by the market. An important section of American opinion holds that the rate charged by the Reserve Banks should be a *penal* rate: that, in other words, the rate should be kept above the rates ruling, not only in the open market, but also above the rates ruling at the commercial banks for "over-the-counter" discounts.¹

The Federal Reserve Board, in its tenth annual report, takes up the attitude that the rate structure in London and New York is identical in this respect, viz. that in

¹ See, for instance, E. M. Anderson in *Cbase Economic Bulletin*, Vol. iv, No. 3: "Re-discount rates should be regularly kept above the market rates. The market rate means the rate charged by great city banks under lines of credit to prime borrowing customers who have deposits and lines of credit with several banks and often in several cities." See also Beckhart, *op. cit.*, p. 510: "The consensus of opinion among students of the subject here and abroad is that the *Bank rate should rule higher than the market on each of the several types of paper discounted by the system.*" (Italics mine.)

both centres the open market rate is below the official rate of discount, whilst "in London, as in New York, the bulk of the loans made by commercial banks to their customers are at rates higher than bank rate in London or the Federal Reserve discount rate in New York". English banking practice does not, therefore, establish the inference that Federal Reserve Bank discount rates in order to be effective must be penalty rates—that is, be higher than the rates charged by member banks or customer loans.

"Little in the way of good would result from any attempt to adopt or get this up as the regulative principle in the adjustment of reserve bank rates."¹

Nevertheless, the Board is forced to admit :

(1) That the "temptation which is present under the American banking system to re-discount customer paper and re-lend the proceeds because of the profit arising from such re-discount, when the Federal Reserve Bank rule is sufficiently below the customer rate to make such a transaction profitable, is not present under the English system".²

(2) That "the experience of the Federal Reserve Banks under normal conditions of operation has as yet been too brief to make it possible to speak comprehensively and definitely concerning the proper relation of Federal Reserve Bank discount rates and member bank customer rates".³

(3) Experience is, however, demonstrating "that there is a sufficiently close connection between changes in Federal Reserve Bank rates and changes in rates charged their customers by member banks on a sufficiently large volume of customer borrowings to make Federal Reserve rates an important and at times a leading influence in money centres".⁴

(4) But lastly, "the outlook for Federal Reserve credit regulation would indeed be unpromising, in view of the great disparity of customer rates at member banks

¹ *Report*, p. 2.

³ *op. cit.*, p. 9.

² *op. cit.*, pp. 8-9.

⁴ *op. cit.*, p. 10.

in different sections of the country, if the reserve banks had no other means than discount rates by which to regulate the volume of their credit used, and if this discount rate could exert no effective influence unless it were a penalty rate".¹

The question is ultimately one of first principles. If *normally* a certain proportion of the banking resources of the United States are to be supplied by the Federal Reserve System, then the discount rate can well be under market rates, but, if this is to be reconciled with any attempt to control credit conditions, a rise in official rates must *precede* the rise in market rates, and a fall in official rates must *anticipate* reductions in market rates. It is the tendency of reserve rates to *follow*, rather than to *precede*, market rates, which should be criticized, rather than the tendency of reserve rates to be below market rates.

Turning now to the open-market policy of the bank, a distinction must be drawn between the potentialities of the policy, and the actual practice of the Federal Reserve System. An "open-market policy" is new only in name: it is based on the principle that, other things equal, the volume of funds at the disposal of a money

¹ *op. cit.*, p. 9. It is undesirable to cumber the text with detailed arguments, but it may be pointed out here that the true analogy between London and New York lies, not in the similarity of the rate structure, but in the effects produced when an increased demand for credit makes itself felt. Bank rate in London tends to become effective when the brokers are driven to the Bank; in New York it tends to become effective when the "out of town" banks call in deposits and/or call loans in New York, and thus force the New York Banks holding large country deposits in to the Federal Reserve Bank in New York. Though the institution of the Federal Reserve System has mitigated the concentration of funds in Reserve and Central Reserve cities, it has by no means done away with it. Country Banks will call in spare deposits and thus the effectiveness of rising discount rates at other Reserve Banks tends to be delayed by the very factor which makes the rate more effective in New York itself, in the sense of reducing the margin between customer rates and bank rate. Direct comparison between the London open bill-market and that of New York is almost impossible. In New York the banks can re-discount acceptances bought from dealers with the Federal Reserve Bank, whilst the dealers' market is a very narrow one, there being only six regular dealers in the market; in London the banks do not re-discount bills bought from dealers with the Bank, whilst the dealers' market is a very wide one. The relations of the two central banks to dealers in the two markets are thus very different. For the volume of funds involved in New York and due to other banks, it may be noted, says the *Federal Reserve Bulletin* for January 1923, p. 25, "that amounts due to correspondents constitute about one-fourth of demand deposits of the New York banks, and are generally more than twice as large as their time deposits" (Article on Inter-bank Deposits).

market will be diminished if a central bank reduces its investments or will be increased if a central bank increases its investments, its discounts and loans being assumed constant. Or, to put the matter in another way, it is not the loans and discounts alone which determine the volume of funds which a central bank can place at the disposal of the market, but the aggregate of all its "interest earning" operations. In other words still, the money market will be drained of funds if the reserve rises relatively to aggregate investments, and will be replenished with funds if the reserve falls relatively to aggregate investments. If the market is to be affected, investments other than loans and discounts must rise faster than loans and discounts fall off, or must fall off faster than loans and discounts are rising. If the aggregate of investments plus loans and discounts remains the same: an increase in the one merely offsetting a decline in the other, the money market will remain unaffected.

Other things, of course, are not always equal. A net reduction in the aggregate earning assets of the Federal Reserve System may not in fact imply a reduction in the resources of the market as a whole, if that reduction is accompanied by increased imports of gold, which lead to increased deposits at the Reserve Banks or to a reduction in indebtedness there, on the part of member banks. All that one can say is that, *unless* the aggregate investments of the Reserve Banks had been reduced, the resources at the disposal of the market would have been greater still. A reduction in investments accompanied by an increase in gold reserves neutralizes gold imports to the extent that the two movements balance one another. To the extent that gold imports are larger than the reduction in investments, additional resources will still be placed at the disposal of the market.¹

¹ Cf. *Report for 1923*, p. 16. "That throughout 1923, a year of growing business activity and increased credit and currency requirements, there was no demand for additional reserved bank credit was due to the continued inflow of gold from abroad which furnished to member banks the funds needed to finance the enlarged volume of trade and industry." *Bulletin*, January 1925, p. 2: "Increases during the past six months in requirements for reserve balances at the reserve banks . . . have come at a time when gold imports were not in sufficient volume to meet those requirements."

From the standpoint of Federal Reserve policy, the importance of the open market portion of its aggregate investments lies in the discretionary power which manipulation of this amount affords, and in its use as a measure of the degree of dependence of the credit structure on *some form* of investment by the Reserve Banks. As the Report of the Board for 1923 puts these points: "The difference between discount operations and open market operations is that the initiative in re-discounting lies with the member banks, while in the purchase and sale of securities the initiative may be taken by the Reserve Banks. The extent to which member banks borrow in order to replace the funds withdrawn by the Reserve Banks through the sale of securities, is a measure of the demand for Reserve Bank credit. The sale of securities by a Reserve Bank may thus serve as a test of the degree of adjustment between the demand for Reserve Bank credit and the outstanding volume of such credit."¹ If a reduction of securities *leads* to increased discounting, it is a proof that *unless* in the immediate past a certain amount of open market investment had been undertaken, a greater amount would have had to be borrowed through re-discounting: is a proof, in other words, that the aggregate demand for reserve credit could not only be satisfied by the outstanding aggregate investments. What has been said, however, does not justify the inference that at a time when the discounts of the Reserve Banks are falling off, they are justified in increasing their open-market investments. Sales of securities can only test "the degree of adjustment between the demand for Reserve Bank credit and the outstanding volume of such credit" *retrospectively*: but whether or not the Reserve system ought to expand open-market investments at a time when discounts are falling off cannot be settled by any automatic test. Discounts may be falling off *because* open-market investments are increasing or because the market is getting command over other resources. The policy which ought to be followed in these two cases may be very different.

¹ *op. cit.*, pp. 13, 14.

Apart from any consideration of policy, a continuous reduction in discounts will tend to be followed by a rise in open market investments, for, though profit making may not be the primary consideration with the Reserve Banks, nevertheless, a bank, even a Central Bank, cannot neglect profits and expenses altogether. This is particularly so in the case of the Reserve Banks, the shareholders in which are the member banks, the majority of these having had no option as to whether they should invest in the capital stock of the Reserve Banks or not. The political consequences of a failure to earn adequate amounts might be very serious, so that it is not surprising that the impetus to a considerable development of the open-market investments of the system came in 1922, when discount reached a low level and "some of the Reserve Banks, in order to assure themselves of sufficient earnings to meet their expenses and dividend requirements, began to purchase considerable amounts of short-term Treasury securities".¹ But the desire of member banks to earn dividends is tempered by the fear, on the part of American bankers as such, of increased competition. Those familiar with the political power of the banks, will, therefore, see more than a hint of danger in the resolution which was passed at the American Bankers' Association Convention at the Chicago Convention last year, which, whilst praising the Federal Reserve System for the work which it has done, goes on to assert that :

"The Federal Reserve Banks have been driven, in order to earn their expenses and dividend charges in these more normal times, to compete for business with their own member banks in such fashion that there is danger that in the future the operations of the Federal Reserve Banks may tend to accentuate the swings of the financial pendulum rather than to keep the swings of the pendulum going too far in either direction. We, therefore, earnestly recommend that a careful investigation be made by those who are properly qualified to investigate whether it might not be wise to limit the Federal

¹ Report, 1923, p. 13.

*Reserve Banks to their primary functions as banks of issue and re-discount."*¹

If one turns from questions of theory to questions of fact and studies the actual record, one finds that the outstanding feature of the situation is the stability of the aggregate earning assets over relatively long periods of time,² as the following table clearly shows :

FEDERAL RESERVE SYSTEM

Aggregate Average Daily Earning Assets

	1924 mill. \$	1923 mill. \$	1922 mill. \$
January	1,001	1,191	1,304
February	922	1,153	1,215
March	952	1,199	1,191
April	941	1,165	1,190
May	840	1,173	1,189
June	843	1,123	1,169
July	826	1,120	1,128
August	837	1,078	1,053
September	931	1,123	1,113
October	1,006	1,151	1,185
November	1,085	1,148	1,210
December	1,221	1,200	1,304
Average for year	950	1,151	1,187

Throughout the period, 1922-24, it will be noted that there is a recession during the first eight months of the year, resulting in minimum figures usually in August (in 1924 in July) and an upward swing in the last four months, corresponding to the seasonal demand for accommodation which accompanies the crop-moving period in the autumn.

This periodical recession was, however, more marked in 1924 than in 1923, though less than in 1922, amounting

¹ *Finan. and Comm. Chron., A.B.A. Convention Section*, p. 14. (Italics mine.)

² "Relative stability in the total volume, with changes in the composition, has been the principal characteristic of Federal Reserve Bank assets during the past two years." *F. R. Bulletin*, January 1924, p. 2 (referring to 1922 and 1923).

in the three years 1922, 23, 24 to \$Mn. 251, 113 and 175 respectively. The fact that this seasonal recession coincided in 1924 with a decline in business activity has without doubt given rise to the view that the depression was caused by the recession. The salient figures are as follows:

1924.	Average Daily Earning Assets.	F.R.B. Wholesale Prices.	Production in Basic Industries.	Factory Employ- ment.	Whole- sale Trade.
November	1,085	160	107	91	84
October ..	1,006	159	109	91	96
September	931	156	103	90	92
August ..	837	158	94	87	83
July ..	826	156	94	87	78
June ..	843	154	94	90	76
May ..	840	156	103	93	77
April ..	941	158	114	97	78
March ..	952	160	116	99	80
February	922	163	120	99	78

Before any part, or the whole, of the industrial decline is ascribed to the Federal Reserve System, however, it is as well to bear in mind the following points:

(1) Throughout the period February-November 1924, with the sole exception of March-April, the open-market investments of the system continued to increase, and even April shows a not inconsiderable increase over February, as the following table shows:

	Total Av. Earning Assets.	Total Av. Bills Disc'd.	Total Bills Bt.	Total Av. U.S. Securities.	Total Av. open market Assets.
December	1,227	302	357	554	911
November	1,085	229	265	587	852
October ..	1,006	241	178	585	763
September	931	263	90	575	665
August ..	837	270	28	537	565
July ..	826	318	44	462	506
June ..	843	375	51	416	467
May	840	435	81	323	404
April ..	941	495	174	272	446
March ..	952	479	230	243	473
February	922	516	271	134	405

The maximum amount of "deflation" which the Reserve Banks could have practised under these circumstances, is the difference between the bills discounted and the aggregate open-market assets. Taking average daily figures, between February and July, this difference amounted to \$100,000,000. The question at issue then, is whether the market was deprived of \$100,000,000 of resources, and if so, whether that deprivation was the cause of industrial decline?

(2) When one examines the position from the standpoint of the market as a whole, it is interesting to observe that throughout the period under review the resources of the market have been expanding, as the following table shows:²

Date.	Number of Banks Reporting.	Total Loans and Investments. mill. \$	Total Deposits exclusive of Bank Deposits. mill. \$
December 1923	28,980	37,439	35,834
March 1924	28,669	37,937	35,682
June 1924	28,451	38,407	36,841
October 1924	28,389	39,609	37,579

Between March and June of last year, whilst the aggregate earning assets of the Reserve Banks were falling off, the total loans and investments of reporting banks increased by nearly \$500,000,000, against a reduction in earning assets of the Reserve Banks of about \$100,000,000. It is clear then, that, in spite of that reduction, the resources of the market as a whole must have risen by at least \$400,000,000. It becomes difficult, then, to ascribe the industrial depression in the United States in the spring of 1924 either to a reduction in open-market assets, because these were in fact increasing, or to a reduction in banking resources as a whole, because these were expanding. It is true that *loans* as distinct from *investments* of the reporting banks, fell off by \$66,000,000 between March and June, but just as it is true that a purchase of securities by the Reserve

² *Bulletin*, January 1925, p. 61.

Banks adds to market resources in the same way as an increase in the volume of bills would have done, so it is true that an increase in the total of investments held by the banks of the United States must influence command over purchasing power in the same way as an increase of loans and discounts. Nor is it difficult to account for this increase in the resources of the market. Though demand deposits have been increasing faster than time deposits, requiring larger reserve balances to be held, yet "funds arising out of the continued importation of gold and out of the return flow of currency from circulation have been more than sufficient to furnish the additional resources required by the member banks on account of their increased deposit liabilities".¹ The position becomes clearer still if one takes note of the fact that whilst in the six months ending June 1923 the net imports of gold were \$109·64 millions, in the six months ending June 1924 they were more than twice as large, viz. \$222·4 millions. Over the whole twelve months, net imports in 1924 were \$258·1 millions against \$294·1 millions in 1923, so that the last six months of 1924 witnessed a striking change in the gold position, and this is reflected in the position of the Reserve Banks. "With the reduced amount of gold coming in from abroad, the larger demand for currency and for reserve balances has resulted in an increased demand for Reserve Bank credit and a consequent growth of the earning assets of the Federal Reserve Banks."² At the end of the year the position of the average earning assets held was again within \$21,000,000 of that reached in December 1923.

(6) CONCLUSION

There are other aspects of the American financial situation which well merit attention, though nothing has been said of them here. America is now the greatest capital exporting country in the world, and, if this

¹ *Bulletin*, September 1924, p. 683.

² *Bulletin*, January 1925, p. 1.

movement continues, profound reactions on the mentality of the American bankers are to be expected. At present the tone of the American banker is overwhelmingly provincial, even in New York. And if the attitude of the professional banker is likely to be modified by the trend of events, the attitude of the Labour Movement towards "Wall Street"—an attitude of undisguised suspicion—is also certain to change as the remarkable "Labour Bank" movement extends and Labour leaders are brought more and more into touch with the concrete realities of banking and finance. But the predominant impressions with which the student of banking returns from a visit to the U.S.A. are two in number. The first is a feeling of profound gratitude for the help and assistance which are extended to him by bankers in every part of that vast country: the second is the feeling that the prestige of the Reserve System is much greater abroad than it is at home. The writer has heard the Federal Reserve System discussed many times; rarely, if ever, with approbation, often with extreme bitterness. That does not prove anything beyond the fact that the task of educating America to appreciate the benefits of a Central Banking system has hardly commenced.

THE GREAT AMERICAN PANIC OF 1933¹

I

PANICS have no history—if they had, they would belie their essential characteristic, which is their irrationality. The student of banking can only observe the immediate conditions under which, in each case, they arise, the morbid phenomena which they exhibit and the specific by which, in each particular instance, the cure is effected and confidence is restored. The great panic of 1933 will prove to be no exception to this rule: it is already possible to marvel at a population which stoically endured the great gold drain of 1931-2, but was unable to resist hysteria, confusion and dismay because of purely local banking difficulties in less than a year afterwards. Or shall it be said that in the end it was the associating of the magic name of Ford with the difficulties of the Union Guardian Trust Company of Detroit which opened the floodgates of panic? Whatever the explanation, the drama remains: twenty years after the creation of the Federal Reserve System, called into being primarily to prevent a recurrence of just such a state of affairs, every bank in the country, including the twelve Reserve Banks themselves, was forced to close. Let the reader remember that the United States held an enormous stock of gold: that the volume of its foreign liabilities had been drastically reduced as a consequence of withdrawals nine months previously; that a special Corporation had been created expressly to come to the assistance of weak banking institutions, and that the Reserve System had been armed with special powers to mobilize its gold stocks more effectively; that, if anything, the economic situation was somewhat easier and, finally, that a mere show of strength by the incoming President virtually effected a cure. Great Britain was dragged

¹ Reprinted from *The Banker*, April 1933.

off the gold standard in 1931 by an international run upon the bankers of the City of London; the United States has been driven off gold for the time being by an *internal drain*, by a series of episodes to which there has been no parallel in British banking for something like three-quarters of a century. Here are elements of paradox and of drama for whose roots one must dig deep into the soil of the strange and unfamiliar civilization of the United States.

II

Why is it that America continues to suffer from internal panics whilst Europe is almost free of them? There is a sinister procession of dates in the history of American banking—1857, 1873, 1893, 1907 and now 1933—to which in recent European history there is no parallel. The Austrian crisis of May 1931, the German crisis of July 1931, the British crisis of July-September 1931 are examples of *banking pressure*, but they do not reveal the specific characteristic of a *panic*. The ultimate root of the American difficulties must be found in the specific nature of the American banking system: a system utterly unlike that to be found anywhere else, the product not of economic necessity, but of political conditions, to which time had given a sanction which in an essentially conservative country like the United States no critical intellect could really shake. But the original conditions which produced the actual state of affairs were intended to bring about a position exactly the opposite of that which in fact obtains. The exaggerated particularism of American banking is the root of the present troubles, but that particularism, only gradually developed, has been watched with great distrust and has only continued to be possible because the average human being regards what he is used to as the natural and the inevitable, and therefore attaches to the actual an air of rightness and inevitability which is the enemy of the rational and desirable.

When, in order to provide a market for Government bonds during the hard and difficult days of Northern inferiority in the field, the then Secretary of the Treasury, Salmon Chase, created the National Banking System, the note issue was still an important privilege of American commercial banking, except perhaps in New York City. By taxing the note issues of the State banks which remained faithful to the anti-slavery cause, the Federal Government of the Civil War period was able to drive the banks into the National Banking System. Whatever the defects of that legislation may have been, it did at least provide for an absolutely uniform code of legislation applicable to the whole territory of the United States, for an effective system of inspection and supervision, and for the prohibition of the more dangerous kinds of banking activity. Had the forty-eight States of the Union not favoured concurrent powers of legislation, had the importance of issuing notes not receded into the background, had the National Banking Code made adequate provision for a branch banking structure, the subsequent development of banking in the U.S.A. would have been profoundly different from what it actually was. As the country extended its territory towards the west and as its power and population increased, there might have developed a strong banking system centring upon the great commercial and transport towns of the continent—New York, Chicago, New Orleans, San Francisco, Seattle and the rest. A concentration such as that which has taken place in Great Britain, Germany, and elsewhere would in any case have been impossible in view of the immense distances involved. But in fact things developed very differently.

Even before the Civil War, certain towns, primarily New York, New Orleans, Chicago, were assuming great importance as virtual reserve centres for the rest of the country: a fact recognized in the National Banking Code when it permitted banks to keep part of their cash reserves in the shape of deposits in Reserve and Central Reserve Cities. The centripetal forces at work in this

way were, however, accompanied by centrifugal forces as well. As the population and the occupied area of the United States expanded, the necessary and coincident expansion of the banking system involved the creation of an ever-growing number of banks, partly created under the National Banking Code, partly under the codes of the separate States. For a long time the fact that membership of the National Banking System permitted note issue and conferred prestige gave this system the superiority both in numbers and power: the gradual decline in the importance of the note issue and the growing attractiveness of incorporation under codes less severe than that of the Federal Government led to a change.¹ First the *number* of State banks exceeded that of the National banks (this was in 1894); then, after the War, the *banking resources* of the State banks exceeded those of the National banks (this was in 1921). By that time the Federal Reserve Act had been long in operation: the National Banks, which had been forced to join the system, were exposed to severer revenue conditions than the State Banks and were hampered in other respects. Successive Comptrollers of the Currency, the official guardians of the National Banks, saw the developing situation with dismay, and knew only one way of countering it—to confer upon National Banks the powers conferred under State legislation upon State Banks. When the branch banking controversy first became acute, the line of solution adopted was not to strengthen American banking as a whole by careful Federal legislation relating to the subject, but to give National Banks the right to open branches only where State Banks could do so, and since public opinion was in general hostile to the branch banking principle, the net effect was that the United States entered upon the period of prosperity of 1925-29 with a banking system perhaps reasonably adapted to the one-time necessities of small rural communities, but entirely unfitted to cope with the special problems

¹ See the *Reports of the Comptroller of the Currency* for 1931, pp. 3-9.

of an age of immense change in the scale and tempo of business. Thus the American banking structure reveals the strangest contrasts both in the ability and outlook of those by whom it is directed and in the scale of the respective units which constitute the structure in the aggregate: the giant banks of New York City side by side with the petty village bank, threatened with extinction as a result of better transportation facilities and unfavourable overhead costs: the "small-town" banker, whose only qualification (it is at times a very important one) is that he knows every soul in the place and has a finger in every local pie, is an independent member of the same profession as the President of an institution with perhaps \$100 millions of deposits and with the widest contacts inside and outside the country. Such a system offers great opportunities for men of initiative and ambition: it is easy to enter and easy to leave: it tends to identify the banker closely with the local community and satisfies the desire for self-determination. Perhaps without such a system American economic development as a whole would not have been so rapid: certainly without it local development within the country would at times have proceeded more slowly. But it is a system which has the defects of its greatness: and it is these defects which have periodically resulted in panic.

III

Over a large part of the country the possibility of spreading banking risks is severely limited. The U.S.A. is an immensely diversified area as a whole, but whole States are virtually associated with a single crop—corn or wheat, cotton or sugar, tobacco or cattle. The local storekeeper or doctor, the local motor car agent, and all the multifarious distributors ultimately depend on the price of the single local product for their livelihood; the producer himself has only his land, his crop, or his own personal credit to offer as security and the value of all

three depends upon the price level. The spreading of risks depends upon the banker's ability and willingness to invest part of his funds outside his area, and from a very early time, if he was a prudent banker, he did so. He could hold bonds, he could buy "commercial paper" he could keep funds on deposit with larger banks and instruct these to invest or lend for him. In this way (and because of the other conveniences which the relationship afforded) there grew up traditional "correspondent relationships" between rural and urban banks, which culminated in a very special situation in New York City. There some five or six banks, members of the National Banking System, virtually held the residual cash reserves of the entire banking structure of the country. The funds deposited with them they lent out—largely in the form of "call-money" to the New York Stock Exchange. Every period of pressure and of difficulty led to the calling-in of these funds, put pressure upon the New York Banks to liquidate their investments; and—in the days before the Federal Reserve System—it was not easy for the New York Banks to respond to the demands made upon them. It was to obviate both the over-investment of what was virtually reserve cash on the Stock Exchange and to provide a residual lender capable of taking charge of the situation in periods of pressure that the Federal Reserve System was founded, and a bill-market was encouraged to grow up. The new Central Banking agencies certainly did not supplant the old system altogether; they merely supplemented it by adequate rediscounting facilities. When the Michigan difficulties began to undermine the situation a month ago, the New York banks still held some \$1,500,000,000 for banks in other parts of the country, and it was then certain from the very beginning that if trouble could not be localized the banks of New York City would be involved. Whether they would be able to stand the strain depended upon the magnitude of the demands upon them and on the ability of the Federal Reserve Bank of New York to stand behind them to an unlimited

extent. If the New York banks were to be forced to close, a general closing down of all the banks of the country was inevitable; the shock would cause panic everywhere, and if the banks closed it was inevitable that the great produce and security exchanges would close also.

IV

The first point to bear in mind in surveying the recent history of American banking is that, in spite of the existence of the Federal Reserve System, the mortality among banks was greater in the last decade than at any previous time in American experience.² A bad patch was experienced in the last decade of the nineteenth century; in 1893, 326 banks failed, in 1895 and 1897, 151 and 160 respectively and there were 122 failures in 1904 and 156 in 1908. Since 1921 there has never been a year in which, according to the figures of the Comptroller of the Currency,³ the number of failures fell below 289; in 1924 there were as many as 915 and in 1927 as many as 824. Every slight recession of trade at once resulted in an increase in the number of failures. According to the (not comparable) figures of the Federal Reserve Board,³ in the eleven years 1921 to 1931 inclusive, 9,285 banks closed, 1,082 re-opened, with a net liability of the banks closed of no less than \$3,817,000,000 of deposits. Out of these 9,285 banks, over one-third, viz. 3,400 were situated in places with a population of less than 500, and 3,218 possessed capitals of less than \$25,000 (or £5,000 at par). It is clear that the general incidence of the failures was upon the small banks and upon the rural areas, but if one goes further into the matter one discovers that it has been the banks of the northern and central Middle Western States which have

² The student of American banking conditions will find an exhaustive analysis of this point in Walter E. Spahr's article "Bank Failures in the U.S.", Supplement to *American Economic Review*, XXII, No. 1, March 1932.

³ *Report*, 1931, p. 6.

³ *F. R. Report*, 1931, p. 125.

been particularly affected. In 1931, of the 2,298 which suspended, 1,388 fell into four Federal Reserve Districts, viz. Chicago (631), St. Louis (264), Minneapolis (271), and Kansas City (222).¹ In 1932, out of 1,453 suspensions, 932 fell into the same four districts; the Chicago district accounting for 506, St. Louis for 154, and the two other districts for 136 and 136 respectively.²

These figures raise three problems. First, why was the incidence of failure so much more marked among the rural than among the urban banks? Second, why were failures so much more severe as a whole in 1931 than in 1932? Thirdly, what explains the seemingly sudden outburst of failures among urban banks, an outburst which was the direct cause of the panic?

(1) Quite apart from the special difficulties which attach to a bank merely because it is small and is therefore subject to competitive disadvantages, there came the incidence of agricultural depression, which has affected the rural areas almost continuously in the last decade and particularly so since the disastrous collapse of raw material prices, the usual accompaniment of a cyclical depression. The collapse of land values, and of crop prices, the accompanying decline in the credit-standing of farmers and of those who indirectly live upon the produce of the land has naturally hit hardest those banks whose loans and deposits are most narrowly associated with the rural situation. A high mortality rate among country banks is therefore no cause for surprise—and the failures were heavy even before the general depression set in.

(2) The collapse of a large number of banks is bound to exert a psychological influence even if it is confined to a particular class of banks. But the urban banks of the U.S.A. have also been exposed to special difficulties. In the first place, banking difficulties, even if confined to a particular class of banks, create nervousness among depositors generally and lead to withdrawals of deposits in anticipation of trouble to come. This is the phenomenon

¹ *F. R. Report*, 1931, p. 191.

² *F. R. Bulletin*, January, 1933, p. 44.

of hoarding, of which one has heard so much in recent years: though the actual increase of "money in circulation" is also due to increased cash holdings by the banks themselves in anticipation of increased requirements by their customers. Thus the banks, in order to keep themselves in a liquid position have had to put pressure upon their customers, and this had a cumulative effect both upon business conditions and bond and stock prices, and upon the condition of the banks themselves. For a general desire to increase liquidity, unless accompanied by appropriate central bank action, is deflation; and the depression becomes cumulatively worse, causing loans to be frozen and forcing the weakest banks to the wall. It must not be forgotten that the banking system in the United States has become still more sensitive to stock market conditions since the change in the practice of business by which direct loans to commercial and industrial firms have shrunk in importance relatively to loans against stocks and bonds. A continued fall in stock exchange values means not only that the bank's own investments have declined in value, but that the margin behind customers' loans has fallen also. To these factors must be added the participation of urban banks in speculative real estate operations (one of the main causes, it is said, of the difficulties of the Chicago and Detroit banks) through loans secured by such property—a large part of such loans must be in a frozen condition and cannot, in any event, be used as the basis of rediscounting in periods of pressure.

It is not always realized how great in recent years the shrinkage in American banking figures has been. Between October 4th, 1929 and September 30th, 1932 (the latest date for which figures for all banks are available), total loans and investments had fallen from \$58,835,000,000 to \$45,852,000,000, or by some 22½ per cent.¹ In considering the ability of the banking system to stand additional strain, however, the important question is

¹ *F. R. Bulletin*, January 1933, p. 3.

the volume of assets which can be turned into cash at the Central Bank; and that question is only capable of being answered by reference to the law governing the lending powers of the Central Bank itself. The Federal Reserve System, in general, was unable to lend to or discount for banks outside the Reserve System, i.e. for "non-member" banks. It could (a) rediscount "eligible" paper, i.e. customers' promissory notes endorsed by the borrowing bank; (b) lend for limited (15 day) periods on the bank's own promissory note secured by such paper and/or U.S. Government securities. The limits to its own lending capacity were again a matter of legal definition: it had to maintain a gold reserve of 40 per cent against its notes, and at the same time the remaining cover against the note issue was to consist of eligible paper. But the Reserve System could also provide against the *necessity* of the banking system having to borrow by increasing its own holdings of Government securities or bills by purchases in the open market. If it did this on a sufficient scale the member bank balances at the Reserve System would go up and they could draw out additional cash without reducing their own holdings of eligible assets; though, to the extent that balances acquired in this way were utilized for drawing out cash, the pressure on the final gold reserves of the Central Bank was the same as if the notes were withdrawn through borrowings at the Reserve Banks.

So much it was necessary to say in order that the third question posed above could be answered. The comparative decline in the number of bank failures in 1932 as compared with 1931 was due in part, of course, to the weakest banks having been already eliminated, but it was in part due to the measures adopted in the cause of combating the great drain of gold away from America in the period of September 1931 to June 1932. During that period of time the gold stock fell from \$4,948,000,000 to \$3,941,000,000; the money in circulation rose from \$5,133,000,000 to \$5,751,000,000; during that period also, two great legislative enactments provided

for the creation of the Reconstruction Finance Corporation and for the issue of Federal Reserve notes backed in part by Government securities. The Act creating the Reconstruction Finance Corporation endowed it with a capital of \$500,000,000 and with borrowing powers equal to three times its capital (increased by the Relief and Emergency Act of July 21st, 1932, to six and three-fifths times its subscribed capital). The Corporation was authorized to make loans to a great variety of financial institutions, including loans "secured by the assets of any bank that is closed or in process of liquidation to aid in the reorganization or liquidation of such bank", a quarterly report of its activities having to be laid before Congress. Between February 2nd and December 31st, 1932, the Corporation had authorized loans of \$950,000,000 to banks and trust companies, had actually advanced \$850,000,000, and been repaid \$256,000,000, so that \$594,000,000 were still outstanding at the turn of the year. It will remain for some time an open question whether the activities of this Corporation have done more harm than good; the mere fact that it has prevented some banks from closing is not conclusive on the point, and the publication of the names of the assisted institutions together with the critical attitude adopted by some writers of standing¹ undoubtedly helped to unsettle the public mind.

The Glass-Steagall Act undoubtedly relieved the situation by enabling the Reserve System to mobilize its gold stocks. By Section 3 of that Act, the Federal Reserve Board was authorized to allow Federal Reserve Agents to accept as collateral security in addition to the other securities pledgeable for Reserve notes, the "direct obligations of the United States". Thenceforward, during the period authorized by the Act, Reserve notes continued to be covered by gold to the minimum required, but the excess of gold actually held over that required to be held could be reduced even if no "eligible

¹ V. e.g. Mr. J. T. Flynn's article on "Inside the R.F.C." in the January number of *Harper's Magazine*.

paper" in the technical sense was available: gold could be released and Government securities substituted.

The gold drain actually ceased in the middle of 1932: the United States monetary gold stocks rose between July, 1932, and December from \$3,941,000,000 to \$4,429,000,000: between the same two dates, the money in circulation *fell* from \$5,751,000,000 to \$5,699,000,000 and in December was only \$88,000,000 more than it had been a year before. The eligible assets of the member banks in September, 1932, were still \$8,050,000,000: the borrowings at the Reserve Banks were only \$331,000,000 and as their "excess reserves" (i.e. the difference between actual reserves as compared to the minimum requirements of the Reserve Act) at the same date were \$346,000,000, they were in reality hardly in debt to the System at all. Everything pointed to a relaxation rather than an intensification of strain: even in January 1933, the amount of money in circulation again declined and was actually \$14,000,000 less than it had been twelve months before.

V

Between February 14th and March 4th the storm broke. The difficulties of the Michigan banks led to the proclamation of a local bank holiday to last from Tuesday, February 14th to Tuesday, February 21st. So far from seeing in this step the beginnings of disaster it appears to have been warmly and generally welcomed; and the eminent New York weekly, *The Commercial and Financial Chronicle* remarked in its issue of February 18th that the situation "appears to have been handled with consummate skill and it seems possible to say that the worst of the trouble lies behind, with good reasons for thinking that there will be an early return to the normal". Elsewhere in the same article, whilst there is a discreet reference to the then recent "recrudescence of bank embarrassments at quite a number of financial centres in different and widely separated parts of the country", it

is urged that "the country ought now to be nearing the end of the long period of banking embarrassments, and to that extent the situation must be regarded as being improved, with the outlook for the future correspondingly brighter".

The danger of moratoria is that they bring about the very troubles elsewhere which they are designed to mitigate where they are adopted. They encourage hoarding before the banks are closed, and, in a closely knit economic system, they increase strain by preventing payments being made at due dates and thus bring about an ever-widening circle of unemployment and distress. The danger of the Michigan situation really lay in the public advertisement of widespread distress, and the probability that if trouble occurred elsewhere the same remedies would be adopted, so that in the end the whole country would be affected. This is exactly what did happen: not only did hoarding increase, but an ever-increasing number of States passed enabling legislation permitting the closing of banks and for the imposition of limits upon the right of depositors to withdraw. When the example of Michigan was followed by Maryland in consequence of runs upon Baltimore banks, the danger became really acute. Could the New York banks stand the strain on them of a double run by the banks of the interior and their own local customers? Could the Reserve System see its gold stock melt away through hoarding by the public and earmarking by foreigners, and at the same time provide the additional accommodation which would be required?

The crash came on March 3rd. Between February 16th and March 2nd, the total gold reserve of the Federal Reserve System had fallen by \$300,000,000: bills discounted had increased from \$286,000,000 to \$713,000,000: the notes in circulation had gone up from \$2,890,000,000 to \$3,600,000,000. During the same period, the New York Reserve Bank's gold stock had fallen from \$917,000,000 to \$710,000,000; its discounts had gone up from \$54,000,000 to \$281,000,000 and its reserve ratio

had declined from 59 per cent to 46 per cent. The position at the latter date was then still not insupportable, but the pressure became worse, and though reassuring messages had come from New York in time to be published in the morning papers of March 4th, by the afternoon of that day every bank in the U.S.A., including the Reserve Banks themselves, had closed. The incoming President, faced with a terrible emergency, acted with promptitude and vigour, making use of the Executive power under war-time legislation to prohibit the export of gold and the hoarding of gold. The gold standard had disappeared, though as all the banks were closed (and with them the stock and produce exchanges) and exchange dealings were impossible, this important fact did not, for the moment, matter very much. Everything turned upon what was to be done to get the banking system to function again.

The traditional method of dealing with this problem had been the issue of Clearing House Certificates (virtually inter-bank clearing certificates acceptable in lieu of gold or other lawful money), the pooling of reserves, and—in certain cases—the issue to the public of inconvertible notes, certified but not convertible cheques, and the like.¹ It appeared at first as if historical precedent were going to be strictly followed, and there was much talk of issuing both Clearing House Certificates and “scrip”. In the end, wiser counsels prevailed. The Emergency Banking Act, passed on March 9th practically without opposition even in the Senate and unanimously by the House of Representatives, proved to be of a drastic character. It continued the embargo on gold exports; it regulated the re-opening and re-organization of the Commercial banks; and provided for the issue of Federal Reserve Bank notes secured by Government obligations, the eligible assets of firms and individuals, and the promissory notes of member banks. Provision

¹ The reader will find ample material relating to these matters in Professor Sprague's well-known *History of Crises under the National Banking Acts*, and in two articles by Mr. A. P. Andrew in the *Quarterly Journal of Economics* for 1908.

was also made by which direct loans to individuals and firms could be extended by the Reserve Banks (hitherto only possible under very special conditions in virtue of the Emergency Act of July 1932). No bank was to re-open without permission ; but, if the public demanded more money, the provisions of the new Act saw to it that such money would be available. Since the Reserve *Bank Note* as distinct from the Federal Reserve Note requires only a 5 per cent cover (in virtue of the terms of Section 4 of the Reserve Act, which provided originally for the issue of such notes, of course, under widely different conditions), the amount of such notes which can be created, if necessity arises, is obviously very large.

VI

The necessity has, fortunately, not arisen. The public confidence was restored even before the banks, or some of them, re-opened on March 13th, and large quantities of hoarded gold and gold certificates were paid into the Reserve Bank even before the ending of the official bank holiday. By devising the plan of piecemeal re-opening, a masterly sense of economic strategy has been displayed by the President and his advisers ; the worst banks will in all probability never re-open and those which are allowed to do so are made safer than they were before, because the public will now have greater confidence in them ; they will have been tested in the furnace. But whilst the panic is over, the problem remains. Without question, great loss will be suffered by the public and to that extent business recovery will be hampered—on the other hand, the air has been cleared and, most fortunately, nothing has been done so far to prevent the enactment of remedial legislation in the future. But Mr. Roosevelt will be fortunate if Congress continues its acquiescent mood, for remedial legislation will mean sweeping away much time-honoured legislation and much that has been acceptable

to the American people in the past, and it is hardly to be expected that the fundamental revision of which American banking stands in such urgent need can be accomplished without opposition, both on the part of interests adversely affected and on the part of those attached sentimentally to the unit-banking principle as a symbol of democracy and of the pioneer spirit of the country.

CENTRAL BANKING

CENTRAL BANK POLICY

WHAT CAN CENTRAL BANKS REALLY DO?

IN the last few years important claims have been advanced on behalf of the central banks of the world, claims which go far beyond anything which was urged on their account in pre-war days. The works of a brilliant group of economists of varying national affiliation—Keynes, Hawtrey, Cassel, Irving Fisher, Wicksell, and others—have voiced these aspirations at the very time when the actual operations of these banks, under the stress of war and post-war conditions, were giving rise to a not unjustified scepticism. The spectacle of a 98 per cent discount rate at the Reichsbank, in particular, coupled as it was with the utter inefficacy of that rate as an instrument of repression, was not designed to encourage further speculations of the kind already mentioned. It seems more than worth while, therefore, to ask a gathering of economists to discuss the question, "What can central banks really do?"

PRE-WAR THEORY

Such generalizations on the subject as were contained in pre-war books do not help us much. Pre-war theory—in so far as we can speak of it at all—was merely a generalization from the policies supposedly followed by the Bank of England. As Parliamentary inquiries into the policies followed by the Bank ceased many years ago, and as the silence of the authorities was broken only on the rarest occasions—indeed, the most recent appears to be the interview with the Aldrich Commission in 1908—the value of these policies was by no means clear. Had they been clearer, however, they would still have afforded a somewhat precarious basis for theory. For the policy of

¹ Paper read at the Thirty-seventh Annual Meeting of the American Economic Association, held in Chicago, December 30th, 1924.

the Bank assumed found nowhere else banking can obviously be founded on so narrow a foundation.

Such as was, pre-war assumed that the functions of a central bank were, perhaps three, in number, viz. the management of a centralized issue, the administration of a centralized bank, and the "maintenance of sound credit conditions"—the last being indeed the true aim to which the others were clearly subordinate. And, further, "sound credit conditions" were interpreted somewhat mechanically.

THE REQUIREMENTS OF AN ADEQUATE THEORY

Before we accept as possible any or all of the new tasks which the new school desires to thrust upon the central banks, therefore, a revision of the theory becomes necessary. The whole philosophy of central banking requires careful overhauling. And, since a theory of central banking must necessarily deal with more than one environment, the theory cannot be simple, even if it be straightforward.

In particular, a theory of central banking requires to take critical account of the following groups of circumstances:—

(1) The influence of monetary standards and of different types of money market upon the position of a central bank.

(2) The methods open to a central bank.

(3) The presumable relationship between central bank action and the ultimate causes of price changes.

In other words, a philosophy of central banking worthy of the name must deal with environmental conditions, with technique, and with the theory of prices. The remainder of this paper constitutes an attempt at stating some of the more important of the elements to be considered.

A. *Environmental Conditions*

(a) A theory demanding action by a central bank assumes that that central bank is an effective instrument of supply, i.e. assumes that the central bank is a marginal lender of funds. This is by no means always justifiable, and is usually justifiable to some degree. It involves the further assumption that, if the central bank is not at any given moment the marginal lender, it can create such a condition of affairs as will force it into that position, through, e.g. an "open-market" policy. But a thoroughgoing theory must be prepared to establish when, and when not, a central bank is capable of "forcing the market into the bank".

(b) A theory demanding price control by a central bank assumes that the monetary standard is of a character to make this possible. And here one is at once faced by the positive difficulty that certain types of currency standard make price control by a central bank impossible in the long run. In particular, we may lay down the proposition: that an effective metallic standard, of the type made familiar through nineteenth century currency reforms, is inconsistent with price control by a central bank.

It is in this inherent incompatibility, rather than in the unwillingness of central banks to undertake the task of reform, that we find the explanation of the circumstance that prices rose by 2 per cent per annum from 1896 down to the outbreak of the war, in spite of the existence in Europe of efficiently managed central banks. Does it follow from this that central banks had *no* influence on the price level? By no means. In the first place, the *reserve* policy of central banks affected the demand for gold and therefore the value of gold; in the second place, the *note issue* policy of central banks, by increasing to a greater or smaller degree the supply of substitutes for metallic or standard coin, also influenced the price level. A central bank could therefore directly influence the local price level and through this, indirectly, the

world level of prices in the short run ; but so long as the central banks of the world did not own the gold mines of the world, they were obviously not in a position to control the long-run trend of prices.

(c) On the other hand, there are some currency systems which imply the *possibility* of price control, e.g. an inconvertible paper currency, the issue of which is absolutely in the hands of the central bank, which is conceived of as being free to shape its issue policy as seems best to it. Not all inconvertible paper currencies are in this position, nor are all central banks ; and it is one of the most important points in a rounded-off theory to determine what economic and political circumstances are most likely to lead to an independent policy in these respects.

(d) A further point of importance concerns the structure of the banking units with which the central bank is brought into touch, and the nature of the credit instruments employed in such a given system. It is ridiculous to suppose that a central bank working in the midst of a banking system based on the idea of "unit banks" can operate in precisely the same way as a central bank surrounded by a relatively small group of large banks each operating a chain of branches. The difficulties of central banks working in an economic environment in which eligible media of discount are unobtainable in sufficient quantities are well illustrated by the case of South Africa, and to some extent, by the United States.

(e) The ease with which the central bank can affect the money market situation at any given moment will vary, lastly, with its own reserve requirements and with the reserve requirements which are imposed by law or by custom upon the other banks. If its own reserve requirements are fixed at a high point, its direct lending operations are thereby limited ; if those of other banks are fixed high, that will force them sooner to the central bank or drive their customers there, the higher, other things being equal, these reserve requirements are. If the reserve requirements of the outside banks are reduced and those of the central bank are increased,

that will diminish the effectiveness of intervention. If, on the other hand, the reserve requirements of the outside banks are strengthened and those of the central bank are weakened, that will increase the efficacy of the intervention of the central bank. In other words a renewed study of reserve requirements in their relationship to central bank philosophy is one of the tasks which economists should undertake. In so far as there was a study of this matter in the pre-war period, emphasis was too strongly placed upon the facts of expansion and "elasticity" of issue, and not sufficient attention, to my mind, has been placed upon the relationship of reserve policy to central bank intervention in the money market.

B. *Questions of Technique*

Three, possibly four, methods of control are open: manipulation of the rate of discount, so-called "open-market" policy, the method of rationing, and lastly, and more doubtfully, the exercise of moral pressure. What is to be said for and against these various methods of control? The first acts selectively among the borrowers, the bank maintaining a relatively passive attitude; the second and third represent the activities of the bank on the market, the outsiders being deprived of discretion. The fourth possible method represents those rights which are usually attributed to a constitutional monarch, the right to advise and the right to warn.

Discount rate policy. What is the object of varying the discount rate? It is usually argued that the main purpose of a rise in the discount rate is to beat off fresh borrowers, but rising rates, as experience tends to show, may provoke fresh borrowers in anticipation of further rises in the future, so that, instead of declining, aggregate loans actually tend to increase. There is, in fact, a good deal of mystery as to what the rise of the central bank rates of discount is really intended to do. A recent controversy between the *London Economist* and Mr. R. G. Hawtrey

ended by the latter making a somewhat rhetorical statement: "If changes in bank rate cannot be relied on to affect the volume of trade borrowing, they cannot be relied on to do anything whatever."

But, as a matter of fact, the rise in the bank rate may be intended to do a good many other things besides check borrowers; it may be intended, for instance, to attract funds from abroad, and to cause a necessary lift of deposit rates offered by outside bankers in order that the draining away of funds may be prevented. In other words, the object of a rise in the rate may be less to discourage borrowers than to encourage lenders. But in any case a rise in the bank rate will obviously have no effect if there are other lenders who seriously undercut the rate, and it is this consideration which has given such an attractive air to the open-market philosophies of recent years.

From a social point of view, again, the whole matter of the discount rate requires systematic investigation. The question at once occurs, for instance, whether the rise in the discount rate does not always take place too late; whether it would be possible to discover adequate indices better than these which were utilized in pre-war days; whether again the unpopularity of fluctuating and rising discount rates and the hesitation to use them in a ruthless manner does not, in fact, mean that the discount rate is a relic of a bygone age of banking; whether the rise in discount rates really does act as a sufficient "deterrent" to check economic enterprise. All these are questions on which we can really hear profitably a good deal more than we have heard.

Open-market policy. The use of this method, is or seems to be, the favourite panacea of the moment. It appears to me that it is really desirable that the advocates of the open-market policy should be a little more explicit in their advocacy of it.

(a) It obviously makes a great deal of difference whether the open-market policy is intended to *supplement* the use of the discount rate or whether it is intended

to *supplant* the use of the discount rate. Which aim ought the central banks to follow in this respect? The answer as obviously turns upon the view one entertains as to the efficacy of discount rates in general, and the efficacy of discount rates to a given central bank in particular; and talk upon "open-market policy" in general only serves to veil the essential difference in attitude which is implied in the two alternatives.

(b) It is important to know whether the object of this new policy is to stabilize money rates or to stabilize prices. If the object is to stabilize money rates, then the central bank must obviously buy securities in periods of dear money and sell securities in periods of cheap money. If the object of the central bank is to control prices or attempt to control prices, then it must reverse the procedure stated above. The choice must be based not only upon one's estimate of the possibility of controlling prices in this way, a matter which is open to doubt, but also by one's view as to whether it is desirable to have more stabilized money rates than those which are implied by the use of the alternative method of discount rate variations. A conscientious attempt to control prices by the use of the open-market policy is somewhat too novel to indicate with certainty that the degree of difference between the highest and the lowest market rates would not need to be greater than they have been in the past, and would therefore conflict with the expressed desire of business men for stability in the price of money.

(c) In any case it is extremely desirable that economists and men of business alike should realize that the quantitative elements are the same, whether the central bank uses the method of discount rate variations, or whether it uses the open-market policy. It is certainly true that the open-market policy frees the bank from dependence on the wishes of outsiders to borrow; the central bank can itself determine when to increase and to decrease the volume of funds placed at the disposal of the market; but though this is an important element it is not, by any means, the same thing as implying that

the aggregate quantity of money over which the central bank has control is any greater in the one case than in the other. It follows from this that if the efficacy of action of the central bank is in part determined by its reserve and note issue requirements, that efficacy of action is subject to the same quantitative limits with the open-market policy as with the policy of discount rate variations; and it is extremely desirable that this point should be clearly grasped.

Rationing. Rationing is so unpopular as a method of economic control that it seems hardly worth while to discuss it at any length. It is certainly capable of achieving the object aimed at, provided that people are prepared to swallow the grave economic and social disadvantages which accompany its use. Its dangers are simple. They consist in the possibility of favouritism and in the enormous discretionary power which such a method confers upon the central bank. If the opportunities for extraordinary profits which are conferred upon the fortunate recipients of the bounties which the bank may bestow are to be avoided, the only alternative open is to attempt to fix the price for money all over the market. Not only must the bank fix a price for its own loans, but if these rationed loans are themselves re-lent they must also have their place determined by authority, and that the bank cannot do this easily is so obvious as hardly to require comment. In other words, rationing can be dismissed as a serious factor in central bank policy.

Moral suasion. The effectiveness of warning and advice cannot be estimated without an investigation into the type of banker to whom they are addressed, and of the powers which the central bank keeps in reserve. Further, the effectiveness of such warning will vary from time to time in accordance with market psychology. The rule would seem to be that such advice is most effective at a time when the business world is recovering from a period of liquidation, but that, unfortunately, is also a time in which such warnings are least needed. At any rate, it is clear that advice addressed to a small

group of powerful institutions is likely to be more effective than similar warnings which have to be addressed to thousands of isolated banks ; and thus, we are brought back to the fact already mentioned that the effectiveness of the action of the central bank is intimately associated with the structure of the money market. But however effective warning and advice may be as a subsidiary element in the general scheme of control, it can hardly be contended that economic enterprise has reached the stage when advice by itself would be all that the central bank would need in order to further the policies which it approves.

C. *Price Philosophies*

After all that the critical philosophies of central banking can do in making clear the difficulties associated with environment and technique, there still remains a problem of general economic importance which has to be frankly faced. Is it quite so certain as some people confidently assume that the price structure is directly dependent upon the volume of bank loans, and is it quite so clear as these same people imagine that the volume of bank loans is capable of direct control by manipulation of the rate of interest ? I raise these questions without the intention of answering them at this place, but it does seem to me that economists as a whole have taken these assumptions, which are implicit in the demands which have been made on central banks, much too much for granted. Here, as elsewhere in the field of central banking, what is wanted is critical investigation.

MEMORANDUM RELATING TO THE ORGANIZATION AND FUNCTIONS OF CENTRAL BANKS WITH SPECIAL REFERENCE TO THE PROPOSED RESERVE BANK OF AUSTRALIA¹

(1) The place which the Central Bank should take in the organization and functioning of the money market, and the relation of the Central Bank to other organizations and instrumentalities, are matters which have become much clearer in recent years. For this improvement in our state of knowledge reasons may easily be assigned. Broadly speaking, it was only in Europe as a whole, and particularly in the highly industrialized and, from the economic stand-point, older West European countries, that Central Banks existed before the war, and in some of these countries, e.g. Great Britain, France, Holland and Sweden, they had existed, in some cases for centuries, before the growth of that modern banking structure of which they are now logically the apex. Thus it was not surprising that the pre-war European Central Banks should possess some features not essential to the operations of such institutions from the standpoint of efficient functioning. The fact that it became necessary, after the war, to re-organize many of the European Central Banks (in other words, to rescue them from the consequences of the policies to which they had been constrained by governmental pressure) has brought with it a much clearer realization of what is, and what is not, desirable in the sphere of Central Banking.

(2) The process of classification has been much assisted by the growth of Central Banking institutions in the world outside Europe. Until the establishment of the Federal Reserve System in 1913, it was true to say that ultimate stability of the world's financial arrangements

¹ Addendum to the Report from the Select Committee on the Central Reserve Bank Bill to the Parliament of Australia, 1930.

rested upon two main pillars—the general adoption of the gold standard and the association of the money markets of the primary producing countries with Europe—and this, in the last resort, implied that the European Central Banks (and particularly the Bank of England) were the guardians of sound monetary conditions all over the world. This traditional suzerainty has now given way to a new state of affairs, in which responsibility for sound monetary conditions in the local area is being increasingly assumed by a local Central Bank. The war, which forced the re-organization of many European central banks, broke the traditional link between Europe and the rest of the world. In the reconstruction era a new type of relationship was built up; but the more general creation of Central Banks in North and South America, in South Africa, to some extent even the Far East, has again involved a deliberate adaptation of means to ends, with the consequence that the theory of Central Banking has become much more clearly articulated than ever before.

(3) Two consequences follow. First, whenever it is proposed to establish a new Central Bank, or to modify an existing one, less room is left for doubt and hesitation as to what form the institution should take, and with what powers it should be endowed. The wider the area over which Central Banks already exist, the less room there is for experiments and the less excuse for deviating from commonly accepted models. Secondly, the fact that existing Banks conform to a more or less common pattern, and function successfully only when that pattern is not departed from too widely, increases the certainty that the *de facto* scheme of Central Banking has scientific validity in the sense that the experiences which that scheme incorporates are of such general significance that to neglect them in the framing of new legislation is to heighten the chances of committing avoidable errors. Thus the events of the last decade confirm both the desirability of maintaining a Central Bank in Australia, and the expediency, in doing so, of being guided by the accumulated experience gained by other countries.

(4) The two primary functions of a Central Bank—functions so important as to swamp all other considerations—are to secure financial stability at home and parity of the local currency with the international gold standard. The concentration of the gold reserve in its hands, its monopoly of the note issue, its right to hold the deposits of the government and the clearing and reserve balances of the trading banks, its discount and investment powers, are not ends in themselves, but means by which these two great ends of any Central Bank are to be achieved. If a Central Bank is to satisfy the requirements imposed upon it in these respects, it must not be hampered, either by a constitution which prejudices its ability to act, or by being given tasks which either divert its energies or distort its policy. A Central Bank should not ask for powers wider than those necessary for the control of credit and exchange, and should not be content with less. All the elements of the Central Banking situation, ownership, note issue, discounts, investments, reserves, deposits, disposition of profits, should be judged from one standpoint, and one standpoint alone—how they impinge upon the Bank's ability to control credit and exchange conditions.

(5) In considering the establishment of a new Bank, or the modification of an existing one, the elements of the situation most likely to give rise to difficulties are the scope of its operations, the provision of capital, ownership and government, and the location, nature and amount of the reserve to be kept. As already insisted upon, a Central Bank must be given the right to discount and to make advances, but it becomes imperative to define within what limits its operations under these heads should be confined—

(a) It is axiomatic that there are certain kinds of lending operation which are not within the sphere of a Central Bank, such as direct loans upon the security of real property. But in newer countries where a highly organized money market does not exist, and where therefore short-term loans and investments of the most liquid

kind are not so easily obtainable as they are in the older and more advanced areas, the temptation to allow a Central Bank the right to participate in types of lending more liquid than loans upon land, and yet not as liquid as investments or advances upon short-dated bills, becomes very great, especially at times when public opinion is prejudiced against the commercial banks or when the supply of credit to would-be borrowers is limited. Demands then arise that the circle of customers should be widened: that the Bank should be allowed to do a commercial banking business and that the gap in the existing financial facilities should be filled by entrusting the Central Bank with some specialized task alien to its central purpose. Such demands are dangerous, since they may easily lead to a situation in which the Central Bank has assumed obligations to customers which it is morally incapable of suddenly cutting off, with the result that it may be as heavily involved in a credit situation as the other banks, and is thus unable to come to their assistance; in other words, it itself may be in an illiquid condition.

For this situation, education of the public, rather than over-elaborate legal prohibitions, is the appropriate remedy. A general understanding of the true functions of a Central Bank will prevent sectional demands for a widening of the activities of the Bank in a particular direction from becoming dangerous and will at the same time enable the Bank to assist the business and trading community generally in the only way which is not inimical to its proper functions, viz. through advances to the commercial banks, which they, in their turn, can pass on to their customers in the shape of increased credit facilities. It may be argued that the commercial banks will not be willing to make use of the facilities afforded by rediscounting at the Central Bank. Even in that case, if the Central Banks deem it in the general interest that credit conditions should be made easier, there are more efficacious, certainly less dangerous, methods by which the Central Bank can achieve its ends

than direct commercial operations. It can always buy securities in the open market. The funds so released find their way through the sellers into the commercial banks and finally increase the bankers' balances at the Central Bank. Thus it is not necessary, in order that credit may be made easier, for the Central Bank to engage in commercial banking operations, which may easily prove to be an embarrassment when credit conditions require curtailment. The danger, indeed, with Central Banking in all new countries is that the Central Bank should be looked upon simply as an engine by means of which cheap money is pumped into the economic mechanism. But the degree to which contraction may become necessary is proportionate to the degree of previous expansion. By refusing to expand credit too easily in a period of expansion, the Central Bank lightens the task of subsequent contraction. Whilst, therefore, it would be a mistake to tie the Central Bank down too rigidly by means of legislation, its executive should be supported by public opinion in any effort it makes in normal times to prevent its resources being so fully engaged as to limit its freedom of action and its power to exercise control.

(b) What has been said of commercial (and, *a fortiori*, of agricultural) loans, applies of course even more to loans to government and other administrative instrumentalities. Close and intimate relations between governments and Central Banks are a necessity for the easy working of the money market and of public finance alike. The Central Bank must assist the market in periods of maximum revenue collections; it must help the government in periods when its ways and means position reveals a normal deficit of income in the early part of the financial year. But to confer upon a government an unlimited power of borrowing, especially an unlimited power of borrowing by means of unsecured advances, and to confer upon the Central Bank the right to accede to these requests, is a policy which all experience reveals to be full of danger. Just because the Central Bank is

not an ordinary banker, and just because the government is not an ordinary borrower, some degree of control over the relations between the two is a necessity, in the interests of sound public finance and of sound banking conditions. The government should lean upon the Central Bank as little as possible, and one method by which undue dependence may be avoided is the building up of an active outside market in short-dated government securities, such as Treasury bills. If the Central Bank stands ready to take up these bills from holders at its published discount rate, no risk (other than a normal commercial one) is run by outside institutions holding these bills: the Central Bank is not constantly aiding government, and government is not encouraged to regard the Central Bank as a constant source of supply. It may be argued that in new countries a Treasury bill market does not exist. But one of the most important aids in building up such a market is some limitation upon the borrowing powers of government, or, alternatively, some limitation upon the lending powers of the Central Bank. To sum up, up to a point the right to borrow at the Central Bank helps not only the government, but also the money market (for it helps to stabilize the total volume of funds at all times employed in the market). But if borrowing is pushed to the point at which it threatens the liquidity of the Central Bank it becomes a major danger to be avoided at all costs. Some legislative check would, therefore, be in place to prevent the contingency from even arising.

(c) Whilst public opinion concerns itself mainly with the possibility of credit expansion, it remains the unpleasant truth that it is much easier to expand credit than to contract it. Looking at the Central Bank problem from the standpoint of a new and developing area, the question arises: how is it possible for the Central Bank in such an area, where an organized short-term money market does not exist, to contract credit? Expansion is popular and extremely easy; contraction is unpopular and technically difficult. Nevertheless the utility of a

Central Bank is ultimately to be measured, not by its ability to add to the credit stream in periods of expansion, but by its ability to contract credit when necessity demands it.

In so far as the local commercial banks borrow from the Central Bank, the appropriate instrument of control is the rate of interest which it charges. But the local trading banks may not be borrowing at all, or conduct their borrowing operations in another centre (London or New York). Under these circumstances the *direct* use of the discount rate is subject to limitations. But the Bank is not without other weapons at its command. The mere fact that it raises its rate is a danger signal to which, in the course of time, the local business and banking community can be trained to pay attention. It is still open to the Central Bank to sell long-dated securities and to throw upon the outside market the burden of financing the current needs of the government, thus absorbing part of the credit of the local banks and in turn forcing these to borrow from it. But in its attempt to secure control, the Central Bank will find that one of its most important weapons is the moral pressure it can bring to bear. To be able to bring moral pressure to bear, it must secure and retain the confidence and friendship of the local trading banks; so that it can stand to them in the relation of a constitutional monarch to his cabinet, armed, that is, with the right to advise and the right to warn, even if it does not possess the right to coerce. Thus to limit its trading operations may prove to be wise, not only because this abstention relieves it of immediate difficulties, but also because it increases the degree of co-operation between all sections of the market. And to be in a position to advise wisely, it must cultivate friendly and intimate relations with other Central Banks, which can bring to its aid intellectual as well as material assistance in times of stress. And thus the form of government of the Bank is important, not only as regards the business operations of the Bank in the narrower sense of the word, but also as aiding or hampering it in

its relations to other Central Banks—relations which are of much more than nominal importance in the modern world.

(6) In discussing the form of government of a Central Bank, the first point which necessarily arises is the ownership of the Bank. The present reaction against State-owned Central Banks finds its origin naturally in the difficulties to which Central Banks were exposed in the war and post-war period—difficulties to which most banks were subject, indeed, but which naturally are most acute when the State is the sole owner, because this means that the power of appointment is vested in political hands. That there exists in certain countries a strong political feeling in favour of State-owned Banks cannot be denied, but the strength of that feeling can be modified if the following points are borne in mind and brought prominently before the public :—

(a) The inherent danger that a State-owned Bank will, under political pressure, be made a mere instrumentality of unsound finance.

(b) The case for a government Bank is obviously weakest where there is a broad capital market, capable of providing all the initial capital required, and where there is a fund of banking and general business experience upon which the Bank can draw for its executive personnel. This applies without doubt to all the British Dominions.

The view that the Central Bank ought to be State-owned because of the right to issue and control the currency is deficient, in so far as it neglects to prove that the State ought not, in its own interests, to delegate these powers. Granted that the power to issue and control currency is a matter of prerogative, it is still open to question as to what is the best instrumentality for this purpose. The State has the power to determine what is the best instrumentality, but it does not in the least follow that a State Bank is the best instrumentality. Indeed, all experience goes in the contrary direction. The terms upon which the State ought to delegate its powers ought to be such as to allow the management

of credit conditions to be undertaken with the least danger of abuse. What those terms are can best be gathered from economic experience, and is a matter upon which political science can throw no light.

(c) The popularity of the principle of the State-owned Central Bank in certain quarters is due to the dislike of allowing private profits to be made out of the operations of Central Banks and to the desire to allow the State to draw such profits as are available. But it is not necessary to create a State Bank in order that private profiteering be made impossible or in order to secure that the State shall profit from Central Bank operations. Subscriptions to the capital of a Central Bank can be obtained at a rate of interest not appreciably greater, if indeed at all greater, than that which the State itself has to pay upon its loans. In other words, the dividends can safely be limited, and the State be given a share, even a growing share, in the profits of a privately-owned Central Bank, either by securing to the State the entire profits from the note issue (as in Great Britain) or by securing to it the whole of the residuary profits after payment of a fixed dividend and certain compulsory appropriations to reserve, as in the United States.

(d) Nor does the adoption of the principle of a "shareholders' bank" rule out altogether State participation in the ownership of the Central Bank; all that it does is to limit the participation to a minority interest in the enterprise. The principle that the Bank should be owned by shareholders is perfectly consistent with limiting the powers of interference of the shareholders; they are so limited in most of the great European Central Banks. It is not too much to say that Central Banks do not exist for the benefit of their shareholders, but that the shareholders exist for the benefit of the Central Banks. They are a necessity because they prevent the danger of the Bank being controlled by political interests; in other words, they are a guarantee of independence for the Bank's executive. That is their only justification which is conclusive.

It should be obvious that a wide range of experiment is possible between the two extremes of a Bank the whole of the capital of which is owned by the State, and a Bank, the whole of whose capital is owned by individuals or legal persons. The latter is the prevailing European type, as exemplified by the Central Banks of Austria, Belgium, France, Germany, Italy, Poland, Switzerland, Holland and Norway, and it finds its classical example in the case of the Bank of England. But intermediate types are also possible, such as Central Banks with limited classes of shareholders only, as, for instance, the Federal Reserve Banks of the United States, which are owned by the constituent member banks (i.e. trading banks) of the system, or Central Banks, such as those of Chile, Colombia, Greece (temporarily), Denmark and Czecho-Slovakia, owned in part by the State and in part by the shareholders. Thus the pure State Bank is very much the exception, and reason as well as experience is against the further extension of the principle.

(7) If the main reason for the existence of a class of shareholders legally owning the Central Bank is to preserve the independence of the Central Bank, the main positive function of the shareholders is to assist in the selection of the directorate. The principles on which the government of a Central Bank should be built up are three in number :

(i) The directorate of a Central Bank should be free from sectional pressure of all kinds. There is a great difference between appointing individuals because they have a large experience *in* a particular branch of economic activity, and appointing them *as representatives* of that particular body of experience.

(ii) The directorate of a Central Bank should be composed on the understanding of the fact that it is an executive, rather than a deliberative, assembly. The board of a Central Bank is not a "Parliament of Industry" but a Cabinet. There is therefore a real danger that if diversification of point of view is the point chiefly aimed at, the result will be to diminish the efficiency of the board. Decisions must be arrived at, and for that, something

like agreement upon general principles is absolutely essential. The safeguard against erroneous action lies, not in over diversification of the personnel of the board, but in choosing the proper electoral constituency and in a clear grasp of the essential functions of a Central Bank.

(iii) The directorate of a Central Bank should be appointed for a sufficiently long period of office to prevent their actions from being biased by fears of what will happen if their views do not happen to be immediately popular. Not only should they hold office for a sufficiently long period of time ; the terms of their appointment should be such as to make their removal from office difficult, otherwise the security afforded by a nominally long period of office is illusory.

(8) The application of these general principles does not necessarily imply any one single rigid method of selection. As in the case of membership, a large number of alternative solutions are possible between the two extremes of appointment purely by the State and appointment by the shareholders without any, or at most slight, constitutional limitations upon their powers. Thus it is possible to allow appointment or selection by shareholders on the basis of definite constitutional limitations, and/or subject to the ultimate approval of government. Examples of this method of solving the problem are to be found in the Central Banks of South Africa and Japan and the Federal Reserve Board of the United States. Or it is possible to confer upon the shareholders the right to appoint a majority of the directors, but to give to the State a right to appoint a minority.

(9) In practice the shareholders of Central Banks do not participate actively in the choice of the board, in the sense that the merits of rival candidates are canvassed and discussed at a general meeting of the shareholders. In practice, the rôle of the shareholders is to confirm appointments, not to select appointees. Thus selection by shareholders is largely equivalent to co-option, subject to a veto by the electoral body. The case of the Bank of England shows how admirably this system can be

made to work ; in the sense of bringing to the Bank Board a wide range of talent and experience, freed from all suspicion of political influence, but expressive of the changing phases of economic opinion and practice. The charge that a "purely commercial board" will confine its recommendations to the shareholders to a narrow circle of wealthy mediocrities cannot be sustained in the light of British experience. In any case, the fear that the Board may be composed of unsuitable persons leads at most to a right of veto on the part of the State, not to the right of direct appointment by it. For direct appointment by the State carries with it even greater dangers than those which it avoids, especially when the majority or the whole of the board is appointed in this way.

Due allowance must of course be made for the fact that local circumstances are not always the same. The demand that the State should appoint is based upon the fear of undue conservatism and narrow-mindedness in the commercial community, and the apprehension that there does not exist among the individuals likely to be chosen the range of experience requisite for the directorate of a Central Bank. Where such fears prevail, still more where there is some justification for those fears, the appropriate remedy is not necessarily State appointment, but, at most, an admixture of State appointees coupled with the right of veto and the framing of careful provisions as to the areas of knowledge and experience from which individuals are to be selected. But, as already pointed out, a directorate is an executive, not a deliberative assembly ; and an executive body of lower average intelligence and experience may work better if its members are homogeneous than a more brilliant body of individuals connected by no common point of view. Thus in framing the constitution of a new Bank even for a "new" country, the presumption is in favour of liberty of choice by the shareholders, rather than of selection through political channels, more especially in countries in which party feeling runs strongly.

(10) The last of the general issues which requires discussion is the regulation of the Reserve. In recent Central Bank legislation four tendencies are apparent, viz. :—

(i) The minimum reserve ratio is fixed in the neighbourhood of 35 per cent or 40 per cent of the liabilities to be protected.

(ii) For the purpose of fixing the amount of reserve required to be kept, liabilities upon deposit account and upon account of note issues are assimilated.

(iii) The Bank is given power to hold all, or some of the reserve, not in the shape of gold in vault, or gold earmarked on its account in some other country, but in the shape of foreign exchange assets of divers kinds, provided that these assets are payable in gold on demand or at maturity.

(iv) The Bank is freed from the obligation to encash its notes, except in large amounts, and this not in gold coin, but in gold bar and/or stable foreign exchange, at its option.

These tendencies, representing a growing degree of uniformity in the reserve regulations of modern Central Banks, are primarily the result of the growing recognition that the function of the reserve is no longer to safeguard the Bank against insolvency in the event of internal panic, but to protect the Bank in its task of maintaining the international parity value of all its obligations, whether these take the form of note or deposit liabilities. They are also in part a recognition of the circumstances that the pre-war gold standard—involving the domestic circulation of gold coin and the holding of large masses of gold physically in the vaults of the Bank—was extremely wasteful, not only from the minor standpoint of profit-earnings, but from the much more important standpoint of conserving the world's supply of monetary gold. Gold economy, which in the pre-war days of rising prices, might have been neglected with impunity, has now become a problem of grave importance; and the possibility of replacing holdings of physical gold by holdings

of gold assets in some form is a contribution of the first magnitude towards the solution of the problem. Indeed, there is every reason to suppose that the *de facto* position is lagging behind what is desirable in respect to gold holdings. The actual minima of 35 to 40 per cent are high, and the amounts actually kept are higher still; whilst of recent years a distressing tendency to convert foreign exchange holdings into actual gold holdings has been manifest in some quarters. Whilst it is impossible to conceive the problem of the price level being solved without international co-operation, an element making that co-operation possible is the removal from actual Central Bank regulations, and the non-incorporation into new Central Bank regulations, of high minimum reserve requirements, and particularly of requirements which hamper in any way the replacement of physical gold assets by foreign exchange assets, whether such requirements take the form of demanding a certain minimum holding of actual gold or the form of defining the location of reserves in such manner as indirectly to limit the amount of foreign exchange assets which may be held.

(11) In the decades which lie before us the importance of co-operation among the Central Banks of the world—the need for which was first emphasized by the Genoa Conference of 1922—cannot be overstressed. It is not only that, as already suggested, each Central Bank is interested in having assistance from others in the control of its own local money market, and that all Central Banks are interested in the maintenance of sound credit conditions over the whole of the commercial world. The world is confronted by a price problem of enormous magnitude, failure to solve which may involve social and economic catastrophe. Under these conditions, an intimate understanding between the Central Banks is not a matter of academic interest alone, but an absolute necessity for orderly economic progress. The degrees of intimacy and personal understanding which will be necessary if the world credit machine is to function adequately require careful cultivation; and amongst the chief aids

to their cultivation is a reasonably common form of constitution. It must be obvious that, unless Central Banks, themselves independent of political control, can be certain that other Central Banks can carry out decisions, commonly arrived at, in an atmosphere free from political pressures and interferences, co-operation between them will be made more difficult, with serious consequences to the world as a whole, and particularly to countries interested in primary production.

(12) If the considerations so far adduced are applied to the constitution of the proposed Central Reserve Bank of Australia, as embodied in the Bill now under consideration of the Senate, it will at once appear that that constitution is defective in certain essential respects—

(i) The principle of State ownership is adopted in its entirety, notwithstanding the fact that it is proposed simultaneously with the creation of the new Reserve Bank to convert the existing Commonwealth Bank into a trading bank, which is also to remain a pure State Bank, in the sense that its government is to be in the hands of officers subject to government appointment, and working in the first instance with funds which are government funds. Since Section 7 of the Commonwealth Bank Act gives the trading bank practically unlimited banking and borrowing powers, and since Section 9 (g) of the Central Reserve Bank Bill 1930 specifically exempts loans or advances "to any corporation carrying on the business of banking" from the general prohibitions against unsecured loans, it is clear that a dangerous situation may easily arise from the financial relations between the two State enterprises, the State in its capacity of trading banker bringing pressure to bear upon the State in its capacity of Central Banker which it could not have brought upon a private corporation. Whilst the principle of a pure State Central Bank is in all cases open to objection, it is obviously still more open to question under the circumstances outlined above.

(ii) In any case the composition of the proposed board carries the subordination of the business of the

Bank to State direction to what must be regarded as an extreme point. Out of the nine persons who are to compose the board no less than four are to be servants of the State, viz.—the Governor, the two Deputy Governors and the Secretary of the Treasury. This, it is true, leaves a bare majority of one against what might be called the official element on the board, but in practice it is clear that much of the business of the Bank will be done by the executive committee envisaged by Section 23 (5) of the Bill; and since the executive committee may consist of as few as three persons, of whom two may be official members (23 (6)), it is clear that the official members will have a voice out of all proportion to their numbers, for there is no limitation in the Bill as to the “powers and duties” which may be delegated by the board to the executive committee (23 (8)).

(iii) With so large an official element on the board, the question of safeguarding their independence of action becomes one of the utmost importance. Two of the official members are to be Deputy Governors of the Bank, to be directly appointed by the Governor-General, it is true, but necessarily in a subordinate position vis-à-vis that of the Governor, as is indeed recognized by the Bill (in Section 15 (3)), which obliges a Deputy Governor “to perform such duties as the Governor directs”. Whilst these officials are from the nature of their official position not likely in any case to act in a direction contrary to the views of their official superior, they and the Governor himself are liable to moral pressure of a most objectionable kind owing to the insecurity of their tenure of office. Though these officials are appointed in the first instance “for a period not exceeding seven years”, they, and all the other directors, in virtue of Section 16 of the Bill “shall hold office only during good behaviour”. What the intent of this clause is is nowhere made clear, but if it is intended to confer upon government a discretionary power to remove members of the board more or less at will, it is obvious that action inconsistent with the wishes of the Government of the day is virtually excluded,

however desirable that action may be in the interests of the country.

(iv) In view of the fact that the Secretary to the Treasury is an official member of the board (subject therefore in any case to a divided allegiance) the borrowing powers of the State appear unduly wide and indeed dangerous to the stability of the Bank. Every government requires the right to borrow on ways and means or against Treasury Bills for short periods of time, but some provision should exist by which the loans, if uncovered, should be covered by securities which the Bank can dispose of in the market at need. In addition to the general powers conferred by Section 8(c) to deal in Commonwealth and State securities and the power to make loans and advances against the stock or debentures of the Commonwealth, State and subsidiary authorities conferred by Section 8(b), the Bank is empowered by Section 9 of the Bill to give unsecured advances without limit of time or amount, not only to the Commonwealth, or a State, but also "to any authority constituted under the law of the Commonwealth or of any State". This is surely carrying liberality to the extreme, especially when the very narrow non-official majority on the board is taken into consideration.

(v) The remaining points to which attention should be directed are the reserve regulations. The bank contemplates a minimum reserve ratio of 25 per cent against notes, a minimum of 25 per cent on the first £20,000,000 of deposits, and a reserve of 50 per cent on deposits exceeding £20,000,000. Of this reserve, 50 per cent, but not more, may be held in London, either in gold coin or bullion, British Government Securities and Trade Bills with a maturity of not more than 120 days. The remainder must be held in Australia entirely in gold coin and bullion (Section 50 (1) and (3)—(5)).

The reserve position is thus as follows. Let N=notes outstanding, D=deposits not exceeding £20,000,000 and D'. aggregate deposits. Then the required reserve will be

$$R = \frac{1}{4}N + \frac{1}{4}D + \frac{1}{2}(D' - D),$$

and the minimum amount of gold required will be half this amount, whatever that amount is. The net result of this regulation may be stated as follows :—The reserve position will vary, not only with the growth of the liabilities, but with the form which the growth in the liabilities takes. If the growth in the liabilities takes the form of additional deposits, the *absolute* amount of reserve required will grow faster than the growth in the liabilities as a whole ; if the growth in the liabilities takes the form of additional notes, the absolute amount of reserve required will grow no faster ; if both notes and deposits, the result will depend on the relative movement in the notes and the deposits. These varying consequences can hardly be regarded as satisfactory. Even if the notes and the deposits were assimilated, a sliding scale reserve against both (on the assumption that 25 per cent were held against the first £40,000,000 and 50 per cent against the remainder) would raise the minimum reserve *ratio* nearer to 50 per cent, the greater the ratio of the excess liabilities is to the total liabilities ; although the minimum reserve, under the circumstances, would never reach 50 per cent. It must be obvious that the regulations actually contemplated are extremely defective. All that is required is that, as the liabilities increase, the *aggregate reserve* should increase, not that the *reserve ratio* should increase ; still less that the reserve ratio should increase differently according as the increase in the liabilities takes the form of notes or of deposits. The danger of a drain of gold abroad does not necessarily grow faster than the growth of liabilities generally, and the main function of a reserve in these days is to safeguard the exchange position. The amount of reserve required varies with changes of circumstances, and it should be the duty of the board of the Bank to see that the reserve is adequate to meet the exigencies of the situation.

A further objectionable feature is the limitation of the amount of interest earning reserve to 50 per cent of the total, and the location of the physical portion of the reserve in Australia. If it is intended thereby to secure

the encashment of Australian notes in *gold coin*, it conflicts with the spirit of the remaining reserve provisions, which, by fixing a higher ratio against deposits than against notes, regards the former as the more sensitive form of liability. But, in fact, all that is necessary is that notes and deposits alike should be encashable either in foreign exchange (i.e. Drafts or T/Transfers on London) or in gold bar. If this is accepted as a rational solution of the problem of securing convertibility, no gold need be held in vault at all ; still less need a purely mechanical division be made between gold held in Australia and earning assets held in London. If gold is wanted at all, it will be wanted in London and not in Australia ; unless, indeed, an utterly wasteful use of gold is to be encouraged. Since Australia is profoundly interested in the future of world prices, she should not adopt a form of Central reserve and currency regulation which is antiquated in conception and inimical to her own interests, as well as to those of the world as a whole.

INTERNATIONAL TRADE

THE FUTURE OF INTERNATIONAL TRADE¹

I

POPULAR discussion of the place of international trade in the economic life of the world shows a marked tendency to oscillate between two extremes of argument. Enthusiasm for measures of tariff protection leads to the advocacy of the view that it is justifiable to risk a reduction in the existing volume of international trade because the "home market is so much more important than the foreign market"; the fact that without the existing volume of foreign trade the home market might be very much smaller is therefore ignored. On the other hand, those who see the dangers involved in increasing the difficulties of the export industries often fall back upon a line of argument which implies that without foreign trade a nation cannot "survive"; a line of argument which ignores the fact that, without a home market of a certain size, the volume of foreign trade would be less than it is. Popular discussion, in other words (and in this direction it echoes certain schools of economic thought), fails to appreciate the fact that "nations" are political and not economic entities, and that the proportion of exchanging which goes on across national frontier lines cannot be dissociated from the mass of economic activities with which it is organically connected. The object of international trade, as of all trade, is to increase the sum total of material welfare, and an increase of welfare is perfectly consistent both with an increase and with a decrease of "foreign" trade, according to the circumstances of time and place. A shift of demand, for instance, from an increased consumption of foodstuffs to an increased consumption of services may lead to a net loss in the volume of foreign trade; a shift in the reverse direction might increase the volume of international

¹ Reprinted from *The Fortnightly Review*, November 1931.

trade: but both movements are consistent with an improvement in the material well-being of the average man. Apart, altogether, from the misleading inferences drawn thus from nominal changes in the volume of foreign trade, due to an increase or decrease in the aggregate length of the frontier lines of the world which may accompany changes of sovereignty, the significance of changes in the volume of world trade is by no means easy to establish. So long as the general position has not altered markedly, rapid changes in the volume of international trade, as compared with changes in other indices, enable valid inferences to be drawn, but the general position may alter. It is the contention of this article that the general situation likely to develop in the course of the next half century will differ markedly from that obtaining in the nineteenth century: a point of great importance when it is realized how coloured our thinking still is by what occurred during that hundred years of revolutionary change.

II

The events of the nineteenth century in the sphere of international trade constitute a gigantic justification of the fundamental dogmas of the Free Trade School; for measured against the vast background of world-colonization, of population expansion, and of technological change, the place of the tariff, as an agency of acceleration of economic change, is clearly seen to be but a very modest one. International as well as intra-national trade grew because its growth was inseparably and inextricably associated with general world conditions making for economic progress. Five elements account for the general direction of change, but throughout they acted and reacted upon one another and in common dominated the expansion of international trade.

The first of these elements was the growth of technique, including, in particular, improvements in the technique of transportation, which enabled the interior lands of America, Canada, and Australia to be settled and their

staple products to be brought upon the world market in exchange for the staple goods which industrial progress was constantly cheapening in price.

The second factor was the use of steam power, and then of oil fuel. Steam power gave Great Britain in particular, and world trade in general, a balancing factor in the shipping freight market, enabling the heavy inward cargoes of raw materials to be more easily compensated than would have been the case otherwise, and thus reducing the cost of all goods carried internationally.

The third element was provided by the unequal distribution of financial resources, which involved the necessity of international capital movements and then of interest payments. The most convenient manner for new areas to absorb capital is in the shape of constructional goods; the most convenient way in which such areas can pay interest is in the shape of exports of their local produce—and the general situation was such as to enable these movements of goods to take place.

Fourthly, for a considerable part of the nineteenth century, there was a progressive improvement in freedom of communication, i.e., consolidation of areas permitting of the untrammelled passage of goods—Germany, Italy, Austria are cases in point—whilst at the same time the general level of customs rates remained low, because, in the period of bourgeois ascendancy in politics, Free Trade as a creed was popular. Even when the tariff reaction came in the 'eighties and 'nineties as part of the contemporary solution of the problem of a falling price level, the absolute level of the rates imposed was not so great as to prevent constant improvements in industrial technique reducing their real significance; whilst the fairly general acceptance of a broad interpretation of the most favoured nation clause reduced their importance still more.

Lastly, and most important of all, the world was being peopled, and the constant growth of population, together with a rising standard of life, provided a seemingly inexhaustible market for raw materials in the manufacturing

areas and for manufactures in the "overseas" areas. This ultimate factor was so important as to swamp the effects of other factors in the long run altogether. The relative rates of growth of particular industrial nations might diverge from one another ; and particular industries might suffer from the rise of competing industries aided by subsidies and protective tariffs. The fact remained that, so long as population as a whole grew and with it standards of life, there was no overwhelming pressure on any of the constituent parts of the world economic system. Among the best customers of each industrial nation were the other industrial nations, and all of them together progressed as the raw material areas grew in population and in wealth. This equilibrium position was destroyed by the war, and the question of the future is how far the conditions which made it possible have *permanently* disappeared.

III

One effect which the war has had has been an increase in the number of sovereign states in the world, especially in Europe. With this growth in the number of separate states has gone a growth, therefore, in the number of separate recording agencies. Part of any increase in world trade, therefore, which has taken place in recent years is a purely nominal increase, due to the circumstance that what was formerly domestic trade, and hence not recorded, has become international trade between inhabitants of different trading areas, subject to statistical record and to customs duties. Whilst, between 1913 and 1928, the growth of world trade was practically almost as great as the growth in the production of foodstuffs and raw materials (about 25 per cent in both cases), and, therefore, whilst the nominal expansion of international trade was at a rate much greater than that of population increase, there are factors in the situation which prevent any over-optimistic interpretation of the trend of events.

Had the peace been accompanied by universal free trade, there would have been no effect at all upon the *real* volume of trade (as distinct from statistical changes), but for the extent to which the productive machine had become less efficient and the nature of demand had altered, making imports (and therefore exports) less necessary. In fact, however, since the war national frontiers have increasingly tended to become economic frontiers as well, and other economic changes have also intervened, militating against a growth in the volume of foreign trade, either directly or indirectly. Apart from tariff changes, to be discussed separately below, four such factors require discussion.

To begin with, in certain countries, social changes have taken place which have reduced the capacity for export for the time being. The break-up of the great estates in South-Eastern Europe has made their agrarian economies less efficient producers of wheat; Russian Communism, which has reduced the foreign trade of that country with a population of 160,000,000 to the level of that of Switzerland, the unsettled conditions of China, are both instances in point. Some of these conditions, however, are not necessarily permanent.

Secondly, there has been a marked shift in recent years in the real ratio of interchange between raw materials and manufactured articles, so that the physical volume of the latter, which has to be exported in order to obtain a given quantity of the former, has largely diminished. This shift in the ratio means that it is becoming easier for manufacturing countries to provide themselves with the food and raw materials they require, but, until the problem of labour transfer has been solved, the result is increased unemployment in their exporting industries. From the standpoint of the agricultural states, this shift implies that, in so far as costs have not adjusted themselves, importation is less easy than it was. The shift in the real ratio of interchange is, therefore, one of the most potent factors making towards the industrialization of such areas.

Thirdly, there has been a growth of feeling everywhere since the war against the dominance of the agrarian and raw material producing states by the industrial; a reluctance, as it is put by the advocates of industrialization in India and Australia and elsewhere, to continue to be "hewers of wood and drawers of water" for the more advanced industrial nations. This reluctance is, at bottom, purely irrational; since concentration upon mining and agriculture by no means necessarily implies inferior economic strength. But in so far as it reflects the shift in the ratio of real exchange alluded to above, or in so far as it voices the inherent social desirability of diversification of the economic life of a country, the demand for industrialization is comprehensible on rational grounds, and is likely to be an element of increasing importance in the future.

Lastly, there has been since the war a considerable growth of the feeling that certain industries are indispensable to a country on the ground of national safety. The argument that "defence is greater than opulence" is one that cannot be disproved on economic grounds, but in the modern world there is only too much reason to suppose that it is often exploited for economic purposes. But, whatever the possibilities of abuse involved, it is not likely that the policy to which the principle of national safety leads will be easily abandoned.

IV

The most striking practical manifestation of the temper of the age in the sphere of international trade is the growth of tariff walls. Attempts have recently been made, e.g., by the Economic Section of the League of Nations, to measure the objective burden of tariff rates, but, even if such attempts were more satisfactory technically than they actually are, it would be impossible to disentangle the effects of tariff changes upon the volume of international trade in general from the effects produced by other causes operating at the same time. There can be no question, however, that this tendency of prices to

fall sharply in recent years has accentuated the deterrent effect of duties levied not directly on the value of a commodity, but on some physical attribute possessed by the commodity, even if the rate has not changed. In fact, the tendency of rates has been upward, so that the pressure of the tariff has been cumulative.

In any case, the height of the tariff wall is not the sole criterion to be taken account of when the burden of protection is being estimated, since administrative devices, prohibitions, and restrictions of various kinds may in practice greatly add to the check upon foreign trade, though they do not increase the burden of the tariff-rate. All in all, it is hardly open to question that the tendency to stifle the growth of international trade by government action of one kind or another has greatly increased in recent years; though there may be some exaggeration in the *current* complaints about the effect of tariffs. A period of bad trade and business depression invariably increases the demand for protection and accentuates the deterrent effect of existing tariff schedules. If and when world trade recovers, some mitigation in the intensity of the tariff propaganda is to be expected; at the least, a more critical investigation of claims for protection from particular industries and interests. At the same time, it would be folly to suppose that the deeper-lying causes to which the protectionist movement owes its strength are likely to disappear in the near future. Profound technical changes are at work which make it likely that a greater degree of self-sufficiency, and therefore a relative decline in international trade, will be characteristic of the world in the future than was the case in the era which ended with the war, and tariffs are likely to be used to accelerate the changes, social and economic, bound up with the technological situation.

V

The *first* factor which is likely to diminish the volume of international trade, relatively to total economic activity, if not absolutely, is the increasing importance of services

and other "sheltered" occupations which cannot be imported. It is true that, if migration were as free as it was in the nineteenth century, a slackening in the rate of demand for concrete goods might simply mean an inflow of persons rendering services. But migration is now less free than it has been since the beginnings of modern industrialism; for example, an increase in the demand in the United States for domestic service does not result in a free flow of German or Swedish immigration, and so does not, through an increase of population in America, indirectly stimulate the growth of international trade, even in the shape of shipping services. The increasing margin over necessities which is characteristic of progressive societies means that the growth of international trade in staple foods and raw materials will lag behind the growth of well-being generally, in so far as this free margin is devoted to expenditure upon services.

A second factor, again, is the slackening of population growth and, therefore, of the rate of increase in the demand for the crude foodstuffs and raw materials, which formed so striking an element in the international trade of the last century. But the factor of population change merges with a third element—technological changes in agriculture of a very far-reaching kind. The large-scale farming experiments of the Soviet Republic and of the Western States of the American Union make it appear probable that the wheat farm of the future will extend over areas much greater than those formerly considered normal. As a consequence of the "factory farm", thousands of farmers will be driven off their present holdings and alternative sources of occupation must be found for them. In the food-producing countries the trend will therefore be to manufacture locally much that used to be imported—if necessary under the stimulus of high tariff walls. Otherwise there will be grave local *agrarian* unemployment and consequently grave political instability. The agricultural revolution is therefore likely profoundly to modify the trade of the world, not only in agricultural staples, but in staples altogether.

In the older and more industrialized countries which still retain an important agricultural base, e.g., Germany and France, the progress of agricultural technology implies an increasing possibility of self-sustenance, without importation in normal years. The agricultural countries must turn to industry to absorb their surplus farming population, but in the industrial states the necessity for food imports will also decline as local wheat production undergoes a process of mechanization. It is true that it is by no means so easy to effect a revolution in methods under a régime of peasant ownership as it is either under Russian Communism, or under agrarian capitalism of the American or Australian type. But the inference seems warranted that, given the stationariness of population on the one hand, and great agricultural improvements on the other, the exchange of cruder food and raw material supplies for crude manufactures will no longer play the same part in the future as it once did. The *volume* of foreign trade seems on these grounds likely to decline, relatively, if not absolutely; but perhaps absolutely as well.

Much the same result may be anticipated from the march of scientific discovery in other fields. The international trade in oil has taken the place of international trade in coal; but if the efforts now being made to perfect a commercially possible process of oil extraction from coal come to successful fruition, international trade in oil from Asia or America to Europe will cease to expand, and will decline, so far as countries rich in coal of a suitable kind are concerned. Artificial silk limits the possibilities of international trade in raw cotton as well as in cotton goods. In some cases, of course, a new invention or discovery merely changes the *character*, but not the *volume*, of international trade; but where a new product can be manufactured successfully in any industrialized area out of local materials, not only the nature but the magnitude of world trade may be unfavourably affected.

VI

If these tendencies work themselves out uninterruptedly, the international trade of the world may come to possess a significance other than that to which we are accustomed. Climatic conditions will always ensure that inter-regional trade will remain of great importance, and the growth of wealth may add to that importance—witness, for instance, the growing importations of South African fruits. Nor are the arguments for international trade based upon the possession by particular areas of specialized kinds of skill or experience at all weakened by what has been said. Even the absolute scale upon which international trade in wheat and other staple foods and raw materials is conducted will, in all probability, remain a vast one. But the element of growth, if there is to be an element of growth at all, will be provided more by the luxuries, less by the necessities of existence; for it is the luxuries, rather than the necessities of life, which must be depended upon to absorb the labour freed by scientific discoveries and technological change. In the early days of international trade it was the luxuries which were exchanged, since these alone combined small bulk with high value, and could thus break the high costs of carriage involved. The problem to-day is no longer the high cost of carriage, but the increasing degree to which science is making the whole world independent of local circumstances in the production of necessities, coupled with an increasing determination on the part of the agricultural peoples to emancipate themselves from the dominance of the advanced, industrialized states.

COMMON SENSE AND THE BALANCE OF TRADE¹

EVER since the fall of the Labour Government and the collapse of the gold standard the concept of the balance of trade has dominated our political thinking, governed our economic policy, and served only too frequently as a convenient substitute for thought, even in the highest quarters. The general revival of anxiety about the position of the balance of trade is, indeed, a most remarkable phenomenon, for English political economy may be said to have arisen as a protest against the exaggerated importance given to the balance in the economic and political philosophy of the mercantilists. I am concerned to show in this article that there is a problem, and a very serious one, confronting the nation, but that to discuss that problem in terms of the balance of trade is merely confusing and misleading.

To anyone who believes that even a national crisis does not justify the sacrifice of clear thinking there is something almost appalling in the way in which the use of mercantilist concepts and ideas is resulting in a general misunderstanding of what our true problem is. Public opinion is being taught to concentrate upon devices by which the balance can be "made" to balance: the real point lies, however, elsewhere. Economic forces are always in a position to bring about, and do in fact bring about, an adjustment of the balance, but economic forces cannot enable us to contract out of the general consequences of the fall in the standard of life which will inevitably accompany the decline in the national income which is threatened by the international world situation. The problem facing us is usually put thus: What shall we do if the balance of trade proves, as suspected, to be adverse to the extent of £100,000,000? The real problem, it

¹ Reprinted from *The Manchester Guardian Commercial*, January 1932.

appears to me, is this : What shall we do if the national income falls through the elimination for some time to come of that portion of the national income which is derived from foreign investments and from the rendering of international financial and shipping services ?

It has long been a commonplace among economists that the excess of imports over exports (in the case of Great Britain) and exports over imports (as in the case of Germany)—in other words, the visible balance of trade—throws no light whatever upon the general economic position of a country. Before inferences could be drawn this excess had itself to be explained. Unfortunately, in the effort to do so, the economist invented, at a very early stage, the concept of the "Balance of Payments", and by giving the balance of payments a statistical formulation the subject has tended to become even more confused than it was before. The tendency has become confirmed to take the excess of imports for granted : to total up the amount representing earnings from shipping and financial services and interest upon foreign investments and to regard the difference between the sum of these "invisible" items and the excess of imports, if positive, as the "amount available for new foreign investment" during the period of time covered by the computation : with the result that if in any period of time the sum available for new investment fell short of the amount of new capital issues offered for overseas countries in the London money market a further series of attempted explanations were forthcoming, explaining, or attempting to explain, the discrepancy.

Instead of explaining the movement of imports and exports as the resultant of the way in which the inhabitants of a particular country chose to specialize their labours, spend their income, and invest their savings, on the one hand, and the way in which inhabitants of the rest of the world chose to specialize their labour, spend their income, and invest their savings, the excess of imports was taken as something given, which would somehow or other persist even if other elements in the

situation were to change. Instead of the balance of trade being explained in terms of the balance of payments, the balance of payments was explained in terms of the balance of trade. This is responsible, among other things, for the curious view that the amount of capital which can be effectively exported during a given period of time is "determined" by the "excess of the credit over the debit items" in the balance of payments, a view which overlooks the fact that if the amount of capital exported were different from what it actually is, all the items, including the excess of imports over exports, would in all probability have been different.

The same assumption that the balance of trade, or the visible excess of imports, was something given, not organically related to the whole of the circumstances of economic life, underlies much of the current anxiety as to the position of the British balance. It is assumed that, somehow or other, we shall continue to import a volume of goods so great that it will be in excess of our ability to pay the bill. This, or something like this, is in the minds of many who speak of the balance becoming adverse to the extent of £100,000,000—they believe that there will be a bill of £100,000,000 to meet, for which the necessary funds will not be forthcoming "unless something is done to stop the imports". They have never asked themselves if what they fear is really possible.

If one takes an area without an independent currency system of its own it becomes easier to see what the underlying principles really are. Suppose one takes an area like Bournemouth, which must undoubtedly possess an "adverse balance" of imports. If there is such an excess of visible imports into Bournemouth, no one thinks that this is in itself such a remarkable phenomenon as to require an elaborate explanation of how the excess came to be paid for. If anyone ever bothered to give an explanation he would say that the excess importation of bricks and cement and motor cars and laundry machinery and electrical fittings was due to the activity of capitalists

moving into a promising field of investment; that this excess importation of food and clothing and other direct objects of consumption was due to the presence of a large resident population of rentiers and pensioners and the people who supplied them with services, and that, in addition, there were thousands of visitors annually who consumed goods as well as fresh air.

Nor would anyone have the slightest difficulty in understanding why in some particular year the supply of such goods, luxuries and necessaries alike, imported into Bournemouth should fall off. If he had any difficulty in finding an answer all he would have to do is to ask the local shopkeepers. They would explain that, owing to the Stock Exchange depression and the absence of dividends, local rentiers were economizing; that, owing to unemployment in South Wales, "people were staying away this year"; and so forth and so on—matters so familiar that they appear no explanation at all. At any rate, no one would be in the least surprised if, under these circumstances, Bournemouth's "adverse balance" were to diminish; nor would anyone ever ask how Bournemouth, by taking elaborate precautions, could prevent itself having an adverse balance. Sir Henry Page Croft's constituents (who are, of course, inhabitants of Bournemouth) may lie awake of nights worrying about the position of Great Britain, but they would, without doubt, be capable of explaining changes in the local balance of trade in a simple and perfectly satisfactory fashion.

What differentiates the position of a country *vis-à-vis* the rest of the world from that of a single town or district inside a "country"? It is certainly not the fact that a larger part of the income of a country is necessarily more "autonomously" derived than the income of particular sub-divisions comprehended within it. The dependence of the population of Great Britain on external sources of income, taking the country as a whole, is probably very much greater than the dependence of the inhabitants—e.g. of some remote Welsh or English agricultural

counties—on external sources of income. The real difference between the position of a country and that of its sub-divisions is constituted by the fact that the "country" has an independent unit of currency and an independent banking and monetary system, which is imposed upon the sub-divisions, and is uniform for all the sub-divisions. This, and not the greater or smaller proportion of the income drawn from without the territorial limits differentiates the position of a state from the position of its sub-divisions.

The consequences which flow from this fact are very important. The existence of independent sovereignties in the sphere of money and banking permits of the imposition of methods of adjustment so nicely calculated to bring about equilibrium after changes in the relative efficiencies of production in different areas, or changes in the way in which inhabitants of different areas choose to spend their incomes, that one is tempted altogether to overlook the most drastic method of adjustment of all—a total loss of spending power.

The manner in which monetary manipulation brings about an adjustment of the balance of payments is, of course, very well known. In the case of a country not upon the gold standard the expenditure of currently accruing income upon goods and services payable in terms of another currency, at a rate faster than inhabitants of other currency areas are demanding goods and services payable in terms of the local currency, leads to a fall in the rate of exchange sufficiently great to enforce economy in the consumption of such foreign goods and services, on the one hand, and sufficiently great also to encourage a further consumption of such local goods and services by inhabitants of other areas, on the other. In the case of a country upon the gold standard, the possibility of a varying rate of exchange being absent, adjustments are brought about by the deliberate enforcement of loss of income, until that loss of income, and the lowering of prices to which it leads, again cuts off a portion of the demand for foreign goods and services

and also encourages an increased demand for locally produced goods and services by foreigners.

Analogies to such methods of adjustment are not entirely absent within the limits of a given currency system: inside the limits of a single country the method of adjustment consists in the local variation of prices and in a more cautious extension of bank credit. If, e.g., a local watering-place is charging too high prices in a period of boom, the method by which the boom is brought to an end is that people stay away and the amount of local banking accommodation is cut down. Cutting down local loans to builders, etc., stops the further development of local enterprise, and the fact that people stay away brings down local prices to a parity with the rest of the community. In the case of an effective international gold standard, the rate of exchange does not vary, but marginal adjustments of prices and incomes are brought about and the local balance of trade adjusts itself to these changes. No one has ever been heard to worry about such a district continuing to import "because of the inelastic nature" of the local demand for all sorts and kinds of goods: if the prices charged locally are too high and there is no demand for its products, supplies will very soon dry up.

The body of economic doctrine devoted to the question of the balance of payments and the method by which equilibrium is brought about has been concentrated almost exclusively on the monetary aspects of the problem: the consequences to a country of a decline in the resources from which it, in the final analysis, derived its ability to purchase anything whatever have been not unnaturally overlooked, since the wealth and national income of most European countries was expanding rapidly during the period when the dominant body of economic theory was being built up. But the situation to-day has changed: and the progress of the international depression is bringing us face to face with a real crisis, of much deeper import than the problem of adjusting the balance of payments with which it is superficially associated.

The danger which is confronting us is not that we shall be unable to "balance" our balance of payments, for whatever difficulties there might have been in bringing about a speedy adjustment before we departed from the gold standard have been removed by our adoption of paper. The real danger is that our standards of consumption have been built up upon the possession of a large annual surplus income derived from the ownership of securities and the rendering of financial and shipping services. The international depression now seriously threatens the continuance of this "surplus" income: surplus, of course, only in the sense that it is over and above what is produced in the country for current consumption during a given period of time. A failure of this income in the future would inevitably involve a considerable fall in the volume of imports; it would solve the problem, therefore, of the excess of imports, but in a most uncomfortable manner. The fall in imports would measure the extent to which our well-being was reduced, for it would follow directly upon the reduction of the real annual income of the nation.

This problem—the decline of our overseas income and its effects upon our ability to buy—cannot possibly be solved, it will be noted, by any tariff, however scientifically devised. For it is not a question of a continuance of abnormal imports which is to be feared, but a decline in our imports owing to a falling off in our resources. If, e.g., the holders of Brazilian, Hungarian, and other securities no longer receive an income, they must reduce their expenditure in some way: if they no longer consume foreign luxuries the imports of these will fall off *directly*. If they cease to be able to save, and so prevent the constructional trades from prospering, the falling off of employment in these industries will reduce the purchasing power of the workpeople engaged in them, and *their* consumption of foreign goods will fall off.

But why, it may be objected, should a falling off in the national income of x per cent cut off a proportionate amount of our foreign consumption? May not the whole

of the enforced reduction in expenditure fall upon home-produced goods, leaving all foreign importations unchanged, so intensifying the problem? The answer to this point is that it takes one into an entirely different field of discussion: the effect of different methods of expending income (whether on home or foreign produced goods) upon the rate of exchange necessary to secure equilibrium. That a drastic fall in national income *must* affect imports will be clear on reflection: it is not unlikely to have *disproportionate* effects upon imports, since a certain proportion of the national income must be spent on special goods and services which cannot be imported in any case.

In a world which would permit of free movement the result of a decline in the national standard of life would be the emigration of the younger and more ambitious sections of the population. In the modern world, in which this is not possible, relief comes, or partly comes, through the pressure exerted upon those who supply this country with its normal imports. We are still so important an element in the markets of the world that cessation of buying on our part *reduces* prices of the things we used to buy, and this enables our remaining income to go farther than it otherwise would. The terms of trade shift violently in our favour.

If the income from our past investments largely goes, and international trade and finance continue to decline, can we hope to avoid a lowering of the standard of life? Not in the immediate future, for we should have to attempt to divert labour into less remunerative channels, and the measure of that lesser remunerativeness would be the smaller income thereby afforded. It is only now, when we have rejected free trade, that we see that our standard of life was really built up upon two principles—the concentration of production on the lines of greatest profitability and upon the possession of a balancing factor in the flow of income which was to a large extent independent of local vicissitude. The tragic feature in our present position is that international

events should have threatened simultaneously both of the pillars of our national economic life: 1931 may have proved even more of a turning-point in our national history than appears at first sight.

SELF-SUFFICIENCY AS AN ECONOMIC IDEAL¹

CURRENCY AND CAPITAL IN AN "ISOLATED STATE"

"DEFENCE", wrote Adam Smith in the *Wealth of Nations*, "is greater than opulence", and innumerable sermons, lay and professional, have been preached upon this text. It is not my intention to add to their number, but to examine at some length a more modern, certainly a more fashionable, variant of the theme—namely, that (the path, if not to opulence, at least to material welfare, lies through self-sufficiency.

One application of this doctrine is familiar: it is widely held that the method of escape from our present economic anxieties is by means of a self-sufficient British Empire. But this application is neither the most novel nor the most interesting to the economist. The point to which I wish particularly to draw attention can in the first instance best be stated negatively. It is the belief that if we were not part of an international economic order many of our current problems would not have arisen. Further, that the problems which have arisen in consequence of our participation in the world order are the most difficult to settle. Lastly, that if we were not part of a world order, the remaining problems which await solution would be much easier to settle than they actually are.

The "isolated community" has always been a favourite hypothesis of the speculative economist: our present discontents are rapidly turning it into a panacea for social reformers and practical politicians also. This transition of thought is significant. Our nineteenth century forefathers believed both in cosmopolitanism and in competition, and rightly believed that the two were

¹ Reprinted from *The Manchester Guardian Commercial Banking Review*, July 1930.

inseparably connected. We, for the greater part, have ceased to believe in competition and deify "organization": it would be only logical if we ceased also to believe in internationalism, and put forward the isolated state as the ideal. A generation of politicians which believes that Colbert was greater than Cobden is already committed to the attempt to translate the ideal into practice.

The greatest danger which supporters of a point of view which has long been dominant run is that they are unwilling or unable to see the strong points in the case of their opponents. If the free trade point of view (and by this I mean not only the belief in the absence of tariffs, but the whole complex of cosmopolitan sentiment and doctrine with which free trade is historically associated) had been as completely proof against argument as some of its supporters think, it would have been difficult for a consistent body of antagonistic thought either to remain or to revive. In fact, if we once accept the possibilities of isolation there can be no doubt that a series of advantages would accrue. We may legitimately doubt the possibility of isolation, and we may question whether the advantages it would bring with it outweigh the disadvantages. What it is dangerous to do is to ignore altogether the advantages which isolation could bring with it. I propose, then, to begin by asking what these advantages would be if isolation be, for the sake of argument, granted as a possibility.

Consider, first, the problem of the currency. An isolated community could adopt any currency system it chose without any of the complications arising from the existence of a foreign exchange problem. If it desired to stabilize its price system, or go off the gold standard in order to inflate, or adopt any form of standard whatsoever, its choice might still profoundly affect its internal wellbeing, but whatever choice it made the complications introduced through the co-existence of other currencies would not arise. Thus the whole of the difficulties arising from the adoption of the pre-war parity with

gold in the case of Great Britain would have had no significance whatsoever for such an isolated community.

An isolated community obviously would have no foreign trade. Its material wellbeing would depend entirely upon its own local volume of production and the way in which this product was distributed. Thus there would be no complications arising out of international competition. Importing and exporting nothing whatsoever, its industries would not be dependent on the vagaries of foreign markets, or be affected by the rise of new competitors or new products, or be upset because in neutral markets countries with lower costs of production were replacing its goods by their own.

Consider next the problem of social reform. An isolated state might well choose to redistribute income so as to result in a very substantial degree of equality of wellbeing. It might consider it advisable to give everyone a minimum income from the day of birth till the day of death. How much it could redistribute in this way would depend on the resources of the community and upon the "settled expectations" of the inhabitants. But it would not be faced with the problems of immigration or emigration. The average income might be high or low, but the dissatisfied could not move out of the area because they had better chances elsewhere, nor could immigrants from other areas with a lower standard come in and complicate the problem by increasing the population faster than the income to be redistributed, thus lowering the average all round.

What is true of human beings under conditions of isolation would be true also of capital. Whatever the rate of interest in such a community might be it would not be affected by the movements of capital in or out of the area. A higher rate of interest elsewhere would not result in a drain of capital from it with a resultant rise in its interest rates: if its own rate of interest were absolutely high, that fact would be immaterial, no capital would flow in, and no danger of a sudden withdrawal of such capital could in consequence arise.

Lastly, consider the problem of taxation. However high taxation might be there could be no flight to more hospitable shores of capitalists or their property. In all probability, therefore, the limits to "taxable capacity" would be less rigid than they are in a non-isolated community. Human nature being what it is, people's expectations are largely determined by what goes on in neighbouring communities. The Chancellor of the Exchequer in an isolated state, whatever his worries might be, would be free from many of the anxieties to which Finance Ministers are subject in communities with which we are more familiar.

It appears, then, that in many important matters—currency, public finance, social reform, the production of goods and service, the supply price of capital—an isolated community is free from influences emanating from without which may prove highly embarrassing when present, as in fact in the modern world they always are. But the fact that external influences are at work does not in the least prove that they must always be embarrassing. That is the very point which calls for investigation. But whether embarrassing or not, an isolated community could go its own way in these particular matters, unhelped or unhindered by intrusion from without.

Such a community would, of course, have difficulties of its own. In the first place, apart from any possible effects of governmental policy, its material welfare would depend upon what kind and volume of natural resources would be within the confines of its own territory. The richer and the more varied these resources were, the better off it would be, and the less its material wellbeing would increase if communication with the outside world were opened up. But the smaller the territory, the less varied the resources, then the greater the chances that material welfare would increase through international intercourse, even if international intercourse involved all the limitations upon independent national action outlined above. Not only so, but there might still be a considerable net

gain in material welfare, though the degree of actual limitation involved might be very great. The smaller the original endowment of resources, the greater would be the pressure exerted by the forces impinging from without, but the greater also would be the gain in material welfare through international intercourse.

In the second place, isolation, in and of itself, does not in any way remove the limitations upon action imposed by the generally accepted characteristics of human nature. There would still be a limit to the amount of taxation which could be imposed: a limit to the redistribution of resources in order to achieve a more substantial measure of equality: a limit to which savings are independent of the rate of interest: a limit to the extent to which population could be allowed to increase unchecked and so on. No doubt we can construct Utopias, once given the primary postulate of isolation, and proceed to imagine a kind of society in which self-interest played little, if any, part in the determination of the social structure. But this is a quite illegitimate procedure when all that one is concerned with are the effects of isolation as contrasted with non-isolation. Those who agree that non-isolation prevents certain types of action are inclined to overlook the existence of the internal psychological limits of which we have just made mention.

The reason why, with a given range of resources, non-isolation is in the last resort to be preferred to isolation is simply that the accretions of welfare which result from international intercourse, though accompanied by difficulties which would not have been present in the case of isolation, are so great that the direct advantages outweigh the disadvantages, and therefore make certain kinds of remedial action—admittedly more difficult to implement given intercourse—less necessary in order to attain a certain quantum of economic welfare. It is true, in other words, that an isolated community is free from certain difficulties from which a non-isolated community is not free, and that certain types of action

can be pushed farther in the one case than in others. But to admit these arguments is not to admit that economic welfare would be greater under isolation than under intercourse, merely because under intercourse the limit to what can be done comes earlier. The limit comes earlier, it is true, but then the necessity for the kinds of action contemplated is not so great, since a greater measure of welfare can be attained without their aid.

The modern social reformer, seeing that, given the existing volume of economic resources, redistribution would give better results, is naturally inclined to stress the evils of a system which limits his power of action. By doing so he overlooks the fact that without international intercourse in the first instance the volume of resources over which he desires to obtain control would in all human probability have been very much less. These smaller resources might be better distributed—that is, more equally shared, but it does not follow that the final result would have been better than that actually existing.

It is also clear that, in general, the level of taxation required to raise a given sum would be lower, given international intercourse, than given isolation, for taxable income and resources will be greater. Therefore, though the existence of an international economic order undoubtedly imposes limits on the tax powers of a single country, yet the problem of the limits to which taxation can be pushed also becomes less acute. The results on the currency system of an international economic order are less clear. There it may be the case that an international standard, involving falling prices, may reduce economic welfare; but since it is an accompaniment of international trade which increases material resources, the loss is in all probability greatly less than the gain.

In fact, of course, isolation is impossible. Had it been consciously attempted historically, the population of the world would in all probability have been much less, and its wellbeing enormously less, than it is now. The case of China, so often cited as an illustration as proof

of the possibility of high culture combined with isolation, proves nothing—for the area of China is very great, and its resources are very varied. Moreover, China as an historical and geographical entity is itself the result of a process of expansion and aggregation: and it has still to be shown that Chinese material welfare would not have been greater if she had profited earlier from the march of Western invention and discovery. In any event, so far as European countries are concerned, it is clear that without contact with each other and the rest of the world an enormous difference would be made in average material welfare.

The international order is, indeed, implicitly taken for granted by everyone, including the politicians and statesmen who attempt to interfere at different points with the detailed results of world intercourse, not always with the happiest consequences. Where isolation is preached, it is always with an area in mind so great—as in the case of the British Empire—that it includes all those varieties of soil and climate, natural and acquired aptitudes and resources, which are necessary to a high degree of material wellbeing. It would not be difficult to show that on balance isolation even for the British Empire would be a grave mistake. The present fashion of lauding isolation is simply another case of taking all the advantages resulting from a given situation for granted: seizing on certain incidental disadvantages and then evolving a philosophy of action which would, indeed, remove the disadvantages, the advantages accruing from the previous state of affairs being assumed to remain.

Common sense has long since summed up this attitude of mind: it is another instance of wanting to keep the cake and of eating it as well. So long as the hypothesis of the isolated state is used as a method of determining what, if any, are the incidental disadvantages which accompany the gains from an international economic order, it is a perfectly legitimate intellectual instrument. But intellectual instruments, when utilized for the purposes of current political and economic controversy,

become, like sharp knives in the hands of children, dangerous to those who wield them, and are returned in a blunted condition to those in whose keeping they might have served a useful purpose.

UNEMPLOYMENT AND CAPITALISM

THE ECONOMICS OF EMPLOYMENT IN ENGLAND, 1660-1713¹

“Meaning is the foundation of system in History.”
LORD HALDANE’s *Meaning of Truth in History*, p. 24
(Creighton Lecture, 1914).

I

No period in English economic history has suffered more from the tendency of subjecting facts to a pre-conceived notion than has the Restoration period. Regarded by some as the period of neo-mercantilism, more recently by others as the period of incipient capitalism, the interrelation of ideas has not been analysed as an end in itself before the final judgment has been passed. This process is the more to be deprecated inasmuch as both of the categories of thought under which the web of fact and argument has been subsumed are vague and capable of more than one construction.

The following paper is an attempt at a positive analysis of the system of thought of the half-century which lies between the Restoration of Charles II and the Treaty of Utrecht, as regards labour and labour problems. Only then will it be possible to attempt evaluation from an ideal standpoint.

II

The basis of thought during the period was the desirability of a large population. “It is a mistake to suppose”, says Petty, “that the Greatness and Glory of a Prince lyeth rather in the extent of his Territory, than in the number and industry of his people, well united and governed.”² “Fewness of People”, he says elsewhere in the same work,³ “is real poverty; and a Nation wherein

¹ Reprinted from *Economica*, January 1921.

² Petty, *Treatise of Taxes*. Hull’s Edition of Petty, vol. I, p. 22.

³ *Ibid.*, p. 34.

are eight millions of people is more than twice as rich as the same scope of land wherein are but four; for the same Governors which are the great charge may serve near as well, for the greater as the lesser number." So Defoe, "I cannot but note how . . . the Glory, the Strength, the Riches, the Trade and all that's valuable in a Nation as to its figure in the world depends upon the number of its People, be they never so mean or poor."¹ "People", argues Davenant, are "the most important strength of any Nation."² Coke re-echoes Petty when he says that "It is not the greatness of the extent of a country which makes it formidable, but the number and well governing of the People."³ This insistence on a large population was based on the conviction that a large population meant a large trade, that a small population implied a small trade. A large population consumed more than a small one, a small population produced less than a large one would. The assumption is, of course, a static one, it implies a limited rate of production and consumption *per capita*. But it was as wealth producers and consumers that people were demanded. It was in this twofold aspect that foreigners were to be welcomed. "Unless foreigners come in amongst us, in few years there will not be people to manure our lands, eat our provisions, wear our manufactures or manufacture the staple commodities that are of the growth of the Kingdom."⁴ Here the twofold idea is very well put. The consumption idea is again prominent in Brewster.⁵ "The increase of hands in labour improves and increases manufactory, even of the very expence of them that are added: one man that works may have five or six that only eats and wears." So again Coke,⁶

¹ Defoe, *Giving Alms no Charity*, 1704, in *Genuine Works*, vol. II, p. 428.

² Davenant, *Discourses on the Public Revenues and on the Trade of England*, Dis. III, vol. II, p. 2. Edition of 1771.

³ Roger Coke, *Reflections upon the East India and Royal African Companies*, 1695, 1029, c. 106.

⁴ *The Grand Concern of England explained in several proposals offered to the Consideration of Parliament*, 1673. *Harl. Miscell.*, vol. VIII, p. 555.

⁵ *Essays on Trade and Navigation*, 1695, p. 8. (For Brewster, see *D.N.B.*)

⁶ Coke, *Discourse of Trade*. Part I: "Reasons of the Decay of the English Trade", 1029, c. 10.

"Multitude and concourse of People advance trade, scarcity of people diminish trade." . . . "As the strength and grandeur of every country is founded in the number of the inhabitants, so is the riches and trade of it, for every man's necessities are supplied by trade, so that . . . in the whole, trade is increased . . . as men live more or less on Society and Conversation; and therefore, wherever people are thin or few, they are poor, lazy, rude and of little use to the publick."¹

The logical conclusion of this line of thought was obviously that, whatever the moral quality of demand, the volume of production depended upon it. "The main spur to Trade, or rather to industry and ingenuity, is the exorbitant appetite of men, which they will take pains to gratify and so be disposed to work, when nothing else will incline them to it; for did men content themselves with the bare necessaries, we should have a poor world, . . . now in their pursuit of those appetites, other men less exorbitant are benefited. . . . Countries which have sumptuary Laws are generally poor; for when men by those Laws are confined to narrower expence than otherwise they would be, they are at the same time discouraged from the industry and ingenuity which they would have employed in obtaining wherewithal to support them in the full latitude of expence they desire."²

Defoe puts the matter even more clearly in *The Compleat English Tradesman*.³ "Trade is propagated by our crimes, the people support one another by their extravagance and luxury, their Gaiety and Pride: gluttony and drunkenness assist to maintain the Nation, the people grow rich by the people, they support one

¹ Coke, *Reflections*, etc., p. 15.

² Dudley North, *Discourse upon Trade*, 1691. *Jobus Hopkins Reprints*, p. 27. Davenant, though holding that "thrift does proportionately enrich a whole people, as it betters the conditions of a private man", still gives a qualified assent; "perhaps it is not impossible but that our industry would be less active if it were not awakened and incited by some irregular appetites which are more easily found fault with than avowed". *Discourse*, vol. I, p. 390.

³ So far as I am aware no English writer has noticed the bearing of this passage on Mandeville's *Fable of the Bees*. Professor Sombart has used the passage in his *Der Bourgeois* (1913).

another ; the Taylor, the Draper, the Mercer, the Coach-maker, etc., and their servants, all haunt the public houses ; the masters to the taverns, the servants to the ale-houses, and thus the vintner and the victualler thrive and grow rich. Those again getting before hand in the world must have fine clothes, fine houses and fine furniture ; their lives grow gay, as the Husbands grow rich and they go on to the Draper, the Mercer, the Taylor, the Upholsterer, etc., to buy fine clothes and nice goods ; Thus the Draper and Mercer and Taylor grow rich too, money begets money, trade circulates and the tide of money flows in with it, one hand washes the other hand, and both hands wash the face.”¹ Even by the Balance of Trade fanatics the consumption of “fripperies” is condoned if the labour that goes to make them is English labour.² The tendency to regard all consumption as productive should have been strengthened by the assumption that the total wealth of the community was neither increased nor diminished by payments from one subject to another in the realm—an assumption derived partly, at any rate, from the current theory of the Balance of Trade, for, runs Davenant’s argument, “by what is consumed at home, one loseth only what another gets and the nation in general is not all the richer”.³ It ought to have been seen that neither was it poorer, but unfortunately the assumption that by foreign trade the wealth of the nation was actually increased in a way that home trade was unable to bring about led to a distinction being drawn between trade and labour useful for producing articles for foreign trade, and trade only serving to

¹ p. 118, cf. : “It may indeed be true that the Increase of Crime is the increase of Commerce and the wickedness of the time is the blessing of the Trade, the Vanity, the luxury, the folly, and even the vice of the People is the cause of that increase . . .” (p. 147).

² Samuel Fortrey, *England’s Interest and Improvement*, 1663 : “That the excess of this expence consist chiefly in the art, manufacture and workmanship of the commodity made in our own country ; whereby ingenuity would be encouraged, the people employed and our treasure kept at home, so as the Prince would be nothing damaged by the excess for the ruine of one would raise as much on other of his subjects.” *Jobus Hopkins Reprints*, p. 27. See also Cunningham, *Growth, etc.*, *Modern Times*, p. 392. Dr. Cunningham seems to me to be mistaken in assuming the truth of J. S. Mill’s dictum, “demand for goods is not demand for labour”.

³ *An Essay on the East India Trade*, Works, vol. I, p. 103.

satisfy the "unproductive" home consumption.¹ At the same time the benefit of a large consumption at home still remained in the background of consciousness; this being justified on the line of argument that if there was to be consumption at home, home production was preferable to the importation of foreign goods, on which the nation lost positively.

Nevertheless, the resulting confusion as to what was, or was not, beneficial consumption did not interfere with the desirability of population as a factor of production. It tended, however, to make the phrase "increase of population" synonymous with "increase of workers in those industries which are desirable". So in the assertion "there is nothing so much wanting in England as people: and of all sorts of people, the industrious and labourious sort, and handicraftsmen are wanted to till and improve our land and help to manufacture the staple commodities of the Kingdom: which would add greatly to the riches thereof."² Population was looked upon mainly as a factor of production, only incidentally as a factor in consumption, owing to a theory of foreign trade which threw suspicion upon home consumption.

Now, a working population could be drawn either from foreign countries or from the inhabitants of this country, and both possibilities led to a mass of proposals.

¹ Fortrey: "Our case should therefore be to increase chiefly those things which are of least charge at home, and greatest value abroad", loc. cit., p. 19. Davenant: "It is the interest of all trading nations whatsoever that their home consumption should be little, of a cheap and foreign growth and their own manufactures should be sold at the highest market and sold abroad; since by what is consumed at home, one loseth only what another gets, and the nation in general is not at all the richer, but all foreign consumption is a clear and certain profit. So that in the woollen manufacture England does not get by what is spent here by the people, but by what is sold abroad in other countries", thus leading him to justify the importation of East India goods, op. cit., I, 103; cf. also Child, *A New Discourse of Trade*: "I do agree fully . . . that luxury and prodigality are as well prejudicial to Kingdoms as to Private Families, and that the expence of Foreign commodities especially foreign manufactures is the worst expence a nation can be inclined to, and ought to be prevented as much as possible" (Preface). "We are not half so much given to Hospitality and good Housekeeping as in former days, when our greatest expence was upon our Bellies, the most destructive Consumption that can happen to a nation", ibid. 57. Also Brewster, op. cit., ". . . there is a receiv'd opinion to be removed and that is, that expence of the Labour and Products of a Country is the support of the Artizans and brings Riches to men of Real Estates" (p. 50).

² *Grand Concern*, p. 555.

The first possibility led to the inclusion among the proposals of the economists of the day, of the naturalization of foreigners.¹ The second possibility led to a double examination of tendencies: (1) as to the tendency of plantations unduly to depopulate the mother country, (2) as to the tendency of the current methods of relieving the poor to withdraw men from the labour market.

(1) Opinion was decidedly divided on the advisability of allowing emigration to the plantations. Coke argued roundly that "the Trade of England and the Fishing Trade are so much diminished, by how much they might have been supplied by those men who are diverted in our American plantations."² Child argues that although a loss of population is in general undesirable, yet that the settlers of our North American plantations, being largely malcontents with the state of affairs in England, would have been lost in any case, whilst they serve a useful purpose in the plantations by employing English shipping and taking English goods.³ Davenant⁴ argues on the same lines, suggesting at the same time that England should be made a "General Asylum" and—then "our own malcontents may retire without any prejudice: for the recruits of people such a course might produce, would answer the annual evacuation occasioned by our West India Colonies."⁵

(2) The unanimous opinion of the writers of the time was that the poor law of Elizabeth tended to reduce the available supply of labour, a result also produced by indiscriminate charity. The writer of the *Grand Concern*

¹ Child, *Discourse* (pp. 141-5) argues for the naturalization of Jews in a manner which shows the suspicion of them entertained by the merchants of the day. Roger Coke was in advance of the majority of the writers of the day in desiring the immigration of Roman Catholic artificers.

² *Discourse of Trade*, Part I, p. 7.

³ *Discourse*, chapter x., "Concerning Plantations": The first settlers of Virginia and Barbadoes were such as "could probably never have lived at home to do service for their country but must have come to be hanged or starved or aged untimely by some of those miserable diseases that proceed from want or vice, or else have sold themselves for soldiers . . . in the Quarrels of our Neighbour" (p. 184).

⁴ *Works*, vol. II, "On the Plantation Trade", p. 5.

⁵ *Ibid.*, p. 6.

argues that the cost of the poor is £70,000 a month and this is "employed only to maintain idle persons: doth great hurt rather than good: makes a world of poor, more than otherwise would be, prevents industry and labouriousness: men and women growing so idle and proud, that they will not work, but lie upon the parish wherein they dwell for maintenance".¹ The Poor Law is "a thing most piously designed: yet proving an encouragement to thievery and idleness, a charge to the industrious inhabitants of every Parish and an injury to the whole nation".² So Brewster, "There is no Nation I ever heard of, who by a Compulsory Law, raiseth so much money for the Poor as England doth . . . our Charity is become a Nuisance, and may be thought the greatest mistake of that Blessed Reign, in which that Law passed, which is the idle and impoverished man's Charter: for if Shame or Fear of Punishment makes him Earn his Dayly Bread he will do no more, his Children are the Charge of the Parish and his Old Age his Recess from Labour or Care: he makes no Provision for it in the time of his Youth and Strength, because he hath better Security for his Maintenance than money of his own laying up."³ So also Cary, Davenant and others.⁴

Insistence on this point marks the breakdown of the view that a large population is desirable because of its possible consuming power. Defoe's eulogy of the People "be they never so mean or poor", evidently is not to be taken in its literal sense, but refers to the productive power capable of being exerted by a large working

¹ He goes on: "But, if . . . the money collected were employed to set all of them that are able to work to some kind of employment or other, suitable to their capacities . . . it would be of infinite use and advantage to the Nation."

² *Reasons for a Limited Exportation of Wool*, p. 12.

³ *Loc. cit.*, p. 59.

⁴ Cary, p. 157: "But above all our Laws to put the Poor at work are short and defective, tending rather to maintain them so, than to raise them to a better way of living." "The Laws render the Poor more bold, when they know the Parish Officers are bound either to provide them work or give them maintenance." Davenant, cf. *Essay on E.I. Trade*, vol. I, p. 100. Also *The Trade of England Revised*, 1681: "The poor addict themselves to idleness and pilfering because they know that if they come to want the Parish is bound to keep them."

population. Brewster's artificer is to be relieved "of the five or six that only eats and wears" in order that the supply of labour may be *pro tanto* increased.

III

The view that the nation only "gained" by production for a foreign market (and the qualified assent given to production for home use) supplied the reason for insisting on a large working population. For to achieve success in trade it was necessary to produce cheaper than one's rivals, and the larger the supply of labour, the lower were the wages that need be paid. Hence a large population was not merely desirable as furnishing the requisite labour power, but it also enabled that power to be obtained on cheaper terms. The lower the wage the more trade would be stimulated. The admission of aliens and the reform of the poor law could both be directed to this end. The logical consequence of this was that if all labour could thus be employed in industry, there would be no need for a poor law at all. The desirability of dispensing with the poor law thus led to a further argument that all impediments to the employment of as much labour as possible should be avoided.

It would seem that the theory of wages thus set up was the "Supply and Demand" one. This, however, ran counter to another theory of wages current at the time, i.e. that wages depended on the cost of food.¹ The discussion of the commercial clauses of the treaty of 1713 especially is full of reference to this conception. "Wages in France were never above two-thirds of those that were always given for the like labour in England. This in all probability is owing to the meaner way of living in that country. Labouring People seldom have any other Ambition than to live and save nothing. Therefore if the yearly Subsistence of such Persons in France is purchased by two-thirds of the Price that is given

¹ The origin of this theory seems to be due (1) to the comparison between the desirable and the actual, (2) to the Elizabethan Labour Code raising or lowering wages according to the plenty or scarcity of the times.

for the Subsistence of like Persons in England, this will very well account for their receiving no more than the two-thirds of the English wages. And from hence it appears that the French refugees, when they came first to settle here, perpetually undersold the English, till they raised themselves by degrees to our Country Diet.”¹ Thus also Davenant²: “The additional duties on beer and ale and the tax upon malt are apparently a burthen upon the woollen manufactures, affecting the carder, spinner, weaver and the dyer, who all of them must be raised in their wages, when the necessaries of life are raised to them. The consequence of which must be that our woollen goods must come at a heavy and disadvantageous price into the foreign markets.” The Irish Cattle Acts were constantly attacked on the grounds that by lowering the cost of provisions in Ireland, they allowed the Irish woollen industry to compete successfully with the English.³

It was possible to reconcile these two positions in several ways:

(1) It was possible to deny the fact that wages moved as the price of food moved. Thus Petty⁴ argued that “It is observed by Clothiers and others, who employ Great numbers of people, that when Corn is extremely plentiful that the Labour of the poor is proportionately dear: And scarce to be had at all (So licentious are they who labour only to eat or rather to drink).” So also Child: “And for our own Poor in *England* it is observed, that they live better in the dearest Counties for provisions, than in the cheapest, and better in a dear year than in a cheap . . . for that in a cheap year they will not work above two days in a week: their

¹ *The Consequences of a Law for Reducing the Dutys upon French Wines, etc.*, 1713, p. 6, 1029 c. 9/5; also *General Maxims in Trade, Particularly applied to the Commerce between Great Britain and France*, 1029 c. 9/6, p. 10.

² *An Essay upon the Probable Methods of making a People Gainers in the Balance of Trade*, 1699, Works, Vol. II, p. 267.

³ *Grand Concern*, 558. *Reasons for a Limited Export of Wool*, p. 14. *The Proverb Crossed or a New Paradox Maintained, That it is not at all times true, that Interest cannot lye*, 1677. Both Tracts in *Collection of Tracts on Wool*, 712, g. 16.

⁴ *Political Arithmetic*, Hull's Edition, Vol. I, p. 274.

humour being such, that they will not provide for a hard time, but just work so much and no more, as may maintain them in that mean condition to which they have been accustomed.”¹

(2) It was also possible to argue that as the price of commodities was increased by a rise in wages, so lower wages meant lower food prices and therefore wages in industry could be lowered. This was Defoe’s argument. “If wages grow high, Provisions rise in Proportion, and I conceive it to be a mistake in those People . . . who say Labour is cheap. . . . because Provisions are cheap, but ’tis plain Provisions are cheap because Labour is cheap.”² He therefore drew the conclusion that wages, though they affect the price of commodities, were themselves determined purely by supply and demand: wages rise and fall like the exchange.

(3) It was lastly possible to argue that, though in the last resort wages moved with the cost of food, yet in practice the standard of comfort was so high that actual wages were in excess of that minimum subsistence level, or at any rate that they should be no higher. Petty³ argues that it is impossible to “raise” the value of money and forbid wages to rise at the same time, for then “would this Act be onely as Tax upon the said Labourers, as forcing them to lose a half their Wages which would not onely be injurious but impossible unless they could live with the said half (which is not to be supposed) for then the Law that appoints such wages were ill-made, *which should allow the Labourer but just wherewithal to live; for if you allow double, then he*

¹ Child, *loc. cit.*, pp. 15, 16. Coke expressly argues against the Poor Law: “It is a discouragement to all industrious and labouring people, when lazy and idle people shall be maintained in their idleness from the fruits of their labour and industry. It encourages wilful and evil-disposed persons to impose what wages they please upon their labours: and herein they are so refractory to Reason and the Benefit of the Nation that when Corn and Provisions are cheap they will not work for less wages than when they were dear.”

² “The Employers are the Remitters, the Workmen are the Drawers; if there are more Employers than Workmen, the price of wages must rise, because the Poor man wants to do it; if there are more Workmen than Employers, the price of Labour falls, because the Poor man wants his Wages more than the Employer wants to have his Business done,” *loc. cit.*

³ Petty, *Treatise of Taxes*, p. 87, Hull’s Edition, Vol. I.

works but half so much as he could have done and otherwise would which is a loss to the Publick of the fruit of so much Labour". However, whether the theories were reconciled or not, there is no doubt about the practical anxiety displayed as to the necessity of low wages.

First, as to the influence of foreigners. Child argues that high wages are due to Incorporation "whereof the cure is mainly by an Act of Naturalization and without Compulsory Laws".¹ Brewster, arguing for the admission of foreigners, declares that "it is undeniable that if the Increase of Hands abates the Price of Manufactorys, it will enlarge their Exports and Expence at home".² So as regards the effect of charity: the cost of production in England is not high "because Provision is dearer in England than it is in other Countreys", but because "Begging is suffered so Rife in this Kingdom. Now if this Begging Trade be not suppressed, there will never be any good done either upon the Clothing Trade or any other."³ By setting the parish poor to work,⁴ they will "help to manufacture the staple commodities of the Kingdom at cheap rates and thereby bring down the wages of handicraftsmen, which now are grown so high, that we have lost the trade of foreign consumption. . . . This mischief of high wages to handicraftsmen is occasioned by reason of the idleness of so vast a number of people in England as these are: so that those that are industrious and will work make men pay what they please for their wages: but set the poor at work and then these men will be forced to lower their rates: whereby we shall

¹ Child, Preface to *Discourse*.

² Loc. cit., p. 9.

³ *The Trade of England Reviv'd*, 712, g. 16, 1681, p. 10. The tract argues a similar charge against the Poor Law.

⁴ *Grand Concern*. The advocates of the woollen trade disliked the introduction of other industries on the ground that this tended to raise wages. Thus W. C(arter), in 1700, argues against the introduction of the linen trade, since it may "injure that of the woollen by diverting some that are now in it and so raise the price of spinning: than which nothing can be more prejudicial: for . . . nothing can retrieve our lost trade abroad, but underselling our competitors; so then we must labour to make wares as cheap as we can and not set up another manufactory. To bid who gives most for spinners is a ready way to ruin the Clothing Trade of England." *An Alarm to England, To prevent its Destruction*, 1029, e. 9/23.

quickly come to sell as cheap as foreigners do and consequently ingross the trade to ourselves". Paterson, demanding a Council of Trade for Scotland, fiercely denounces "a third sort of thieves, which is that idle and dissolute people called beggars, for although they be somewhat more tame and familiar with us, yet are they really but another sort of thieves", and demands government control of industries to eradicate the trouble, slavery not being efficacious "as in such a case only the strongest and ablest of them would be taken up by particular men . . . so that the evil might thereby be somewhat lessened and abated but far enough from being rooted out."¹

This attitude of mind had two distinct and dangerous consequences. Firstly, resentment against the high wages paid to the "independent labourer" and resentment against the good living guaranteed by the poor law led to the identification of the two aspects of the question and made the problem one of low wages. "To employ the poor" in industry and to employ the poor in a workhouse began to be regarded as the same problem, because the latter seemed to be an aid to the former. If the workhouse labourer was to work in order to bring down the wages of the "industrious" worker, he incidentally brought down his own remuneration and thus identification seemed plausible. On the other hand, just because of this identification, it seemed plausible to argue that this or that industry ought to be begun at the expense of the parish or the county rates, since this policy would increase the total amount produced, and yet lessen throughout industry the rate of wages.²

¹ Saxe-Bannister's Edition of the Writings of William Paterson, 1859. *Proposals and Reasons for Constituting a Council of Trade*, p. 92 (12268, d. 2).

² Some few writers do not think high wages disadvantageous. Child, in the Preface to the *New Discourse*, discusses the matter and decides that high wages are not a disadvantage to trade since (1) the Dutch pay higher wages than the English and (2) high wages are a sign of the riches of a country, low wages an indication of poverty. More interesting are the views of Cary and Sir Dudley North. Cary argues (1) "that we must consider that Wages must bear a Rate in all Nations according to the Prices of Provisions . . . and this price must arise from the Rates of Land, it cannot be imagined that the Farmer whose annual Rent is Twenty Shillings per acre can afford it as low as he who pays but Half-a-Crown, and hath the same Cropp, nor can he then expect labour so cheap as the

For all but a few writers this ended the matter. The minority argued that under given circumstances workhouse employment tended of itself to accentuate the problem of employment. This conviction arose from the fact that they recognized that it was possible to glut the market and thus sell nothing at a paying price. The most famous exponent of this view is Defoe. Arguing that wages are above subsistence level and therefore that there is no lack of employment, "since any man would work for just as much as would supply himself rather than starve", he argues that to employ the poor in workhouses in manufacturing woollens is to employ them in a trade already "managed to a full extent" and therefore would mean merely "transferring the manufacture from *Colchester*

other. This is the case of England, whose Lands yielding great Rents require good prices for their Product . . . you cannot fall wages unless you fall Product, and if you fall Product you necessarily fall Land" (op. cit., 144/5); (2) Experience shows that high wages can be paid and this "proceeds from the Ingenuity of the Manufacturer and the Improvements he makes in his ways of working. . . . Various methods are used all which save the Labour of many Hands so the Wages of those employed need not be lessened" (146). He adds: "New Projections are every day set on foot to render the making our Manufactures easie, which are made cheap by the Heads of the Manufactures, not by falling the price of Poor People's labour: cheapness creates Expence, and Expence gives fresh Employments, so the Poor need not stand idle if they could be perswaded to work" (147). He thus arrives at the same conclusion but by a different route.

Sir Dudley North argues that the importation of East India goods will not lower wages, since it may lead to the introduction of improvements which lessen the total cost of manufactures and therefore lower prices while leaving wages as high as they were before. "Arts and Mills and Engines, which save the labour of hands, are ways of doing things with less labour and consequently with labour of less price, though the wages of men employed to do them should not be abated. . . . Such things are successively invented to do a great deal of work with little labour of hands: they are the effects of necessity and emulation. . . . If my Neighbour by doing much with little labour, can sell cheap, I must contrive to sell as cheap as he. So that every Art, Trade, or Engine doing work . . . cheaper begets in others a kind of necessity and emulation either of using the same art, trade or engine, or of inventing something like it . . . that no man may be able to undersell his neighbour. And thus the East India Trade, by procuring things with less and consequently cheaper labour, is a very likely way of forcing men upon the invention of arts and engines by which other things may be also done with less and cheaper labour and therefore may abate the price of manufacture, though the wage of men should not be abated" (p. 67). The same is true of Order and Regularity: "The more variety of artists to every manufacture, the less is left to the skill of single persons, the greater the order and regularity of every work, the same must needs be done in less time, the Labour must be less and consequently the price of labour less, though wages should not be abated."—*Considerations upon the East India Trade*, 1701 (1130, g. 3).

See also Defoe, *Plan of English Commerce*, 3rd ed., p. 60: "This (i.e. reduction of wages), therefore, is beginning at the wrong end of trade; but the true way is, keep up the goodness of your manufacture so as to make it excel in Quality and its exceeding in Price will be no Deficiency in Trade."

to London and taking the bread out of the mouths of the Poor of Essex, to put it into the mouths of the Poor of Middlesex".¹ That being said, he adds, "If they will employ the Poor in some manufacture which was not made in England before, or not bought with some manufacture made here before, then they offer at something extraordinary."² Another writer who considers the matter is T. Firmin, who answers the objection against his scheme, "What will you do with all the yarn these poor people shall spin? If you weave it into cloth, the commodity is brought over so cheap, that you will never be able to sell without much loss," by arguing "That we had much better lose something by the labour of the poor, than lose all by letting them live in sloth and idleness; for suppose you should give sixpence for that work which is really worth but fivepence; here will fivepence really be got to the nation, though one penny should be lost to the parish."³ The real difficulty lies, not in giving sixpence for a thing worth fivepence, but in only giving a penny for a thing costing sixpence to produce, and this the author does not cope with. However, the intention is plain, philanthropy must temper economic argument. This, of course, made it still easier to advocate the extension of workhouses, and the disciplinary virtues of the workhouse blinded the more far-sighted business man, if he was not dazzled by its philanthropic aspects. Thus Cary advocates public or private workhouses, in which "Employments must be provided . . . for all sorts of People, who must also be compelled to go thither when sent and workhouses to receive them . . . the design is to provide places for those who care not to work any where and to

¹ *Giving Alms no Charity*, p. 442.

² It must be admitted that the passage suggests sarcasm, but to the ordinary man at the time it was written it need not have appeared so, since the current view of the trade with France was that it was not an interchange of goods for goods. The current assumption was that England lost heavily on the trade.

³ *Some proposals for the employing of the Poor, especially in and about the City of London*, T. Firmin. He advocates homework as well as workhouse employment. Cp. William Goffe's *How to advance the Trade of the Nation and to employ the Poor*, in *Harl. Miscell.*, 4, 385. He argues that putting the poor to make goods of the kinds the nation is "overstocked with already" is but "undoing in one place to make another".

make the officers of Parishes industrious to find out such Vermin, when they shall know where to send them, by which means they would better be able to maintain the impotent."¹

The result of the main tendency of thought on this subject was a flood of pamphlets advocating the employment of the "poor" in all manner of ways, concern for their well-being proving very often a cloak for some specious project or other.² A sanctimonious writer demands the introduction of flax spinning in "Proposals for building in every county, a working Almshouse or Hospital, as the best expedient to perfect the Trade and manufactory of linen cloth."³ William Goffe⁴ demands the encouragement of sail-cloth making and fishing by means of a tax on all parishes for three years according to the "poor tax rate". The use of the parish poor in the woollen manufactory is a favourite device.⁵ Petty demands their employment in what would now be called "Public Utilities". "Making all high wayes so broad, firm and even, as whereby the charge and tedium of travelling and carriages may be greatly lessened. The cutting and scouring of Rivers into navigable; the planting of useful trees for timber, delight and fruit in convenient places."⁶

¹ Cary, loc. cit., p. 159.

² The author of *An Appeal to the Parliament concerning the Poor, that there may not be a beggar in England*, 1660 (Somers Tracts, 7,520), demands accurate statistics and the settlement of a "poor man's office . . . where handicraftsmen and labourers that want work and such as want workmen may enquire".

³ Harl. Miscell., 4, p. 489, 1677. This is clearly a projector's pamphlet.

⁴ loc. cit.

⁵ See above, and *The Proposals for Promoting the woollen manufactory promoted by several well widders therunto, Inhabitants and citizens of London*, 1679, 712, g. 16 (18).

⁶ *Treatise of Taxes*, vol. I, p. 29: I assume this to be public employment from the context. John Collins ("Accomptant" to the Royal Fishery Company) also demands the employment of the poor in the reclamation of waste lands. *Salt and Fisbery*, 1682, 981, b. 5. Another pamphlet on the fishing trade is James Puckle's *England's Path to Wealth and Honour in a dialogue between an Englishman and a Dutchman*, 2nd ed., 1700, 1029, 2 g. (4). His Fishing Company is to have the power of "Fathers of the Poor" (a plan obviously based on Child's proposals, Somers Tracts, 11, p. 607) controlling church collections, poor rates, etc. His argument runs "Gold and silver mines England hath none and in time of Peace no way to get Bullion but by foreign traffick, to which nothing can more conduce than cheap fishing and cheap working and manufacturing the commodities which compose the exports of our kingdom and that is not to be effected except Labour be cheap, which it can never be where Provisions are dear. But the cheaper our Provisions are the cheaper our exports may be afforded."

The logical conclusion was that by the application of this method either (1) the poor law could be dispensed with, since if wages were lowered sufficiently, the sale of products abroad would provide industry with a market and the poor law simply turned the scale and caused a glut (Defoe) or (2) that the poor law industries simply became part of the wealth-producing organization of the nation. Both ideas as to employing the poor had the result of causing labour to be regarded simply as a factor of production, standing, as it were, outside "The Nation", an anticipation of the result produced later by the Wages Fund Theory of Wages.

Two further results may be noted :

(1) If the amount of non-profitable relief was to be reduced, it seemed obviously desirable to afford as much employment to labour in industry as possible. Hence came an attack on labour-saving devices and the theory that the most beneficial trades were those which employed most labour. Thus Defoe: "All methods to bring our Trade to be managed by fewer hands than it was before, are in themselves pernicious to England in general, as it lessens the employment of the poor, unhinges their hands from the labour and tends to bring our hands to be inferior to our Employ, which as yet it is not. . . . 'Tis the excellence of our English manufacture that it is so planned as to go through as many hands as 'tis possible ; he that contrives to have to go through fewer ought at the same time to provide work for the rest."¹

(2) The employment of public funds in industry led to a demand for protection, which the previous assumption strengthened.²

The most interesting attack on the "work fund" idea comes from Sir Dudley North. "If to make work for the people," he says, "a Law is made this year to destroy the Trade of the East Indies, some other such law

¹ loc. cit., 438, cp. Barbon, *Discourse of Trade* : "The advantage to the Nation from Trade is from the Customs and from the goods that Impleys most Hands." An idea probably derived from his interest in building schemes.

² Firmin demands the prohibition of goods by higher duties, Goffe the prohibition of the export of unwrought goods.

will be wanted the very next. We may well hope that, in time the Navigation of the Thames, of every other river be destroyed, that many may be employed in the carriage which is now performed by few. By degrees, not an Art or engine to save the labour of hands will be left in England. When we shall be reduced to plain labour, without any manner of art, we shall live at least as well as the wild Indians of America, the Hottentots of Africa, or the Inhabitants of New Holland. As often as I consider these things, I am ready to say with myself, that God has bestowed his blessings upon men that have neither hearts nor skill to use them. For why are we surrounded with the Sea? Surely that our wants at home might be supplied by our Navigation into other countries, the least and easiest labour. By this we taste the spices of Arabia, yet never feel the scorching sun which brings them forth; we shine in silks which our hands have never wrought; we drink of vineyards which we never planted. The Treasures of those mines are ours in which we have never digged, we only plough the deep and reap the Harvest of every Country in the world.”¹ “Certainly every individual man in England might be employed to some profit to do some work which cannot be done without him; at least the contrary is not evident, as long as England is not built, beautified and improved to the utmost perfection, as long as any country possesses anything which England wants, Spain the gold and silver of America, Holland the Fishing and other Trades, France the wines, as long as champagne and burgundy are not drunk in every Parish; some of these things might be appropriated to England.”²

At least the erstwhile Turkey merchant cannot be accused of lack of optimism.

IV

Under which category of thought is the system of economics analysed in the preceding pages to be put? The question is one of some importance.

¹ *Considerations upon the East India Trade*, 1701 (1139, g. 3), pp. 58-9. ² *Ibid.*, pp. 54-5.

The answer depends upon the view taken as to what was the dominant consideration in the minds of the men of the time. The time was one of intense international rivalry,¹ and the economic writings of the time envisage the economic problems of the day as primarily bearing upon the international position of the Nation. "To buy cheap and sell dear"² was not the maxim of the orthodox free trader, but seemed the obvious policy to pursue in order to oust Holland and to rival France. The phrase was, in other words, applied to the economic activities of the State considered as an entity, and did not primarily apply to the individual merchant at all. Indeed, the current assumption that the State might lose though the individual gained made it obvious that any facile coincidence of private and public advantage was not yet part of the intellectual equipment of the time.³ It was only when the identification of private with national profit began to be made that any advance could take place.

The theory of employment outlined in the previous pages was justified on the basis of the current theory of international trade, and is thus a mercantile theory in the Smithian sense of the word. The peculiar importance of the international trade views of the day has been, to my mind, unfortunately obscured by the extension of the meaning of the term "Mercantile System" to cover a wide ground—that in which it is co-extensive with State power in an absolutist sense.

Another view has recently been trenchantly stated by Professor Levy.⁴ He sees in the labour theory of the Restoration the promptings of the Puritan conscience, transforming itself by contact with economic facts into

¹ G. B. Hertz, *English Public Opinion after the Restoration*.

² "The art is when we deal with strangers, to sell dear and to buy cheap." Fortrey, loc. cit., p. 29.

³ A letter to the Honourable Arthur Moore, Commissioner of Trade and Plantation, 1713. 1029, c. 9(10): "A merchant may gain a thousand pounds to his country and yet gain nothing, nay, even lose by the adventure himself." "In what any single person shall be a loser, there, endeavours will be made to hinder the publick gain." Fortrey, *ibid.*, 12.

⁴ *Economic Liberalism*, 1913.

a half-fledged theory of *laissez-faire*.¹ Genetically regarded, this view cannot lightly be dismissed, yet it appears to be somewhat exaggerated.

(1) The influence of Puritan thought seems undoubtedly most marked in the emphasis placed upon the evils of idleness. In so far as the economists of the time urged reformatory methods they were no doubt profoundly influenced by the Puritan theory of morals.²

(2) The harshness of tone towards the poor attributed to this ground can be exaggerated. Thus William Goffe, a regicide and a Puritan,³ argues that "the poor ought to be encouraged and mercifully dealt with, and kindly used, until their slow hands be brought to ready working and ought at first to have the highest price the commodity will bear to themselves", the expenses of training to be paid by the parish.⁴ So Firmin, who argues for his scheme on the ground that it will ease the minds of "all that have any bowels of compassion" and increase their enjoyment of the good things of this world, as well as making property more secure and confirming the hopes of Christians,⁵ and appearing among the elect on the Day of Judgment, pleads for discrimination: "Do not imagine that all the poor people in England are like unto those vagrants you find up and down the streets. No, there are many thousands whose necessities are very great, and yet they do what they can by their honest labour to help themselves; and many times they would do more than they do but for want of employment."⁶

(3) A true theory of *laissez-faire* would have rested content with high wages, provided they were the product of "natural" laws. The evil influence of high wages

¹ See particularly chapters VI and VII.

² See particularly Cary, loc. cit.: "Nor is God more honoured than He is among these industrious people, who abhor vice on equal principles of Religion and good Husbandry, Labour being usually a barrier against sin, which doth generally come in at the doors of idleness" (p. 166).

³ vide *D.N.B.*

⁴ loc. cit.

⁵ loc. cit., pp. 9, 11.

⁶ loc. cit., pp. 9, 11.

seems, during the period under review, to be far more the expression of an employing class desiring cheap labour in order to capture foreign markets, an axiom of business not entirely alien to our own day.¹ The enterprising business man of the day was in conflict with the tendency of his employees to remain content with a fixed standard of comfort. Of course, in so far as "progressive" ideas were the result of Puritanism, the two streams of thought fused. But it was the theory of international trade which gave the characteristic turn to the thought of the day. Moreover, to use the work-house as a means of beating down wages was not *laissez-faire*, but the contrary. The *laissez-faire* attitude surely implies an absence of state aid in any form.²

The necessity of ousting England's trade rivals appears, after all, to have carried the day.

¹ Cary was not, as we have seen, in favour of low wages.

² It is worth noting that the pamphlet, the *Grand Concern of England*, which, *inter alia*, desires the abolition of coffee houses and stage coaches and caravans, is not at all liberally inspired, although it demands lower wages in order to achieve a monopoly of foreign trade! It is characteristic of the difficulty of summing up the thought of the day that Child (who believed in the efficacy of a law to reduce the rate of interest) argued that wages varied "naturally". "Such as our employment is for people, so many will our people be, and if we should imagine we have in England employment but for one hundred People and we have born and bred amongst us one hundred and fifty people, I say the fifty must away from us or starve or be hanged to prevent it. . . . If by reason of the accommodation of living in our foreign plantations we have evacuated more of our people than we should have done, if we had no such plantations, I say . . . that decrease would procure its own remedy, for much want of people would procure greater wages and greater wages, if our laws gave encouragement, would procure us a supply of people without the charge of breeding them, as the Dutch are." *Loc. cit.*, 127.

RATIONALIZATION AND TECHNOLOGICAL UNEMPLOYMENT

In recent years British economic structure has been enriched by the incorporation into its vocabulary of two new terms of art: an incorporation of interest is significant on more than one ground. One of the other American in origin, their adoption has improved the international character of the social and economic problems of the age and to the directions whence we seek to customise ourselves to find inspiration; vague and uncertain as their content is, their use indicates a shift in the centre of gravity of economic discussion, for they relate to problems of production, and their use is thus a sign that that pre-occupation with distributional problems, beginning with Ricardo, but especially characteristic of the last quarter of a century of British economic thought, has taken a new turn. Lastly, the circumstance that widespread currency has been given to those new and alien terms in connection with the public discussion of the questions to which they relate has created an unfortunate impression that the economic life of the world is being confronted by novel, vast and mysterious problems, of a kind hitherto unknown. The problems involved are indeed of the utmost importance, but when their character is analysed, it will be found that they derive their importance more from a change of scale than from the novelty of their nature.

The phenomena to be discussed are capable, if not of exact, at least of fairly definite statement. Throughout the world a conscious process of re-organization is taking place, involving both the structure of industry and the methods of production. To this process the name of rationalization has been given. It is many-sided, but

¹ Address to Section F. of the British Association for the Advancement of Science, 1930.

among the characteristics of the rationalization process are: a greater employment of the labour force, a growing standardization of foreign markets, an increasing output, and a rising—*in some cases, even to our own increasing*—*AN* at per worker. These *ass* day wages, organizational and mechanical changes have, *th* remain, the *er* result of economizing the amount of labour, *course,* *rectly* required per unit of output, and—in *sc* Purital, *he* distribution of goods over space and time was the *ationalized*—of involving also a net reduction, *character* amount of labour required to place a unit of output, *to use* *nds of the final consumer*. Given this trend the *vages was* arises: Will not the opportunity for finding *pire attitu* t in industries subject to these processes of *chan* *form.* so undergo a change? In other words, does rationalization inevitably bring with it unemployment due *to* the technological alterations involved? If an affirmative answer is given, then *part* of the existing volume of unemployment in Germany, the United States and Great Britain is not due to causes *local* to the area concerned, such as the popular explanations that unemployment is due respectively to the gold standard or the pressure of reparations or the Wall Street slump, nor even to such *general* factors as the present fall in world prices, but must be directly ascribed to the technological or structural alterations which are taking place. Undoubtedly, if unemployment is resulting from technological changes, the social problem of dealing with it is greatly aggravated by the existence of other local and general causes of unemployment. But we are not entitled to assume that when the *local* causes making for unemployment have disappeared we shall then find ourselves with unemployment reduced to some pre-war “normal”, for there is no reason to suppose that in the immediate future the rationalization process will come to an end. *If* rationalization does cause unemployment, the post-war “normal” may be high *r,* perhaps considerably higher, than in the pre-war period. Thus, in the final analysis, we are face to face with the curious result that one of the most popular of all remedies

Unemployment may in itself be one of the causes
 of the evil for which a remedy is to be found.
 The first requisite in attempting to analyze the rela-
 tion between technical improvements and the volume
 of employment is an historical standpoint. The
 resistance to change is a permanent element in human
 society: no alteration in the structure of society or in
 its detailed economic arrangements can be made without
 some interference with vested interests. All abstract
 reasoning can teach the value of mechanical invention
 and discovery and with improved organization the
 greater part of the work of a population would
 never have been born: a science of population would
 without economy of effort phraseology may prove that
 life is possible—nevertheless, the standard of
 may be resisted, and upon German, the improvement
 consideration. The problem, in the standard of
 is one of the distribution of the gains and the sacrifices.
 No one would expect the farmer to rejoice at so bountiful
 a crop that it does not pay to cart it to market: to appre-
 ciate the significance of the law of diminishing returns is
 as important as to understand that the practice all round
 of the principle of restriction of output means lessened
 material welfare. Neither Robinson Crusoe nor a purely
 communistic State would be distressed by the problem
 which we have to discuss here. Under Crusoe economics,
 mechanical invention and improved organization would
 allow of increased consumption or increased leisure, or
 both, to the sole person interested; under a purely
 communistic régime, improved organization and technical
 progress (assuming them to be possible) would increase
 the national dividend or diminish the national expendi-
 ture of energy, or both, without necessarily making things
 worse for anyone concerned, for, ex hypothesi, goods
 would be still shared in common. In the communistic
 State rationalization might result in unemployment,
 but it would not mean, what it may mean under a régime
 of private property, a very unequal distribution of the
 gains and losses from the changes taking place—though

even in a communistic State some difference would in practice have to be made between the employed and the unemployed in order to diminish the attractiveness of leisure to the unemployed.

The progress of technique has been the characteristic feature of the Western World since the eighteenth century, but it was in the early years of the Machine Age that the problems arising out of the contemporary developments were most fully discussed by economists. For this reason the discussion of the problem of rationalization by the classical economists has a direct significance for the present age: the problem of the "Influence of Machinery upon the Condition of the Labouring Classes" which was debated by Ricardo and McCulloch, Chalmers and Babbage and Senior is in all essential respects the problem which vexes us to-day. Whatever may have been the attitude of the popularizers of economic thought, the original thinkers of the time were by no means so intoxicated with the progress of technique that they failed to see that it had its drawbacks. Ricardo, in his celebrated recantation in the chapter on Machinery in the third edition of the *Principles*, finally arrived at the conclusion that the "substitution of machinery for human labour is often very injurious to the interests of the class of labourers . . . the same cause which may increase the net revenue of the country may at the same time render the population redundant, and deteriorate the condition of the labourer";¹ and, in summing up his thought, argued roundly that "the opinion entertained by the labouring class, that the employment of machinery is frequently detrimental to their interests, is not founded on prejudice and error, but is conformable to the correct principles of political economy."² But this view,

¹ *Principles*, McCulloch's ed., p. 236.

² *op. cit.*, p. 239, cf. this with the utterances of a more modern pessimist: Capitalistic rationalization, in the absence of constantly expanding foreign markets is "driven back upon the home market: and there it defeats itself and creates around it a desolation of unemployment and human decay". Labour "deprived of its independent source of income (cf. Ricardo's "Gross Revenue") ceases to be effective in the market as a buyer, and thus defeats the aim of the reduction in costs which has been achieved". G. D. H. Cole, *The Next Ten Years*, p. 109.

though it can be only on inadequate grounds, was based by Ricardo on a reason which must be regarded as untenable. Charles Dunning, the most fervent contemporary postle of the application of scientific method to economic life, discusses the whole issue very admirably in his work *The Economy of Manufactures*. Whilst reduced prices, consequential upon the use of machinery, have a tendency to re-absorb the labour inevitably displaced, yet in order to prove "that the total quantity of labour is not diminished by the introduction of machines, we must have recourse to some other principle of our nature." This principle turns out to be the influence of the increased power to enjoy upon the desire to enjoy: "He who has habitually worked ten hours a day will employ the half-hour saved by the new machine in gratifying some other want; and as each new machine adds to these gratifications, new luxuries will open to his view, which continued enjoyment will as surely render necessary to his happiness." But this optimistic psychology of wants does not prevent Babbage from stressing, (a) the effects of new machinery in redistributing the demand for labour, so that "considerable suffering among the working classes" results, (b) the increased competition which rationalization sometimes induces among the workers, for "even though the increased demand for the article, produced by its diminished price, should speedily give occupation to all who were before employed, yet the very diminution of the skill required, would open a wider field of competition amongst the working classes themselves", (c) the difficulty in deciding whether, when improvements were made, the process of displacement should be gradual or immediate: "the suffering which arises from a quick transition is undoubtedly more intense: but it is also much less permanent than that which results from the slower process: and if the competition is perceived to be perfectly hopeless, the workman will at once set himself

¹ This and the following citations are taken from the fourth edition of the *Economy of Manufactures*, 1835, paras. 404-407.

to learn a new department some part." In the end Babbage was driven ^{State} ^{made} between every doubting tone: "That machines do ^{to} ^{not} diminish ^{their} ^{first} ^{introduction,} invariably throw human ^{our} out of employment, must be admitted; and it has been maintained, by persons very competent to form an opinion on the subject, that they never produce that effect. The solution of this question depends on facts, which unfortunately have not yet been collected", and he makes a powerful plea for further statistical information, which after the lapse of a century, one is still forced to echo.

Neither Chalmers, who believed in the doctrine of the Wage Fund, nor Senior, who did not, denied that the effect of machinery might be to increase unemployment. "It is not the true vindication", argues the former, "that the making of the machines opens so great a source of employment, that the making and working of them together take up as many hands as did the making of the commodities without the machines; for, in this case, there would be no abridgment of labour, and no advantage to master-manufacturers in setting up the machinery. And it is not a sufficient vindication, that, when an article is cheapened by machinery the demand for it is so much enlarged, as still, in spite of the abridgment in labour, to require as many, if not more, labourers for its preparation as before: for this, though true of many, perhaps most trades, is not true of all." The true defence is that "the fund, out of which wages come, is left unimpaired". Senior's general position cannot be shortly described, but he does at least admit that when the demand is inelastic, employment declines, though this is to him the exception. Citing the case of a screw which "in the manufacture of corkscrews, performed the work of fifty-nine men", he argued that this example "is as unfavourable to the effects of machinery as can be proposed: for the use of the commodity is supposed to be unable to keep up with the increased price of production, and the whole number of labourers employed

² *Political Economy*, Appendix Note B on Machinery, p. 56.

on it is, consequently finished. This, however, is a very rare occurrence. The usual effect of an increase in the facility of providing a commodity is so to increase its consumption as to occasion the employment of more, not less, labour than before."¹

The classical school had thus, by the middle of the last century, resolved the problem into its constituent parts. To enquire what conditions will rationalization involve in employment in (a) a single industry (b) in all industries taken together. Or, is there some inherent "principle of human nature" upon which reliance can be placed to solve the problem, after transitional effects have been overcome? Those were, and remain, the fundamental issues which have to be faced.

Available figures do reveal impressive improvements in production in recent years, and gain added significance when placed in juxtaposition with figures relating to employment. An increase in *per capita* and aggregate output in a single industry accompanied by a decline in the number of workers engaged does not, of course, necessarily imply the existence of any unemployment at all, since an industry normally loses a certain percentage of its workers every year, and if the rate at which new entries take place is adjusted to the new technical conditions, the consequences of technical improvements can only be judged indirectly. An increase of aggregate and *per capita* production over industry, generally accompanied by growing or stable unemployment, does, however, suggest that the rate of improvement is for the time being so great that, over the range of industry covered, the chances of employment are diminishing: though unless the unemployment returns cover the whole, or a very significant part, of the employable population, it may still be the case that, *indirectly*, the effects of rationalization are being offset, in whole or in part, by an increase in the volume of employment in the occupations not recorded in the returns. And since production figures are biased by the choice of base years, the incidence

¹ *Political Economy in Ency. Metropolitana*, 1850, p. 166.

of the trade cycle, changes in some demand for particular commodities and the likelihood between, even the co-existence of increasing aggregate output with increasing or stable unemployment is not by any means a completely valid test of the relationship between the elements in the problem.

The best advertised figures are undoubtedly those relating to the United States.¹ Put into their simplest form, the Census of Production figures show that between 1919 and 1927 (the last a year of comparative depression of trade) the number of workers in the four main divisions of American industry, viz., agriculture, mining, transport and manufacturing, declined by 7 per cent, quantitative output increased by 20 per cent, and output per worker by 30 per cent approximately. The figures adduced by Mr. Woodlief Thomas carry the same implications with them: they relate to a comparison of the years 1918-20 as base with 1924-6.²

INDEX AT BEGINNING OF PERIOD=100

	Workers.	Output.	Output per Worker.
Agriculture 1924-6	95	112½	118
Mining „ . . .	100	127	127
Manufactures „ . .	91½	128½	140½
Railways „ . .	91½	100	109
Average „ . .	93	120	129

Accurate unemployment figures for the U.S.A. do not exist: estimates exist for 1928 which vary from 1.9 millions to 2.6 millions: one estimate for 1927 was 4,000,000, whilst another authority gives an estimate

¹ Some of the material cited below has already been made use of by me in an article, "Is America Prosperous?" *Economica*, No. 28, pp. 7-8.

² Woodlief Thomas, "The Economic Significance of the Increased Efficiency of American Industry" in *American Economic Review*, Supplement, 1928.

which varies from 42,000 in 1921 to a minimum of 2,000,000 in 1927.¹

A census of production does not exist in Germany. The revised index of production recently published by the Reichsinstitut für Konjunkturforschung (Base 1928=100; consisting of thirty-one weighted industrial groups) shows that production rose from a figure of 69.5 for 1924 to 101 in 1929. In the year of rationalization, 1925, the index rose to 83.3, fell in the slump of 1926 to 79 and reached 100 in 1927. Whilst the maximum number of applications per 100 places available reached a peak at the beginning of 1926 (in the period 1924-9), and the employment situation is marked by great seasonal variations, nevertheless a competent German authority points out that in 1929 "the rise in unemployment, as compared with the previous year, practically corresponded to the increase in the number of available workers caused by the age distribution of the population. In 1929 it was thus no longer possible for industry to absorb this increment."² Some interesting figures are cited by the same authority, illustrative of the growth of efficiency in particular industries. In the Ruhr coal industry, for instance, the total number of employees declined by 10 per cent between 1913 and 1928, whilst the output per employee rose by 26 per cent. In 1929, production per employee rose another 9 per cent up to June, whilst employment fell another 2 per cent, though the monthly figures are clearly affected by seasonal changes. In another industry directly competitive with British industry, the facts are even more striking: "The index of labour efficiency in the German machine industry, using the first quarter of 1925 as a basis, averaged 142 per cent for 1929, as compared with 133 per cent for 1928, 142 per cent for 1927 and 126 per cent for 1926."³

Even in the case of Great Britain, which is generally regarded as having lagged somewhat behind in the

¹ *Recent Economic Changes in the U.S.*, 2 vols., 1929, v. Vol. II, pp. 469-78.

² *Germany's Economic Development during the Second Half of the Year 1929*, published by the Reichs-Kredit-Gesellschaft, 1930.

³ *Germany's Economic Development*, etc., p. 14.

rationalization movement, more than one piece of evidence is available which suggests an increasing productivity as one of the immediate causes of unemployment. Quite apart from the recent speeches of industrial leaders at company meetings representing such diverse products as cement, transport and rubber tyres, the production index of the London and Cambridge Economic Service, when placed in juxtaposition with the employment figures, reveals a far more rapid growth in the former than in the latter. Thus between 1924 and 1929 the combined index of production rose from 100 to 116.2: the employed population over the same period increased from some 9,500,000 to 10,020,000 persons, or some 7 per cent, whilst unemployment was greater by nearly 4 per cent. No doubt the position in Great Britain is extraordinarily difficult to weigh, since world factors of any sort unfavourable to trade and industry are likely to affect this country to a greater degree than more sheltered areas. Nevertheless, the figures do suggest a growing divergence between the movement of production and the movement of employment.

Whilst the foregoing analysis may be sufficient to establish a presumption that in recent years the process of rationalization has been responsible for the creation of part of the existing volume of unemployment; in the end one is forced back upon general economic reasoning. Three general sets of circumstances have to be examined: the motive of rationalization, the circumstances under which rationalization takes place and the methods of rationalization actually adopted.

(1) The first point is simple. The motive of rationalization is in all cases to reduce costs from the standpoint of the capitalistic producer: it is not the reduction of "real" cost or "social" cost. It may very well be the case that a process which reduces pecuniary costs from the capitalistic point of view also reduces "real" cost: a new technique may involve less actual psychic strain to the worker employed. On the other hand standardization may involve elements of social loss: a lowering of

the standard of skill or reduction of the creative and æsthetic element in work. It follows from this that whenever wage costs per unit of output form a substantial element in the price of the product per unit before rationalization, it will pay the producer to reduce that cost, if necessary, by the displacement of labour by mechanical instruments. It does *not* follow that unemployment *must* ensue, since we have still to take account of demand for the product, and of the indirect effects of the economies introduced. But unemployment *may* follow. And from this point of view it is important not to overlook the circumstance that the attractiveness of reducing wage costs per unit of output is not an absolute magnitude : it is a function of the wage cost itself and of the economies to be realized by alternative processes. Now it is at least significant that at the present time the rigidity of wage rates is a striking element of the economic situation in this country : all other prices are falling but the price of labour is not. The same is true of Germany : at least as regards unskilled labour. In 1929 "weekly wages on standard time schedules" of unskilled labour were between 75 per cent and 80 per cent above 1913 : the cost of living was only about 55 per cent above the pre-war level. In the United States, the check to immigration has given labour something like a quasi-monopoly. Under these circumstances, to economize labour as much as possible represents merely ordinary business prudence.

(2) The effect of rationalization upon the chances of employment obviously differs when the striving after economy is the result of a period of intense demand for goods and services of all kinds, or when the striving after economy represents an attempt to meet the exigencies of falling prices or of an unfavourable economic situation generally. The war period represents the first alternative, the present moment the second. During the war, rationalization was forced on because there was an insatiable demand for goods, at a time when a large proportion of the able-bodied workers of the country were

absorbed by the Army. At the present moment, when industry is suffering from a contraction of the market and when, on other grounds, there is already a surplus of labour available, the position is obviously different. Again we are not entitled to assume that unemployment must ensue, for we must again deal with the demand side before we arrive at a final conclusion, but in general it is at least clear that unemployment is *more likely* to ensue from rationalization than was the case during the war.

(3) Lastly, as regards the *methods* of rationalization. Here, of course, the task of analysis is complicated by the fact that a large variety of rationalization methods can be distinguished, the effects of which on the employment situation (even without taking demand conditions into account) may be very different.

(a) So far as so-called "Financial Rationalization" is concerned, that is, the writing down of book values and the consequential cleaning up of the balance sheet position, there is obviously no direct connection with the problem of employment at all.

(b) But financial rationalization when it means—as it increasingly does—a greater degree of integration of enterprises, does affect the employment situation directly.

When integration involves concentration of particular types of output at different works, then, in so far as different degrees and kinds of skill are involved, a problem of mobility at once arises, for grades and types of labour formerly required at more than one point are now required, perhaps, at only one point. The greater the difficulty of getting labour to move, the greater the chances that the further consequences of concentration—improved processes, eliminating the kind of labour which is difficult to obtain by substitution of another kind, or the replacement of labour by machinery—may throw a particular kind of labourer out of work altogether. At the very best one is then left with the problem of re-absorption in another direction.

(c) Standardization of types, whether occurring as a result of concentration of output at certain points within

an integrated group forming part of a wider industry, or whether occurring as a result of deliberate agreement by all the producers, for an industry, has also a direct bearing on the latter supposition, in so far as repetition of work in and of itself entails already the further use of machinery and the substitution of skilled by unskilled labour.

(d) Lastly, we are left with certain rationalization methods which have as their object not the direct cheapening of the product, but control over the market, through common sales-organizations of one or another. Their effect on the employment situation obviously turns on the price and sales policy adopted: and they thus involve the question of demand, to which we must now turn.

In considering the relations between rationalization, the market and unemployment, there is one obvious point which tends to be lost sight of in popular discussion. The degree of rationalization which "pays" is not an absolute magnitude, but depends on the "shape of the demand curve". Thus a complication is introduced through the circumstance that the point of optimum economy in production may involve a volume of output which, if it is to be sold, reduces the aggregate return below the maximum attainable if a smaller volume had been produced and marketed. In such a case—which cannot always be foreseen in advance—and given the absence of effective competition, the economies in labour cost may be eaten up by a rise in the overhead cost, and if there has been a reduction in the volume of labour directly employed, there are not necessarily any resources available by which that labour can be indirectly absorbed. The consumer pays the price which brings the maximum aggregate return. Unless this price is lower than the price previously ruling, he cannot increase his expenditure in other directions. The price need not be lower, because, though prime cost may be lower, supplementary cost, for the volume actually sold, may be so much higher as to lead to no general lowering of cost at all. In other words, rationalization undertaken on technological grounds,

without taking into account depressed conditions may not increase the aggregate national dividend and so may create an unemployment problem which it cannot solve. And we have no right to assume that the race of rationalizers never makes a mistake.

Returning now to the general problem, we necessarily employ concepts which are familiar to all students of economics.

(a) If the demand for an article has an elasticity greater than unity, a reduction in its price results in a more than proportionate increase in the quantity demanded. Thus, even in a rationalized industry, in which labour cost has been reduced, the greater the elasticity, the greater the derived demand for labour, and the greater, therefore, the opportunity for re-absorbing labour and of adding to the total quantity of labour employed. But *how much* labour will be needed, depends not only on the state of demand, but on the technical conditions in that industry.

(b) Even if the derived demand for labour in *this industry* has an elasticity of less than unity, yet provided that the demand for the product of the industry has an elasticity greater than unity, the *indirect* derived demand for labour may have an elasticity greater than unity. For the machinery and other equipment used by the industry has itself to be created by means of labour, and, if the output of the industry is expanding, it requires an expanding plant. Thus the increased demand for labour in equipment industries which marks the first stages of a rationalization movement calling for large quantities of new equipment may continue *after* the first stages have been passed. But too much must not be based upon this. For if rationalization is a continuous process, it will affect not only the industries supplying consumers' goods in the narrower sense, but also the industries subserving these industries.

Optimistic interpretations of the rationalization process will generally be found to be based upon the assumption that what is true in some cases is necessarily true in all.

The demand for certain popular luxuries is no doubt highly elastic, but it is equally clear that the demand for agricultural products, for example, is not. There is no reason whatever to suppose, therefore, that an all-round cheapening of products already available will necessarily absorb *all* the labour unemployed in consequence of technical changes, though no doubt that will be the case to some extent. But to what extent is unfortunately unknown.

Nevertheless, is it not legitimate to argue with Babbage in the passage already cited that, "as each new machine adds to these gratifications, new luxuries will open to his view" ? or with Professor Robbins,¹ that the elasticity of demand for labour in general is greater than unity ? Since rationalization reduces the quantity of labour required for the production of the existing quantum of material welfare, in other words, will it not be possible to add to that volume of material welfare ? Or must we argue with Mr. G. D. H. Cole that rationalization "might succeed in lowering substantially the cost of producing each unit of the national output : but it would only find itself unable to make use of the great new productive power of which it had become the master. For the problem of production cannot be solved unless the problem of distribution is solved with it ; and the lowering of the unit cost of production, unaccompanied by a pouring of fresh purchasing power into the pockets of the consumers, will only mean a more determined policy of restricting output and a widening circle of unemployment" ?²

But, *in the absence of falling prices due to monetary causes taking place coincidentally* (which, as we have already had occasion to point out, intensifies the employment problem) *rationalization involves an increase of the monetary purchasing power in the hands of the consumer.* So long as money incomes in general remain the same,

¹ "Economic Effects of Hours of Labour", by Prof. L. Robbins (*Economic Journal*, March 1929, p. 25).

² *The Next Ten Years*, etc., p. 116.

the margin between money incomes and expenditure goes up in those cases in which the elasticity of demand for products of the rationalized industries is less than unity: or the cheapening of the articles results in a larger aggregate consumption of them, or, if the articles in question are subject to quasi-monopolistic conditions, the same amount is spent on them as before, but profits in the industries producing them increase, and larger profits mean additional purchasing power in the hands of entrepreneurs. The problem as stated by Mr. G. D. H. Cole is not the real problem at all: (the real problem is: what use will "consumers" make of the margin of purchasing power now available as a consequence of rationalization?)

If the answer to this question is that consumers will devote it to the satisfaction of new wants, then it will be true that in the long run rationalization will not involve unemployment. But the run may be a very long one: not only because a transfer problem is involved, but because the newer industries themselves will not in all probability require as much labour as they might have, had not the whole atmosphere of industry been impregnated with the rationalization spirit. From this point of view, an increase in the demand for those personal services which are least affected by the progress of mechanical improvement will help to solve the problem more easily than a demand for goods the production of which requires the direct application of labour to a smaller extent. The growth of the "service industries" in the United States has been expressly adverted to by the very able group of American economists who last year published their *Survey of the developments of the last decade in the United States*.²

But consumers *need* not devote their available resources to the satisfaction of new wants. They may decide to "hoard" their savings in the technical sense described by Mr. D. H. Robertson in his *Banking Policy and the Price Level*: or, in other words, they may desire to keep more of their resources in a liquid form. If

² *Recent Economic Changes*, vol. I. p. xvi.

this hoarding takes place on a large scale a cumulative pressure is exerted on the price level, and the difficulty of absorbing labour is *ipso facto* increased. In the ceaseless combat waged in the human mind between the desire for greater gratification on the one hand and the desire for greater security in the shape of holding free resources on the other, it is not at all times true that it is the former passion which gains the upper hand. At the present moment it would appear as if the desire to abstain from additional consumption were more important than the critics of current standards of consumption would be prepared to admit.

However that may be, the problem of transfer that is in any case involved is one of sufficient difficulty. Contrary to general opinion, even in countries like the United States, with a high degree of labour mobility, transfer may involve not only considerable loss to the individual but also considerable delay in point of time: as appears from an interesting piece of evidence presented by the Brookings Institute of Economics to the United States Senate Committee on Education and Labour in the course of their investigation of unemployment in the United States in 1928-9.¹

¹ *Summary of Testimony and Report of Institute of Economics of the Brookings Institution* by Isidor Lubin, documented, p. 500-1:—

"An investigation recently made by the Institute of Economics of the Brookings Institution reveals that most of the displaced workers have great difficulty in finding new lines of employment once they are discharged. A survey of some 800 workers in three industrial centres revealed that the newer industries are not absorbing the jobless as fast as is usually believed.

"Almost one-half of the workers who were known to have been discharged by certain firms because of curtailment in employment during the year preceding were still without jobs when interviewed by Institute of Economics investigators. Of those still unemployed over 8 per cent had been out of work for a year, and about one-half had been idle for more than three months. Among those who had succeeded in finding work, some had had to search for jobs for over a year before finally being placed. More than one-half of those who had found jobs had been in enforced idleness for more than three months before finding employment. Only 10 per cent had been successful in finding new jobs within a month after discharge.

"The new jobs, moreover, were usually secured at a sacrifice in earnings. Some workers, to be sure, were fortunate enough to find employment which paid higher wages, as was made evident by the fact that about one-fifth of them were making more money on their new jobs than before discharge. Forty-eight per cent, however, were receiving lower wages and about one-third were earning just about the same amount as they formerly did.

[continued

We have now arrived at the point at which it is necessary to apply the foregoing analysis in a more directly practical manner.

(1) Since the rationalization movement is international in character, and, since it undoubtedly results in most cases in a reduction of cost per unit of output, no single country engaged in international trade under competitive conditions can hope to contract out of its consequences, good and bad, except at the expense of its international trade. This is in itself a sufficient reason for pushing ahead with rationalization in this country.

(2) In the short run, rationalization is not a remedy for unemployment but, on the contrary, is itself a factor in making for unemployment, except to the extent that it stimulates demand in the constructional and equipment industries. But since a loss of markets due to progressive reductions in prices by rationalized industries in other countries also adds to the volume of unemployment in this country, the short run evil of unemployment in this country changes in character, rather than grows in volume. Industries are in part depressed because local costs of production are too high and unemployment ensues. Rationalization reduces costs but, until the lower costs have helped the industries in question to regain their market, *and expand it*, unemployment will remain. But unemployment resulting from rationalization is a lesser evil than unemployment resulting from relative inefficiency.

(3) In the long run, since rationalization effects a lowering of real costs, then, given a desire for a rising

"And what kind of jobs did these men finally secure? Trained clothing cutters with years of experience had become gasoline station attendants, watchmen in warehouses, timekeepers in steel plants, and clerks in meat markets. Rotary press operators were pressing clothes in tailor shops. Machinists were selling hosiery for mail-order houses. Welding machine operators were mixing salves for patent medicine manufacturers. A significant number of men admitted frankly that after some months of enforced loafing they had taken to bootlegging.

"It is evident that a large number of the workers now being displaced from industry are being forced into unskilled trades at a sacrifice in earnings and a consequent lowering of their standards of living. At the same time they are being made to bear the burden of unemployment, for which they are in no way responsible and over which they have no control."

standard of life, there is no reason to suppose that the volume of unemployment will not again fall. But, in the absence of any definite knowledge of the elasticities of demand for different products, we cannot foretell in what directions an increased demand for labour will manifest itself. Both American and British experience would seem to show that the demand for labour in the existing body of industries is likely to shrink, absolutely in relation to the population, relatively in relation to the output : whilst every increase in the technical knowledge available to industry will make the demand for labour in relation to output smaller in the new industries, the rise of which we have every reason to suppose (to judge from past experience) will accompany reductions in real costs in the existing industries. Thus the occupied population in the future is likely to be less "industrialized" than in the immediate past : and the growth of trades and occupations outside the narrow concept of "industry" will continue as rationalization proceeds.

(4) The most optimistic view of the situation must take into account the fact that a grave transfer problem is involved, and that monetary and other circumstances having nothing directly to do with the rationalization problem may accentuate the difficulties of transition. The first and most obvious step in the direction of ameliorative measures must therefore be an increase in the mobility of the working population.

(5) In estimating the probable duration of unemployment resulting from rationalization, account has to be taken, not only of the state of technical knowledge, but of the movement of the population. Since rationalization produces its most striking results when the aggregate demand for a product continually increases, a stationary population (and the most advanced nations are tending to stationariness of population), places a limit to the expansion of output in each of the several directions in which the economies of large scale production are most strikingly displayed. At the same time the decline in the number of new entrants into industry, which is to be

expected over the next few years, will diminish the immediate pressure. But it is quite possible that the normal level of unemployment will be higher in the future than in the past; in which case, unemployment will cease to serve as an index of material well-being. The paradox of a rising standard of life with a higher level of unemployment may well be the result of the present tendency in industry.

(6) On the other hand, there are not wanting examples to show that demands for new products and services can be stimulated very quickly, provided they are sufficiently cheap: and there is therefore no reason to fear that we shall all "starve in the midst of plenty". What has been true of the motor cycle, the motor car, the gramophone, the radio, artificial silk, the cinema, the popular press, books, travel facilities, greyhound racing and the rest will surely also be true of the future. No doubt we shall have to give up the belief that "national power" is to be measured by a high percentage of occupied persons in a few "staple industries": but just as we no longer think of measuring our "national power" in terms of agricultural output, so we shall gradually see that those countries which have the highest standards of life *ought* to be those employing the largest proportion of their populations in the supply of "luxuries". All that stands in the way are economic and ethical standards no longer appropriate to the tendencies at work.

(7) There is an obvious relationship between the progress of rationalization on the one hand, and the possibilities of a shorter working day and higher earnings from labour on the other. The rise in the standard of living and the shorter working hours which have characterized the progress of industry in the last hundred years were both conditioned by increased productivity: though it may be true that, unless Labour's demands had been made, the spur to further invention and discovery might have been in part lacking. But at any given moment a balance must be struck between the demand for higher earnings and the demand for more leisure, for, if both

demands are pushed to such an extreme that, if either were granted, the whole benefit of increased productive power would be exhausted, then the grant of the one excludes the grant of the other : and if *both* were, under these conditions, *simultaneously* asked for and granted, a new disequilibrium of costs and prices would be set up which would inevitably cause a new wave of unemployment until further advances in technique and organization had been achieved.

A shorter working day and higher wage rates are, of course, frequently defended, not on the legitimate ground that society can afford them with increasing productive powers, but on the ground that they are *direct* means for reducing unemployment, because they "spread work" and stabilize "working class purchasing power". Unless accompanied by increasing productivity, however, they are incapable of achieving these results : for a shorter working day without a larger output would either involve lower wages or rising costs per unit : and rising money wages without increasing productivity would also result in disequilibrium. But given increasing productive powers, it is possible to lower prices to the consumer and pay the same wages as before for a shorter day or, with the same lower cost to the consumer, pay a higher wage for the same working day. Growing productivity, in fact, gives society a margin to "play with", and this margin is the source out of which unemployment can be relieved. But we have no right to assume that the process works without friction or that the fears of the workers are based entirely on "prejudice and error". In the end, one must rest one's hopes on the known elasticity and responsiveness of capitalistic society : an organization which was capable of surviving the shocks of the war and post-war period is hardly likely to perish because it is learning to turn the arts of production to still better use in the future than it did during the last one hundred and fifty years.

UNEMPLOYED MEN, UNEMPLOYED MONEY¹

Two features of the present crisis puzzle the general public. The first is related to the *external* situation of Great Britain; how it is possible that relative stability of the internal price level should co-exist with a falling dollar-sterling rate of exchange? The second is related to the *internal* situation of the country; it is the co-existence, on the one hand, of unemployment upon a great scale, correlated to under-employment of existing plant and machinery and the accumulation of stocks of raw material, and, on the other, a situation in the money market characterized by a low yield upon gilt-edged securities and low levels of rates for the use of short term money in the open market. In what sense is the first series of phenomena—the economic factors in the situation—related to the second—the monetary factors in the situation? Can it be assumed that it is the “unemployed money” which is the cause of the unemployment of the technical means of production? And supposing that the chain of causation runs from money towards goods, employment and better trade, what is the precise mechanism by which the motive force can be harnessed to the machine which it is intended to operate?

It is desirable first of all to clear the ground of certain popular fallacies. During the first two years of the present depression, public opinion was inclined to attribute the prolongation of the crisis to the insufficiency of the *absolute volume of credit*: all would be well if only the volume of deposits could be increased. In the past ten months, during which the volume of bank deposits has shown an uninterrupted rise, less has been heard of this particular complaint. This is not surprising, in view of the fact that while the deposits of the nine clearing

¹ Reprinted from the *Westminster Bank Review*, December 1932.

banks have risen from a minimum of £1,621,000,000 in February to £1,859,000,000 in November, unemployment has shown no marked sign of decreasing. In place of this complaint there has arisen another—that there are “unused millions” in the banks of the country, which the bankers are unwilling to utilize. In fact, it is not uncommon to find the existence of low rates being quoted as a justification for the presumed existence of the unused millions, and the unused millions then being used as a justification of the low rates of interest now ruling in the open market. To proceed along this line is, of course, merely to argue in a circle. There is a sense in which it is true that the position of open market rates is connected with the general banking situation and particularly with the volume of deposits held by the banks at any moment. This inter-connection, however, does not lead to the inference that there is any unused money lying idle in the banks. The ultimate explanation of the prevalence of the belief in the unused millions awaiting employment in the banks of the country to-day lies in the circumstance that in recent discussions in professional economic and other circles much use has been made of the concept of “hoarding”, and much has been heard of the hoarding of money in America and elsewhere. It is important to note, however, that the prevalence of a desire to hoard does not by any means involve any actual surplus of funds (in the sense of unused funds) in the coffers of the banks. It is not even true that a desire to hoard on the part of the public involves any absolute increase in the volume of currency in the hands of the public, if one is thinking of a rather simpler stage of the same phenomenon.

Suppose that there is a community in which there circulates ten millions of inconvertible currency units which for special reasons cannot be increased: they will not be diminished, because no one is willing to sacrifice purchasing power. What would hoarding in such a community imply? Not that the actual supply of units had either increased or diminished, but only that those individuals into whose possession they had last come were

unwilling to part with them. At any particular moment of time the units must be in the possession of someone : hoarding, under these conditions, simply implies a general unwillingness to get rid of stocks of currency, i.e., to spend money, and that those whose stock is larger than it usually is will not reduce it to the normal amount. This, of course, also means that those whose stock is less than normal, if they desire to hoard, must try to tempt those with more than normal stocks to sacrifice part of them by the offer of goods and services at increasingly attractive prices. The test of whether hoarding (that is, holding purchasing power rather than holding goods or enjoying services) is going on or not is to be found in the behaviour of the price level, not in the increase or decrease of the total stock of the " money " of the community.

What are the consequences of the desire to hoard when there is a banking system ? Sometimes, as in the case of the United States in the early part of this year, hoarding may be combined with an intense distrust of the banks. In that case, there will be both an increase in the cash holdings of the public and a reduction of the deposits of the banking system ; for the cash holdings of the public will have been acquired from the banks through a reduction of their deposit balances. Assuming, however, that no such distrust of the banking system exists, a legitimate assumption in the case of Great Britain, how does the process then work out ?

So far as individual depositors are concerned, the problem is relatively simple. The income of individuals depends upon the expenditure of others, including under " others " governments and municipal bodies, whose income is derived in the main from taxation, and quasi-public bodies, whose income, like that of rentiers, depends upon the ownership of securities or property of one kind or another. Hence, if there is a general desire to hoard, that is, to reduce expenditure, there will be some individuals whose expenditure falls faster than their income, some whose income and expenditure fall *pari passu*, and some whose income falls faster than their expenditure.

Compared with their former position, the first class will have more deposits, the last less deposits and the second class the same deposits.

The problem, so far as the banking system as a whole is concerned, is much more complicated, for the effect of borrowing has to be considered. The amount which banks can lend must be distinguished from the amounts which individuals, concerns or governments are desirous of borrowing. The lending capacity of the banking system as a whole is immediately increased by a rise in the volume of its cash reserve; the *desire* to lend is conditioned by the desire to earn a profit. In so far as the banks are concerned, therefore, there will never be any funds "unemployed", for any increase in the margin of idle cash would at once result in loss of profits. If the non-governmental class of borrowers be taken into account, and if there is a general desire to hoard, *some* borrowers will cease to borrow as much as they did before. For a reduction of expenditure by consumers will cause the volume of sales to diminish, and of those who furnished the goods some will therefore need to borrow less. As the proceeds of sales come in they will be used to repay previous loans, and fewer new loans will be contracted. Other firms will find themselves unable to sell the output for the manufacture of which they have taken loans. Others, again, whose operations at the beginning were in part or in whole financed from their own resources, must now have recourse to loans to complete their operations. How far these various special situations affect the aggregate volume of deposits is a very difficult problem, for the loans of one manufacturer may affect the cash deposits of another, owing to the fact that the loans of the first are drawn out in wages and may percolate through retailers to the second. But repayment of loans will, on balance, reduce aggregate deposits: maintenance of loans will, on balance, maintain deposits: fresh borrowing will increase deposits.

The problem for the banking system is to reconcile the desire to add to balances (i.e., to "hoard") with these

various tendencies to repay loans or to borrow afresh. The incomes of individuals, in so far as they are derived from the operations of the industrial system, either accrue to them in consequence of expenditure out of the net income of other individuals or are due to the borrowing of others. On the other hand, the borrowing of particular individuals and firms may be in anticipation of a demand which, even though hoarding is taking place, will eventually be forthcoming: or they may be borrowing because the demand which they anticipated is *not* forthcoming. Given a fixed ratio of cash to liabilities, then it appears clear that if, on balance, hoarding predominates over expenditure, this very fact will cause an amount of borrowing in some form from the banks equal to the predominance of non-spending over spending. For, if some individuals are to go on receiving income in excess of what they spend, that is, are building up balances in an increasing degree, it must follow that others spend in excess of what they are receiving. This implies borrowing, and the desire of the banking system to employ funds to the maximum will permit of this borrowing.

It makes no difference, from this point of view, whether the borrowing is done by business firms or by government. Abstention from expenditure results directly and indirectly both in a loss of revenue to business firms and in a loss of revenue to government. If a government borrows in order to maintain a given rate of expenditure, that expenditure simply makes it less necessary for some business firms to borrow, for that expenditure is itself the basis of income to business firms or others. If business borrows in order to maintain output, that in itself sustains government revenue to some extent. An addition to the volume of governmental borrowing does not mean that business is "starved" of loans; it may simply mean that business requires to borrow less.

If the desire to hoard takes the form of attempting to sell investments in order to retain the proceeds in cash, how does this desire affect the volume of bank deposits? If A sells to B, the total volume of deposits

will be unaffected ; all that will happen will be a transfer of securities from A to B and a transfer of deposits from B to A. If one supposes, however, a *cumulative* process of this kind going on, it is the purchases of the banks which enable the volume of deposits to be sustained, for if the depression deepens and industrial activity declines, that is, if *on balance* less is borrowed, the banks find themselves with a smaller day-to-day drain on their cash reserve and are consequently in a position to add to their investments. An industrial depression results in a reduction in the actual currency in circulation, and this would produce a larger ratio of cash to liabilities by the banks unless they took steps to correct the position. This they can do by buying securities ; and such purchases allow the public to hold the proceeds of the sales of securities in a liquid form.

It follows from all that has been said that the desire to hoard or, in other words, the abstention from expenditure which is characteristic of a prolonged depression, does not result in unused millions lying idle in the banks. The desire to hoard is substantially a desire to add to the deposits of the public with the banks ; but this desire could not be *generally* satisfied unless the banks continued to lend and to buy securities. There *are* no unused millions in the sense that there would be unused stocks of cash if hoarding resulted in an actually increased holding of currency notes by the public. To enable the public to hoard, an active policy of lending and investing by the banks is necessary. The tangible results of a trade depression are to be found, not in the existence of "surplus deposits", but in (a) a growth of time deposits as against current account deposits, (b) a decline in the volume of industrial and other advances, and (c) an increase in the security holdings of the banks, just as an improvement in trade conditions would result in an opposite trend, so far as these indices are concerned.

The discussion so far has taken no account of the possibility that the cash reserve of the banks might alter, but has been concerned solely with the attempt

to dispose of a misunderstanding of the ultimate factors in the situation. In recent months, however, there has been a considerable increase in the aggregate volume of deposits; an increase which is associated with an increase in the volume of bankers' deposits at the Bank of England, and with a small decline in the percentage ratio of cash to deposits at the Clearing Banks, a movement which in itself allows of some expansion in the loans and investments of the banks as a whole. The relevant figures are as follows:—

	Bankers' Deposits-at the Bank of England	Nine Clearing Banks			
		Deposits	Discounts	Advances	Investments
February 1932	70	1,621	205	888	264
November 1932	86	1,859	389	770	409

(All figures in £ millions)

The fact that a rise of £238,000,000 in the volume of deposits should have coincided with an advance of £329,000,000 in Discounts and Investments and a fall of £118,000,000 in the volume of Advances has naturally given rise to much discussion. Would not the industrial situation have been much improved if, instead of the increase in the volume of deposits being associated with a fall in the volume of advances, it had been accompanied by a rise? This point, it should be noted, has nothing to do with the issue already discussed, which was concerned with the question of the relationship between deposits as a whole and the aggregate earning assets of the banks. The problem now under discussion is connected with the particular directions in which the increased resources of the banking system as a whole have been invested.

It must be remarked, in the first instance, that, so far as the self-interest of the banking system is concerned, the directions in which these increased resources have been invested are not those which would bring in the maximum rate of return; for the yield upon the increased holdings of short- and long-dated securities is considerably less

than it would have been if the same amount had been invested in loans and overdrafts. It is true that the public has an exaggerated idea of the extent to which the earning capacity of the banking system is influenced by the "differentials" between the yield on investments and the yield on loans, for the evidence before the Macmillan Committee makes it clear that there is more elasticity in the minimum loan charges of the banking system than is always realized (*Evidence*, vol. I, Questions 2435-2439). Nevertheless, at the present time the actual volume of loans and advances is considerably below the figure which would correspond to the normal proportion of funds invested in this way under post-war conditions. (The ratio of advances to deposits in past months has been well under 45 per cent as compared with a range of 50 to 54 per cent in recent years.) No doubt this post-war proportion was regarded as somewhat high and, in any case, considerations of prudence might dictate a rather lower proportion during a trade depression, but the degree in which the proportion has now actually fallen is much in excess of the fall which might have been expected on either of these grounds.

It is inevitable that the first effect of an increase in the volume of resources at the command of the banking system should result in some expansion of the volume of investments and this is a normal feature of the banking situation. The nature of the problem was explained by the Macmillan Committee (Para. 85 of the *Report*): "A bank has each day to take a view of its general cash position. Loans and advances are constantly being granted and repaid, bills mature every day and investments are being repaid at intervals. If the result of these day-to-day changes is to show an increase in the cash balance relative to deposits, the bank has to find means of employing its surplus resources at a profit. Its aim ultimately is to distribute its assets in the normal proportions, but it cannot . . . at once expand advances to its customers since it is dependent upon the volume and quality of applications made by would-be borrowers.

In the first place, therefore, the bank finds an outlet for its surplus cash, either by lending money to the market or by buying bills or investments. The choice will be dependent largely upon the view taken by the bank as to the liquidity of its position, the nature of the demands which it anticipates in the early future and the relative profitableness of each type of transaction. The natural outlet in the first instance is, however, the grant of additional loans to the bill market." The international trade depression has, of course, reduced the supply of bills based upon the movement of goods and has thus, since the cash resources of the banks have increased considerably, forced upon them an immediate increase in their holdings of Treasury Bills and fixed-interest securities. So long, however, as the amount actually lent to business and industry falls far short of the amount normally advanced, the initial use of additional resources in the bill and securities markets is no evidence that, if an additional demand for loans and advances were forthcoming, the banks would be unwilling or unable to extend the accommodation required. The function of the bill and securities markets is to "take up the slack": these specialized markets are the first to feel the impact of additional resources accruing to the banks, and the first also to feel the result of additional requirements on the part of industrial and business borrowers. In so far as a recovery in the volume of industrial activity depends upon confidence that additional banking accommodation, if desired, is available, then there is certainly nothing in the present banking situation calculated to impede recovery. In any event, even if the banks were disinclined to extend the volume of accommodation comprised under the head of Loans and Advances, this would by no means constitute a definitive obstacle to the growth of aggregate accommodation to business generally. The low level of rates ruling in the discount market is in itself an encouragement to the drawing of bills based upon trade transactions, though the *initiative* in this case, as in the case of loans and advances, must lie with the business world itself.

From the standpoint of the industrialist, the problem of industrial recovery lies in the direction of reviving demand; and the juxtaposition of "unemployed men, unemployed money" is only a popular rendering of a view which has gained wide acceptance, namely, that the problem of reviving demand is *primarily* a problem of monetary policy. The trade cycle, it is urged, is "purely a monetary phenomenon". But the view that monetary policy in the long run governs economic activity, even if true, is by no means inconsistent with the view that the demand for banking credit of a *particular kind* may itself be a function of the general industrial situation, though that general situation is dominated, in its turn, by monetary policy. The amount of short-term accommodation required by business men moves with the general business situation, and when the general situation is depressed the recovery tends to take place along the line of increasing the volume of capital investment, for, as is now fairly generally known, it is the constructional and capital producing industries which feel the depression most all over the world. A policy of cheap money and expanding cash resources which allows a rise in the price of fixed-interest bearing securities may be a prior condition of the flotation of new securities, the proceeds from which are used to initiate new capital enterprises. The initiation of such enterprises represents, on the economic side, a growth in the activity of the heavy industries, resulting in a fall of unemployment and, therefore, in an increase in the aggregate volume of consumption of the products of the industries manufacturing consumption goods. Short-term credit may expand in anticipation of new capital loans being subsequently obtained, but the prior condition of such an expansion is clearly the state of public confidence, which is itself largely influenced by the falling yield on existing securities and the rise in their capital value which is the cause of such yields. Even if monetary policy thus *ultimately* governs the situation, it must be recognized that the time-lag involved may be a very serious one. A whole complex of

circumstances has in the past few years conspired to shake public confidence in an unusual degree; the influence of monetary policy has been at times of quite subordinate importance. A long spell of convalescence is required before cheap money can exert its normal influence, and so far from the sick body of world industry having been given its required period of rest, it has in the past few weeks been subjected to new difficulties in the shape of uncertainties over international debts—a foretaste of the problems which may arise in the sphere of budgetary policy before many months are over.

AN ECONOMIST LOOKS AT PLANNING¹

I

To plan is to adjust means to ends : and any individual whose mental horizon extends beyond the mere satisfaction of momentary wants, who thinks of to-morrow as well as of to-day, must necessarily subordinate his impulses, the co-ordinated raw material of action, to some kind of order. He must choose between this and that, between the nearer and the more remote in time, the greater and the smaller satisfaction, the more or the less urgent need, the ethically more or less desirable. Planning and rational action are in fact identical : and without a measure of rationality neither individuals nor societies of individuals could possibly persist. Property in the sense of ownership rights, and capital in the sense of apparatus of every degree of simplicity or complexity, are the legal and the economic embodiments of purposes and of the means to their satisfaction, and property and capital in some form are as old as civilization itself. Why is it, then, that Economic Planning should represent of all the slogans of the last two decades that latest in point of time and the most universal in its appeal ? Planning has won assent from the diehards of the right and from the revolutionaries of the left, and its victims, as befits a conflict fought with religious fervour, can already be numbered by thousands. (In the name of Planning the Soviet has exterminated the Russian bourgeoisie and bourgeois Germany appears on the point of exterminating the German Communists ; in the name of Planning, also, Great Britain is in process of reversing the policy of three-quarters of a century and is subordinating the interests of the urban majority to the agrarian minority. The truth is that Economic

¹ Originally read before the Manchester University Ethical Society in the autumn of 1932. Printed in *The Manchester School*, June 1933.

Planning involves something more than the mere adjustment of means to ends, it involves also the *conscious choice of ends*) and the problems which it involves relate therefore both to the ends it is proposed to further and the means by which they are to be reached. Economic Planning is a duality, then, of means and ends. It is this duality which gives it its fascination, it is this duality also which in the end will prove fatal to it.

It is characteristic of all great movements which capture the minds of masses of men that though their objectives can be stated in rational terms, they are carried to fruition by the emotions and the will more than by the intellect. In what hidden sources of emotion is one to find the secret of the astonishing ease with which the idea of Economic Planning is gaining ground in such diverse quarters? These sources are many: some of them are intrinsically admirable, others are perhaps less praiseworthy, and for that very reason have received less attention than they deserve as explanations of the popularity of the movement now under examination.

II

There are two varieties of human temperament especially prone to be attracted by the idea of a planned economy, the constructive and the meddlesome. Mr. H. G. Wells has made the world familiar with the first type in a whole series of brilliant portrait studies. He himself, one imagines, is of this type—scientifically trained, impatient of the crudities and superficial follies of the economic and legal systems, contemptuous of moneymaking, single-minded, lovers of manipulation, whether of machinery, materials or systems and organization. They think of the world in terms of the laboratory, they love the controlled experiment, the orderliness and clean simplicity of applied science. Men of this temperament have contributed enormously to the making of the modern world. From all that one can glimpse of Russia it is men like these who are the real heroes of the

revolution, technicians creating a new civilization in their own image. The other type is intrinsically a good deal less admirable ; but do we not all know the man or woman who is only happy when they are interfering with other people ? The essence of planning is that it involves a plan, and a plan involves order, subordination, interference, power. For that very reason the idea of planning appeals to those to whom the existing order of things represents chaos, anarchy, licence, competition—they itch to have a finger in the pie ; they cannot forget the war and the scope which it gave for the satisfaction of the desire to assert oneself at the expense of others ; it is less the virtues of the plan than the opportunities which it affords of the exercise of power which attracts men of this type. It is, of course, part of the fashionable cant of the age to deny that motives of this kind are significant. All planners, it appears, are public-spirited individuals in contrast to the sordid self-seekers of the economic world ; but if, as Adam Smith asserted, one should be suspicious of traders who profess only the public good, one should also have enough sense of humour to realize that not all professed planners are insensible to the private advantage which would accrue to them if the fates prove kind, and they among mankind are chosen to lead us to the Promised Land. I think that when one is investigating the underlying strength and weaknesses of a world-wide movement, politeness is out of place. *Some* part of the attractiveness of planning to *some* people lies in the opportunities it affords for the exercise of power, and to exercise power is sweet to some, perhaps a very large number of individuals. Those whose desire to exercise authority is partly or wholly frustrated by the present order must inevitably desire to see a change of system.

The mass of men, no doubt, are neither moved by the desire to wield influence nor by the desire to create ; they desire happiness, security, excitement—perhaps, above all, security in middle and old age and excitement in youth. Since Economic Planning represents at

present more an aspiration than a reality, it is not difficult to understand its appeal even to the average of men and women. To the young it represents excitement; to the others it represents, or can be made to represent, security); nor need one be cynical in writing this. The same combination of generous sympathy for the wrongs of others and the desire to eradicate existing evils, together with the sense that one is participating in great events, which constitutes political excitement, and which once led the younger generation to support Radicalism or Free Trade or Fabian Socialism, now leads them to worship at the shrine of Planning. The same fears and the same hopes, the same evils and the same preoccupations which once made socialists or syndicalists of the working classes, now urge them to support the Planned Economy. And the events of the last two decades are sufficiently disconcerting to make the ideal of security in itself overwhelmingly attractive—no more unemployment, no more competition, no more worry! If only the right plan is found! The wonder is not that these new currents of thought should have found supporters, but that they should not have found more.

We have to deal, then, with a movement of ideas which can draw support from two distinct (and perhaps very representative) types of temperament, which can appeal to generous and human and understandable urges and emotions, which, on the intellectual side, can contrast the evils, the terrors and the uncertainties of the times with its own promise of greater control of human destiny and human happiness. Before one can deal with the intrinsic merits and demerits of planning, however, we must examine its relation to the two great systems of thought with which it is confronted: its relation to capitalism and to socialism.

III

The essence of capitalism is that it embodies an order but does not conform to a conscious plan in the sense that there is one unique and single determinable end, to

which the arrangements of the economic order are subordinated. Economic society under conditions of capitalism is planless in this sense, but it does not follow that it is either irrational or chaotic—the two charges usually brought against it by supporters of a planned economy—nor that it prevents forethought, or the adjustment of specific means to specific ends. But it is true that the ends are constantly changing and that the means to any given end exist solely upon sufferance; even if the end remains unchanged, the choice of means is determined upon the basis of relative efficiency, in other words upon the basis of *economy*.

Now that the capitalistic system is clearly being everywhere challenged, it is easier than it ever was before to see precisely what its strong points are, for it is these very features which cause it to be attacked and may in the end result in its overturn. The so-called "irrationality" of capitalism results from the freedom of choice which is permitted to the consumer, and the wants of the consumer alter from time to time, whilst it is a fundamental condition of production in anticipation of demand that investment must take place before demand has manifested itself. In this way some investment will prove to have been abortive; on the other hand, some demands will not be satisfied to the full. If only consumers could be forced to take what was available! How much less wasteful, how much less harassing for the totality of producers! Again, under capitalistic conditions the satisfaction of the demand is left to the competitive efforts of producers, some of which are more efficient than others, whilst at the same time the technique by which given wants are satisfied is constantly altering under the spur of new invention and discovery. It is, of course, true that new inventions are largely (by no means universally) the work of scientists who are not themselves business men, that business men merely "exploit" the discoveries of others and that there seems at first sight no reason why invention and discovery should not proceed with even greater rapidity under

some other system of industrial organization. Those who argue in this way and who actually make it a cause of complaint against capitalistic production that it does not use new inventions *quickly enough* are singularly obtuse. They overlook that it is just the chances of increased gain through the substitution of one process for another which cause new inventions to be taken up; and that it is the competition of product with product and of process with process which constitutes the economic chaos of which they complain. If it is true that under alternative systems of organizing production the same rapidity of change in process and the same freedom of choice to the consumer will be present as under capitalism, it is certain that any such alternative system will exhibit the same characteristics of mistaken judgment occasionally causing a waste of resources and of alternative methods of production resulting in a conflict between producing authorities and organizations. Either there is freedom of choice, or regimentation of the consumer: freedom to make use of the most economical method, as judged from the standpoint of profit or loss, or there is authoritative regulation of the methods of production. Each of these alternatives excludes the other. To have both planning and freedom, regulation and perfect elasticity of organization and technique is an impossibility.

The difficulty of reconciling capitalism and planning may be judged by the mistakes committed in the last ten years in consequence of the enthusiastic acceptance by certain classes of business men in all countries of the doctrine of rationalization. Rationalization, in its essence, is nothing but the idea of a Planned Capitalism: and, though little has been heard of it since the world depression began, it is instructive to investigate the secret of its comparative failure. The essential fact of a market economy was discovered in the earliest days of the industrial revolution by Adam Smith: it is that the division of labour is limited by the extent of the market. The appropriate scale of production, and therefore the

appropriate scale of organization, is not a matter to be decided upon by considering merely the technical possibilities of the situation. In other words, what has caused so many rationalization projects to fail, that is to disappoint from the financial point of view, has been the neglect of the distinction between the *technical optimum* and the *economic optimum*: and the neglect of this distinction is peculiarly liable to occur when the direction of economic enterprise passes out of the hands of those trained to think in terms of the market into those trained to think in terms of the process subsidiary to the output of a certain product or service. No doubt, in certain cases, the market may grow up in course of time so as to absorb the output produced by the plant, which is technically at the optimum size: no doubt, also, in certain cases, the technical plant is not infinitely divisible, so that either a certain scale of output has to be provided for, or the product will not be produced at all. There are mitigating circumstances: the fact remains that the rationalized undertakings of the era 1922-9, with their enormous overhead investment, their centralization of initiative and authority, their greater ability to monopolize the market and to buy on the most favourable terms, have not shown themselves conspicuously more successful than the non-rationalized undertakings. They have lacked *adaptability* and *elasticity* and, for my own part, I believe we shall witness a less blind worship of size and authority and monopoly in business for some time to come—unless, indeed, the whole process of economic adjustment of scale of output to demand is to be permanently prevented by the intervention of the state.

IV

Socialism involves, in the first instance, nothing except the collective ownership of the "means of production, distribution and exchange". It would be possible to imagine a collectivist society permitting

absolutely free choice to the consumer and, as a consequence, submitting to the inevitable margin of wastage involved in producing in anticipation of demands which might not materialize. Moreover, such a society might also agree to the factors of production being distributed among the various enterprises, in accordance with the prices offered by those in charge of such undertakings. The only difference between our present arrangements and those which would obtain under the conditions imagined would be that profits would accrue to the undertaking, considered as a legal person, and not to the individual owners who, under existing arrangements, are the residuary beneficiaries. Under the state of affairs imagined, there would be competition among the state enterprises for the attraction of consumers' demand and competition among them for the use of the factors of production (including capital: so that the rate of interest would still be of importance as a guide). But, since such a state of affairs would clearly involve exactly those features of the existing order (other than the mere ownership of property) which are most frequently the object of collectivist attack, it is not probable that a socialist society would be content with the collectivization of ownership: in practice socialism involves planning, though it does not necessarily follow that all kinds of planning must necessarily result in socialization of the "means of production, distribution and exchange". Apart from the sadistic desire to destroy the rich because they are rich, the desire, in other words, to enjoy what Alexander Bain called "the pleasures of malevolence",¹ what conceivable object could there be in a collective ownership of the instruments of production etc., *unless* thereby the directive principles of society were altered? It is important to realize that I am *not* urging that the motives of socialists are intrinsically bad, but only that socialists would have no motives, other than intrinsically

¹ It might have required some apology a few years ago to introduce such a concept into a serious discussion of the tendencies of the age. Let anyone who doubts the strength of such motives study the attacks on the Russian Kulak and the Russian middle-class and the present orgy of sadism in Germany against Jews and "Marxists".

questionable ones, *unless* the scheme of society which they desired involved something above and beyond the mere collectivization of the instruments of production, etc. That "something", whatever it is, the realization of a greater measure of distributive equality, for instance, or the elimination of "chaos" or "waste" in the productive process, or the emancipation of the productive process from the "tyranny of the price system" or the substitution of "socially desirable" investment for "good security" as the ideal by which the banking system is to be guided involves planning. In this respect, no doubt, the neo-Marxians have gone beyond the teaching of the prophet. Marx ends with the "expropriation of the expropriators", and, as is well known, refused to write the "kitchen recipes" of the future. But, though the strength of socialism as a political force may be owing more to dissatisfaction with the present than to the attractiveness of the future which it holds out, in practice it will be found that a merely negative attitude no longer contents the intellectuals of the labour movement. I am not concerned here with the practicability or desirability of the dreams and plans of the Webbs, G. D. H. Cole, Tawney or Laski. What is common to all these writers is that they view economic society in the light of an ideal—they are, in other words, assuming that socialist society must be a planned economy, not only planned as regards ownership rights, but in regard to the directions which the managers of production must observe. And thus, in the modern world, the popularity of socialistic ideals helps on the propaganda in favour of planning: and the enthusiasts of planning aid the spread of socialistic ideals. It is true, to repeat, that whilst socialists necessarily are planners, not all planners are socialists. But they unite in a common attack upon the existing system, the characteristic feature of which is that it is *not* subordinated to a plan but is based upon the principle of plurality of ends as expressed through the effective demand of consumers. That is the very reason why it is hated by all those who

have chosen some one among many competing ideals as their guiding star for the construction of a new commonwealth.

V

It is now in place to look somewhat more closely at Planning itself. To plan involves, as we have already said, the means to an end and the end itself. The ends which planning is intended to further can be judged from more than one point of view: from the point of view of the means available for achieving them, from the point of view of the measure of agreement which they are likely to receive, and from the standpoint of the congruence of the ends aimed at with other ends also considered desirable. When planning is looked at in this way it will in the end be found that the more comprehensive the ends which planning sets before itself as a conscious objective, the greater the degree of *incongruence* with other ends, the more difficult the determination of means and the less the degree of universal assent which the plan in question is likely to receive.)

(1) The simplest case is that in which the means are known, the end is a single one, and the end itself is generally approved of. Such cases are presented by the planning and construction of a factory, the laying down of a new line of transportation linking up a new centre of population with the existing transport facilities, the lay-out of a new town on predetermined lines. Each and all of these kinds of "planning" involve no great interference with property rights; each one of them is congruent with a great mass of other ends, none of them are incapable of solution by known means even on the assumption of the existing capitalistic order.

(2) We can easily think, however, of another case in which the end is generally approved of, but where the means are in dispute and the congruence of the end with other ends is doubtful. I take the case of the "abolition of unemployment". Here is an end which in general is approved of: everyone desires to see voluntary leisure

increased, no one desires to see involuntary leisure perpetuated. The difficulty is that no known system had been able to abolish unemployment—not even Communism—for it is now quite clear that in the last few years Russia has been passing through a “construction boom” analogous in every respect to that experienced in the capitalistic world and that with the gradual slackening of the intensity of that boom the phenomenon of unemployment is appearing. It is no doubt possible that, if the supply price of all the factors of production were completely elastic, unemployment would be much less than it is, but this involves a greater measure of willingness on the part of labour to submit to wage reductions than actually persists. On the other hand, even if a communistic system were capable of completely eliminating unemployment, it by no means follows that to adopt it in order to relieve unemployment is congruent with other ends also generally approved of.

(3) It is, moreover, possible to think of cases where the means are known, the end is approved of, but where the congruence of the end aimed at with other ends is doubtful, and where general approval of the means is lacking: one has only to think of the agitation at present sweeping over the economic world in favour of a rise of prices. That it is possible to raise prices by inflation or reflation seems to me to be beyond question; whether it is desirable to raise prices in this way rather than through a restoration of confidence or through an adjustment of costs to prices is another matter. But the dispute as to means is not the same thing as a dispute as to ends; so long as a great mass of fixed interest bearing indebtedness remains over as an inheritance from the period of prosperity before 1929 the world is faced by the alternative—either a rise of prices or default upon a hitherto unprecedented scale. That a rise of prices would resolve this dilemma cannot admit of doubt: that there is not unanimity on the point of whether monetary methods constitute the proper instrument of producing the desired result is, however, obvious.

(4) These difficulties of applying a "plan" reach their maximum where there is neither unanimity as regards the means, agreement as to the ends nor congruity between the ends to be pursued and other ends. In other words, these difficulties of planning are at a maximum precisely in the case where the virtues of planning are most extolled by many in the case of economic society as a whole. There is no unanimity as to the methods to be pursued in this case: there is certainly no agreement as to what the end of a planned society should be, and it will be made quite clear, in the course of subsequent discussion, that, if all the economic processes of society are to be controlled, certain other ends will necessarily have to be abandoned.

I do not think that it can be denied that the sentimental appeal which Economic Planning makes is in inverse ratio to the possibilities of its concrete realization. No doubt there are enthusiasts for town planning, for controlled reflation, for the rationalization of the pig industry, for monopolistic reorganization of London traffic conditions. But do such measures cut to the roots of our existing economic organization? Do they not, for the greater part, represent incursions into the capitalistic order, which, whether on balance desirable or undesirable, leave things much as they were? Such schemes are not likely to enlist on their behalf the emotions necessary to provoke a real revolution in our present arrangements: on the other hand, the emotions which are enlisted on the side of Economic Planning are not likely to be satisfied with tinkering schemes of the kind mentioned above. It is the tragedy of Planning that it would never, short of a fundamental change in conditions, satisfy the army of the discontented to whom it appeals.

VI

From the standpoint of economic theory, a planned economy is not an impossibility, but a tragedy: a tragedy in the sense that such an economy is utterly

unable to fulfil the expectations of those who bring it about. It is, of course, possible to slaughter the middle-classes and to bring the most intolerable pressure to bear upon the Jews or any other section of society: it is, in other words, very easy to inflict pain and agony and distress upon classes and individuals, it is another matter to realize the *positive* end for which a Planned Economy is called into existence.

To begin with, a planned economy involves the rejection of *all alternatives save the one which is actually adopted*. A planned society which "plans for change" is, in fact a contradiction in terms. Either the plan is sound or it is unsound: either it admits of alteration, or it does not. If it does not allow for the improvements of technique, changes in demand, variations in the volume and composition of the population, it suffers some inherent weakness from the very beginning. If it does allow for such changes it is not a plan at all, but an aspiration. Who is capable of foreseeing the future and of judging at any given moment how far the best laid schemes will not require amendment? The more rapid the technical and scientific changes to which a society is subject, the less possible is it at any given moment to control its future.

It is, of course, possible to imagine a society in which economic change is definitely resisted. If the invention of new machinery or the exploitation of new sources of power were punishable with death, no doubt such inventions would cease to be made, or, at any rate, announced to the world. A forcible standardization of existing methods for all time might be the aim of the authorities of such a society: but what, in that case, comes of the argument that it is only by deliberate planning for the future that the maximum advantage can be obtained from scientific invention and discovery? The fact is that a planned society is only possible on condition that one assumes static conditions of production, either because changes are not permitted or because changes do not take place on other grounds.

VII

Since a planned society necessarily involves the exclusion of all alternatives other than the one actually adopted, it follows also that a planned society is one based upon the principle of *force*. Acts inconsistent with the furtherance of the plan which underlies the economic activities of the community *must* be restrained, and to restrain is to use force. It is, of course, quite true that capitalistic society also involves the use of force: a system of society based upon private rights of property cannot permit theft and fraud to take place without destroying its own basis of existence. But, since under conditions of free enterprise no specific end or determinate single end is set before the members of the community, the area within which the use of force is required is ipso facto diminished: and it is significant that it is in communities which, like Russia, have adopted the principle of planning that the death penalty should have to be invoked for a series of "crimes", some of which find no place under capitalistic conditions and others of which are there subject to much less severe conditions. It is a *necessity* of a planned society so to increase both the number of crimes and the severity of their punishment: it is necessary to constrain the tendency to experimentation and variation to narrow limits, and the more the plan conflicts with the expression of the normal impulses of human beings, the greater the repressive force must be. It may be that the ruthless use of force, in one generation, will result in the eradication of those impulses deemed harmful altogether: there is no reason at all to suppose that the Russians, in the end, will not be able to destroy those among them who do not exhibit the mental characteristics appropriate to a state of affairs in which the desire to better one's own position is regarded as an outrage against the state. Whether such a society contains within itself the necessary forces to ensure economic progress is another matter altogether: time alone will be able to answer this question. Meanwhile there can be no doubt whatever upon one point:

planning involves the use of force, not only to bring the plan into existence, but to sustain it against failure from without. Against its own internal weaknesses it cannot, of course, be sustained: all that the planning authority can do is to prevent the facts of failure from being discussed, and to prevent the replacement of the plan by more appropriate plans and devices without its own consent. The fact that planning involves force and repression, in other words, increases the chances that economic change will be slower, in the future, in proportion to the area of activity comprehended within the plan: if innovation is to be treated as a crime, the desire to experiment and to innovate must necessarily diminish. A plan is likely to succeed most easily if conditions are static, and the simplest way of securing that conditions shall be static is forcibly to *prevent* them from being anything else.

VIII

That a planned society is liable to rely to a greater and greater extent upon the use of force and compulsion follows from another set of considerations to which hitherto English economists have paid far too little attention. A planned society, as Professor Mises has abundantly shown, *deprives itself of all those guides to rational conduct upon which the progress of economic life, in the last two centuries, has depended.*¹ In so far as the planned society eliminates the market and the price system, it has to substitute other guiding principles by means of which it can direct the use of the factors of production. A society, for instance, which is faced by the problem of how best to use a limited amount of the factor capital, and which refuses to use the rate of interest as a guide to what uses that capital shall be put, will find it very difficult to avoid wastage of such capital resources as are available. A society which refuses to allow relative prices to determine what shall be produced must either settle the matter by *fiat* or must run the risk

¹Die *Gesamtwirtschaft*, 2nd ed., especially pp. 110-17.

of constantly producing the wrong things. The right distribution of resources is *not* a problem of technology or of "industrial engineering", and the wastage of capital resulting from maldistribution of resources cannot be disproved by pointing to the erection of new power stations, or the creation of new cities out of the "virgin plain". Though, no doubt, such things may impress the tourist to Russia, no one has ever thought of pointing to Miami or the other by-products of the Florida land boom as one of the triumphs of American capitalism. There are, in Russia as elsewhere, more and less urgent wants to be satisfied and only a limited volume of the factors of production are available to meet these wants. In the absence of a price system and a freely functioning interest rate, it is only possible to determine the urgency of such wants by authority. In a country in which labour is relatively cheap and capital dear it does not in the least appear *a priori* reasonable that the most urgent wants to be satisfied are the erection of power plants and the building of tractor factories: it may, rationally speaking, be better to extend the production of those things at which Russian *labour* has a relative advantage, and import those things, the capital content of which is high. However that may be, it is clear that if a society rejects the index afforded by the movement of market prices, whether for finished products or for the factors of production, and substitutes therefore some arbitrary standard, it is likely to go astray, and, once having entered upon a wrong path, will be led from one error to another, i.e., in the effort to prevent its own mistakes from becoming apparent, it will be driven from one coercive act to another. The replacement of "pecuniary" by "non-pecuniary" standards is not, in other words, the simple thing that it seems to those who believe that ethical catchwords are a reliable substitute for rational thinking. The further removed the principle actually adopted is from the dictates of rational economic calculation, the greater the degree of force necessary to maintain the system in being.

IX

WHAT is likely to be the outcome of the emotional and intellectual forces which are making for some kind of Planned Economic Society? The economists of the liberal school and the adherents of freedom of enterprise should be under no delusions: it is not by showing the inherent dangers and absurdities of a thorough-going abandonment of rational economic thought that a movement of such vast scope can be stayed. Economic planning is not "impossible" in the sense that attempts to realize it cannot or will not be made: facts prove the contrary. Nor is it true that mistakes committed in the course of experimentation will necessarily prove fatal to such plans: in an age of intolerance the discovery of error is a *crime* and the setting up of rational standards, by which to judge of the errors committed, is greatly impeded. Moreover, it is not necessarily true that the absolute standard of life will fall: all that is likely to happen is that economic progress will be less rapid than it would otherwise have been. The average man is not likely to be greatly impressed by negative arguments of this kind, even if the critics were given liberty of expression, which is not likely to be the case.

Of what use is it to permit of the *details* of a plan being questioned if the principle of the plan is to be held sacrosanct? The much advertised self-criticism of the Soviet economy is only the tribute paid by intolerance to appearances in so far as it does not extend to the *principle* of communism. (And an opponent of communism in principle is silenced by methods more efficacious than counter-argument.) I see no reason, then, why the world should not pass over into a new era of absolutism and intolerance: why the writings and teachings of the French and British humanists and utilitarians should not be burnt as dangerous documents by the public hangman and why the desire to improve one's position should not be treated as a crime to be punished as theft is to-day. The intellectuals who are now

undermining confidence in the future of our present civilization may, then, as the paid servants of a bureaucratic state explain why freedom is a curse and liberty a crime. Let us hope that in due course the age of reason will return, and that mankind will find that the pleasures of malevolence are less satisfying in the end than those which free enterprise allowed us to satisfy.

THE FUTURE OF CAPITALISM¹

I

A BRILLIANT American economist, Professor Jacob Viner, has recently defined the task of economists as being "the defence of capitalism against the capitalists". The joke is grim one, coming at this moment of time. Never before in the history of modern economic civilization, not even at the end of the war, have the prospects for the continuance of the present order seemed on the surface to be so poor. Two years of depression have seriously weakened the foundations of the whole international economic structure, and there are few signs that the depression is coming to an end. The often-heralded demise of the Soviet Republic has not taken place; on the contrary, Russian State socialism can advance, making all allowances for propagandist exaggerations, some striking economic claims. For the first time in history, the two rival systems can be contrasted, and, at first glance, the advantage seems to be—so far as stability and rapidity of progress are concerned—largely on the side of the new and revolutionary order. The situation in the world of thought is no less striking. In America, the classic home of the "pioneer spirit" and of "rugged individualism", it is possible for the Dean of the Harvard School of Business Administration to voice misgivings (see his *Business Adrift*, now in its third edition), which are so widespread among the American business public that his demand for "Planning" threatens to replace all other slogans in popularity. In Europe, the liberal parties, traditionally and inevitably the vehicle of the capitalistic system are everywhere being ground to powder under the pressure of parties

¹ Reprinted from the *Fortnightly Review*, January 1932.

which are founded on the concepts of power and force as the appropriate instruments of proletarian wellbeing or national security. In the purely intellectual atmosphere of the universities, conditions are not much better; on the continent, the universities are the centre of reaction against the existing order; and though in this country the academic trend of thought still attaches virtue to the principle of democratic government, the trend of modern teaching has undermined belief in the ability of the business world to manage its own affairs without the helping hand of the State.

Nor, does it avail much when the supporters of the present order urge that if capitalism is breaking down, the breakdown is due, not to any inherent defects of the system, but to the circumstance that political conditions have arisen which are incompatible with its smooth functioning. The fact would remain, and the plea is in reality a recognition of the fact; for here, as in other spheres, *qui s'excuse, s'accuse*. Moreover, it would not be true to say that the apparent weakness of capitalism is entirely to be explained by the emergence of unfavourable political conditions. Part of the weakness most unmistakably derives from errors and miscalculations made by the leaders of the business world. Above all, the inability of the capitalistic system to defend itself against assault is due to the unwillingness or inability of the leaders of the business world to recognize that success in the conduct of affairs is not the sole requisite for an understanding of the complicated nature of the capitalistic system, still less the best preparation for a rational defence of its characteristic virtues against the critical analysis of its enemies. One of the weaknesses of the present situation is that the attack is much better armed and much better equipped intellectually than the defence. Capitalism is, in reality, stronger than it appears to be. A discussion of the future of capitalism must begin, then, with some preliminary consideration of what it is and, still more, of what it is *not*.

II

The nature of the capitalistic system is generally misunderstood, both by its opponents and by its supporters. This misunderstanding has arisen partly because of the prevailing confusion between the *motives* by which the participants in production are actuated, and the form in which, so long as the capitalistic system of production continues, successful participation in the organization of economic life is *validated*. To put the point more concretely, the basis of the capitalistic system is frequently described as the "profit motive", when, in fact, remuneration by way of receipt of profits is not the typical form of income received by the inhabitants of capitalistically organized countries, and when, secondly, those who do receive profits have been impelled to earn them, not because they have always the same *motives*, but because the *intention* to make a profit, and the successful achievement of that intention, are the conditions for further participation in the economic scheme. The realization of a profit is proof that the profit-maker has successfully complied with the rules of the game, but it is not the game itself. The business unit which fails to make profits is eliminated from the economic system, though it may take a long time to die. But the system does not exist primarily to yield profits, any more than a game exists for the sake of the particular method of scoring by which successful are distinguished from unsuccessful players. All the players must submit to the rules, but they may be severally moved to play by the desire for victory, for prestige, for health, or even for mere distraction. So also, under the existing economic system, those who must make profits in order to go on participating in production may desire wealth for a score of reasons: for its own sake, for the sake of doing good to others, for the sake of power or influence, or security, or merely as evidence of success. The same variety of motives distinguishes those who labour for an income, other than a profit-income, by working for those who make a profit.

The capitalistic system cannot simply be described in terms of the motives or the intentions of the participants. The business man intends to make a profit, it is true ; but what are the conditions which enable him to do so ? It is these conditions which in sum explain the capitalistic system.

An equally important cause of misunderstanding arises from the assumption (it really is nothing more) that capitalism should conform in its working to the principle of competitive individualism. Defenders of capitalism who make this assumption are naturally not in a position to answer critics who triumphantly argue that capitalism has broken down because, in fact, combinations among producers are of great and growing importance, and because the *entrepreneur* in the modern world is ceasing to be the individual working with his own capital, and engaged in ceaseless conflict with others rendering the same service or producing the same kind of product as he does himself. Yet the continuance of capitalism is not bound up either with "free and unlimited competition" or with "individualism", in the usually accepted sense. These concepts applied to the concrete institutions of business at a certain stage of the evolution of modern economic life ; but that life continues to be capitalistic, in spite of the fact that it is learning to be less largely competitive and less obviously individualistic than it once was.

III

The essence of the capitalistic system must be found elsewhere : in the subordination of the direction which productive effort takes to the influence of consumers' demand, as expressed through an organically related system of market prices, and in the willingness on the part of the owners of productive equipment to venture their property in the expectation that, if they are successful, they will make a profit. Finally, there must be acquiescence by the sovereign power in these arrangements, as evidenced by the prevailing state of the law in regard

to the ownership of property, the protection of those who engage directly or indirectly in the system of production, and in the avoidance of legislative or executive acts which will prevent the system from functioning.

It is, then, not the mere existence of private property, or of the division of labour, or of mechanical aids to production, not even the presence of competition, which explains the essential nature of capitalism. That essential characteristic is the presence of the free market, and the subordination to the demands of that market of the entire productive mechanism. This market is an international one, and through it every kind and species of product and service is brought into competitive and complementary relation with every other kind of product and service. The value of products in the market determines, in conjunction with the rate of interest, the capital value of the existing stock of producers' goods, as well as the price of the labour and the auxiliary services which have helped to produce them. Through the mechanism of prices, producers draw their incomes. But, since the magnitude of these incomes is affected by relative price changes as between one commodity and another, as well as by absolute price changes as between two different points of time in regard to the same product, fluctuations in prices determine not only the current trend of production, but also who shall produce, and what will be produced, and by whom, in the future. To this market mechanism, so long as it exists, the strongest and the weakest producer alike must ultimately submit. Further, since every producer must obtain through the medium of the market all those goods which he does not himself produce, and since the price mechanism adjusts the price of every article to the existing state of demand and supply, it appears that there cannot, in principle, be a breakdown of the capitalistic order. For the market supply and the market demand are ultimately identical, every man's supply constituting his demand for the products of everyone else, and everyone else's supply constituting the demand for the products of the first.

IV

The case against the capitalistic system takes many different forms. Even the opponents of the system nowadays take it much too much for granted that it is efficient in the *production* of goods; and even though it can be argued that the capitalistic system is not directly responsible for the rate of technical progress, the case of the motor car, the radio and the cinematograph show with what rapidity, under capitalism, vast new industries can spring up for the exploitation of new inventions and discoveries. But it is the conclusion that, in principle, a breakdown of the economic system of free exchange is impossible, because market prices are constantly working to bring about an equilibrium which, more than any other argument, exasperates the plain man, especially at a time like the present, because it appears so hopelessly at variance with plain fact. The truth, however, is simply this: equilibrium will only be brought about if the forces making for equilibrium are allowed to work themselves out without hindrance. The real issue, therefore, is this: what obstacles to equilibrium arise within and without the system of productive forces?

A somewhat indistinct line can be drawn between factors which *delay* and factors which *prevent* equilibrium. Both kinds of factors have in recent years become of much greater significance than they were in the nineteenth century, with the natural result that depressions (which represent a breakdown of equilibrium) tend to be much more severe. The institutional framework of the capitalistic system has tended to become much more rigid, with the result that a much longer time elapses before a change in the market conditions reacts on the productive mechanism in the appropriate fashion. Partly in consequence of active support by the State, partly in order to safeguard their own *immediate* interests, partly because the scale of enterprise is altered, monopolistic and quasi-monopolistic bodies, both of employers and employed, maintain prices for their particular products out of line with the general direction of price movements.

The consequences are lack of employment for both capital and labour: over-production in one part of the field and under-consumption in another. A more flexible adaptation of prices to one another, and of prices to costs, would result in a new equilibrium position being reached much more quickly.

A further cause of delayed equilibrium is the much greater difficulty, in the modern world, of forecasting the nature and extent of *demand*. Most forms and kinds of production involve long periods of preparation; the only index upon which producers can go at the moment when production is initiated is the price level for a particular product, and by the time the enlarged productive capacity yields its fruit, the demand may have changed, or, what is equally important, the aggregate increased output can only be sold at prices less than those anticipated. It is easy to be wise after the event, and to pour scorn upon the "anarchic conditions" which permit an over-estimate of demand to take place. But, in fact, miscalculations of future demand are equally possible under any system *which permits free choice to the consumer*. Two mitigating circumstances may be adduced. In the first place, industries with a high annual rate of depreciation, and supplying an elastic demand, can and do adjust themselves to altered demand conditions in a relatively short period of time, so that the actual degree of disorganization and of economic waste can easily be exaggerated. In the second place, the failure of demand to materialize may be due to general changes in the economic situation, i.e., general alterations in the price level, over which a single industry has no control whatever.

The fact is that it is becoming ever clearer that perhaps the most important single cause of lack of equilibrium, internal to the economic system itself, is the behaviour of the monetary and banking mechanism. Whether reform is to be sought along the line of making the price level more stable, as recommended by probably the majority of those English economists who have concerned themselves with the problem of the trade cycle;

or whether, as the modern Viennese School insists (see, for instance, Dr. Hayek's recent and brilliant book, *Prices and Production*), salvation is to be found in making the monetary machine behave in a more "neutral" fashion, is a matter which must be left to the technical experts to thresh out. There is agreement on the fundamental point that the behaviour of the monetary machine is a matter of the gravest moment.

The present weakness of capitalism is largely due to the prolonged pressure exerted on it by the falling price-level of the last two years. But that prolonged fall must itself be largely explained by the intrusion from without of a series of factors novel in the history of modern capitalism. Ever since 1914 public opinion has been mobilized in a monstrous fashion against the capitalistic system by those very governments whose task it should have been to make the situation clear to the man in the street. Inflation, owing to the war, led to the absurd attempt to keep prices from rising by the device of proceeding against "profiteering", as if the business man who attempted to preserve the corpus of his capital intact by charging enough to cover replacement costs was performing a criminal act instead of a useful social service. Rents were kept down on the one hand, and complaints were made on the other that "capitalistic house-building" had broken down. But the war follies were as nothing to the mischief which has been done to the international capitalistic order by the reckless confiscation of enemy property, and the inculcation of the view that the rate of profits and the standard of life in Germany could be legitimately reduced to any level whatever (without any deterrent effects on productivity) if only the Allies showed a sufficiently strong and united front! And even if these views have been abandoned by the politicians who put them forward (not, however, before they succeeded in poisoning the minds of Europe for a decade), the fact that the same politicians have not yet been able to settle the Reparations issue and the question of Inter-Allied Debt is, in my opinion, the main reason for the

continued lack of confidence now persisting, which, again, is the cause why business cannot and does not recover.

V

To judge of the place of the State in the capitalistic system solely by the errors it has committed or inspired is, of course, to fall into the mistake of the opponents of the capitalistic system who condemn it without seeing whether, on balance, the good does not largely outweigh the evil. The State is necessary for the continuance and fruitful functioning of capitalism, notably because it provides a system of law and organizes defence against the internal and external enemies of public order and private property. Without positive functions as well, the modern capitalistic order could not possibly survive, for there are a whole range of necessary tasks which it is not to the interest of the individual capitalist to provide at all, or, at least, not to the degree regarded as desirable. The most obvious types of such provision are public education and public health. Capitalistic society, left to itself, will only provide education and sanitary services to the extent to which individuals are prepared to pay for them. All experience teaches that some people—in fact, a great many people—are not prepared to pay for the education of their children, or to pay as much as is really necessary. All experience also teaches that some people, if left to themselves, are not prepared to pay for drainage, water-supply and the other amenities upon which the physical, as distinguished from the mental, health of urban populations depend. Only the State can see to it that the necessary quantity of such services is consumed by everyone. It can dissociate the question of who can pay from the question of who shall receive, which under capitalism are inseparable. It by no means follows that the State must carry out the provision of the service itself; nor that the State need allow those to escape all payment whose ability to pay a price it judges sufficient—for it can subsidize private

enterprise to provide the service on the desired scale and enforce payment against those whom it likes. The point is merely that the State can *enforce* the scale of consumption it thinks desirable, whilst private enterprise cannot. And some of the kinds of things consumed would not have been consumed upon the desired scale without the interference of the State.

Much harm has been done by the refusal of the business world to see that a great deal of the expenditure upon the social services is not only no ultimate drain upon business life, but is absolutely necessary expenditure—as much necessary as the payment of the police or the maintenance of the roads. A population of Yahoos is not only incapable of democratic government, it is incapable of staffing modern industry or of fighting a modern war. Public health provision avoids later expenditure upon prisons, workhouses, hospitals and the whole grim apparatus by which destitution in its worst aspects is relieved. And, to put the matter in its most sordid form, upon the continuance of such public provision a whole series of organized industries nowadays depends. The printing trade and the whole of the amusement industries—from travel agencies to the firms supplying sporting requisites—would not have anything like the frequent demand for their products if it were not for the joint activities of capitalism (which by constant increases in efficiency has raised the scale of wages) and the State (which has utilized part of the surplus accruing through increased production for raising the tone of life among the great bulk of the population). The practical issues which divide individuals—i.e., whether the expenditure might not yield even better results if the administration were improved, and the direction which additional services should take—are less important than acceptance of the principle that some forms of State service are essential to industry.

The place of the State as an active factor in the processes of production has also given rise to much misunderstanding. Some forms of production can only be

undertaken by or with the active help of the State, for the simple reason, as already pointed out, that the scale upon which the individual, left to himself, would demand these goods or services is less than is really required from the standpoint of the general interest. This leaves one with a broad field of activity, some of which is quite clearly unsuitable for State enterprise, some of which is capable of being undertaken by the State or by private corporations. Where an industry is in a rapid state of development, with unknown possibilities of expansion and presenting many problems of experiment before it settles down to satisfy a known state of demand, it is clearly unsuitable for State management—whether it is in point of time a “new” or an “old” industry. Where the industry has been reduced more or less to a routine, where unified management presents great possibilities of economical production, where future demand can be accurately forecast, there is no *prima facie* objection to State ownership and administration. The whole problem of State ownership and administration, which used to excite such passionate feelings, has in recent years undergone a striking change. On the one hand, sensible supporters of the socialist point of view are now themselves convinced that State undertakings should not be put directly under parliamentary or political control, but must be managed by the “quasi-public corporation”, so as to ensure freedom from party political pressure, continuity of administration and the best technical service which appropriate salaries can command. On the other hand, sensible supporters of capitalism are beginning to see that in the industries organized upon a large scale the conditions of work for the vast bulk of the people employed in them approximate to those in the public service; that it is not so much the issue who owns the enterprise as the scale upon which the enterprise has to be conducted, and the type of market it has to serve, which distinguishes one type of business from another. Now, as has been pointed out in a previous article in this series, the extent to which large-scale

organizations are likely to dominate industry as a whole has been greatly exaggerated; the sphere of relatively small-scale enterprise is permanently secured for capitalistic methods of production, and even as regards large-scale undertakings, only those capable of routine operation are really entirely suitable for State administration. It follows from all this that the degree to which capitalism is seriously threatened by the extension of State enterprise and by the activities of the State has been greatly overrated. The threat to capitalism comes not from the nationalization of the mines, or the electric supply, or the railways, but from another direction altogether. The real danger lies in an uncritical acceptance of the virtues of "economic planning", or the attempt, in the interests of "security", to place production in a strait-waistcoat.

VI

All production involves some degree of foresight or of "planning", for, except in the most rare instances, production takes place in anticipation of demand. Now, in order that no capital and labour may be invested in any direction without risk of subsequent waste through lack of demand, what is really necessary? It is obvious that a thoroughgoing "economic plan" requires us to know what demand will be in the future, and that is only really possible if demand can be *controlled* and if supply can be *controlled*. Planning, in any real sense of the word, requires interference with the freedom of the factors of production, and interference with the consumer's right to buy what he likes and in the quantities that he desires. For this reason, planning is only possible in a communistic, non-democratic society. If a single central authority can decide what shall be produced, in what qualities and quantities, and can take effective steps to see that the consumer shall get nothing else, it can solve the problem of planning. As soon as the consumer is allowed to pick and choose, the producer runs the risk of turning out either too much or

too little. The freedom of the market, therefore, must be sacrificed if planning is to be a success; not only so, the right to introduce competing products and alternative sources of supply must also be interfered with. That is why Russian communism is perfectly logical in making foreign trade a monopoly, destroying private enterprise as far as is possible, and in controlling the consumer. A five-year plan, or any other plan, is impossible without such precautionary measures.

But, it may be asked, is there no alternative between our present "haphazard" arrangements and a complete elimination of freedom of choice and of enterprise? Is it not possible to reduce the degree of risk and to prevent the present, often grotesque, disparities between productive capacity and probable demand? Some things are certainly possible, though whether they deserve to be dignified by the name of "planning" is another matter. It is possible, for instance, to attempt, by adequate control over the banking and financial mechanism, to prevent the amplitude of the trade cycle from being as great as it is. It is possible, by the use of better statistical material, to enable producers to realize more fully the trend of production and consumption. It is possible, by better education of the investor, to teach him that a "boom" in a particular industry or raw material is the inevitable precursor of over-production in that industry. It is possible, perhaps, to stop governments from putting more people on the land at a time when world population is ceasing to grow at its old rate; and perhaps possible, also, to prevent governments from supporting valorization and monopolizing schemes before they know how to stop the growth in production and the check to consumption which such schemes engender. It is possible to educate the consumer so as to make him (more especially her) less fickle in his tastes and more regular in his purchases. But the hope that all or any of these arrangements will eliminate all the irregularities of production is chimerical; so long as the future is uncertain, an element of hazard is bound to remain.

corresponding in magnitude to the greater or lesser novelty of the product. But if business men are not prepared to run the risks for the sake of the awards, if they dream of a golden future in which profits are to be earned without the uncertainties of the present, they have already, however unconscious they may be of it, abandoned capitalism for something else, and are preparing the way for a new order—"Planwirtschaft", the "Fascist" state, Communism—who knows? We have, perhaps, worshipped freedom too much and security too little; it is enough for the economist if he can make it clear that both are jealous gods who will permit of no divided allegiance.