THE ORIGINS OF KEYNESIAN MYTHOLOGY: BRITAIN BETWEEN THE WARS

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Introduction

Armed with a improved guidebook it may be interesting and instructive to visit one of the more important battlefields of economic history. The battlefield is Britain between the wars. The period and the place is notorious for persistantly high levels of unemployment. Unemployment averaged 14% and never fell below 9.8% of the insured labor force between 1921 and 1938. The normal cycles of economic activity are observed but the expansions and contractions of economic activity occur about high levels of unemployment. [1]

As every schoolboy now knows it was Lord Keynes who emerged triumphant from the field with a revolutionary economic theory which he used to vanquish the Treasury knights, the remote and unrepentant governor of the Bank of England, Montague Norman and orthodox economists in general.

Keynes regarded the unemployment as an unnecessary sacrifice for a barbarous relic, gold. The return of sterling to the gold standard in 1925 at the pre-war parity has come to be widely explained as a "major historical error." [2] Keynes and the Keynesians interpret the period to September 1931, when Britain abandoned the gold standard, in the following general way. The attempt to return to gold and the commitment to gold gave Britain an overvalued currency. The overvaluation was reflected after 1925

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1 For a discussion of the business cycle and this period see inter alia Aldcroft (1970) and Phillips and Maddock (1973). See also the appendix below.

2 Leslie Presnell in a recent study attributes the decision to return to gold in important part as a response to pressure on Britain exerted by other sterling area countries. Characteristically the sterling area connection is then blamed for weakening the overall British balance of payments [Presnell, 1978]

in a "chronically" weak balance of payments (Sayers 1976 p. 389) Exchange rate objectives therefore necessitated tight monetary and fiscal policies that intensified the unemployment problem. The unemployment is regarded as largely the effect of a deficiency of aggregate demand given the inflexibility of wage rates. The source of inflexible wages is found in the political power of trade unions as manifested by the frequency of strike action over the period. The implication of this interpretation is that Britain should have "managed money" independently of exchange rate objectives. However given that such a policy, despite its advocacy by Keynes and others in the early twenties, was not politically acceptable, Britain would have done better to have chosen a lower value for the pound. Sayers had argued that even such a policy would have led to competitive devaluations by other countries, especially the French, and provided little relief for Britain. (Sayers 1970) The relationship between the overvalued exchange rate, the unsatisfactory state of the balance of payments and the unemployment intensifying credit policies of the Bank of England have been drawn in the many interpretations of the period. [3]

Of direct importance for economic developments of the period was that the Keynesian interpretation of the return to gold was influential in undermining confidence in the advantages of the gold standard both outside and possibly inside the Bank of England and in reducing the political independence of the Bank of England. The loss of confidence by foreign owners of sterling in Britain's commitment to the gold standard in August-September 1931 was the proximate

[3] Among the recent important monetary studies of the period, in chronological order, are D.E. Moggridge, British Monetary Policy 1924-1931, The Norman conquest of 4.86, Cambridge at the University Press 1972, Susan Howson, Domestic Monetary Management in Britain 1919-38, Cambridge University Press 1975 and R.S. Sayers, The Bank of England 1891-1944 Vols. 1,2 and appendices, Cambridge University Press 1976.

cause of the abandoment of the gold standard. We will examine closely the rush of events in the 3rd quarter of 1931 that demanded a fresh British commitment to the gold standard in a highly symbolic form. The symbolism was well understood by the authorities and in the market place. Political sacrifices were called for and made but to no final avail. It remains debatable whether the Bank of England was defeated or surrendered. There is the further issue of how effectively the defense of the gold standard was conducted. A Keynesian interpretation of the suspension of gold payments, to be consistent, regards the suspension as inevitable and therefore better sooner than later. Another irony is that while Britain recovered from the severe depression by 1933 unemployment remained high through-out the thirties.[4]

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[4] The percentage unemployed was 21.3 in 1931; 22.1 in 1932; 19.9 in 1933; 16.7 in 1934; 15.5 in 1935 13.1 in 1936; 10.8 in 1937 and 13.5 in 1938.

With the availability of national income accounts for the period it is now known that the interwar period was by no means as economically disastrous as many contemporary observers believed. On the contrary the period saw respectable economic growth that, even though interrupted by the very severe depression of 1931-1932, compared more than favorably with rates of growth achieved during the high tide of the international gold standard. The growth rates are naturally sensitive to the starting point for such calculations. 1919 and 1920 were very much boom years and 1921 was depressed. Some summary statistics provide a picture of rude economic health. For example between 1920 and 1938 net national income grew on average 2.1% per annum, real income per head by 1.6% p.a., industrial production by 2.8% p.a., and consumers expenditure by 1.1% p.a. By comparison between 1900 and 1913 net national income grew an average by 1.1% p.a., real income per head by 0.4% p.a., output per man hour by 0.6%, industrial production by 1.6% p.a., industrial productivity by 0.2% and consumers expenditure per head by no more than 0.1% p.a. In the period before 1913 exports grew rapidly by 4.2% p.a. while between the wars exports fell on average by 1.2% per annum. [5] By comparison with other countries British economic performance in the 20's compares well with all except the U.S. and in the thirties the comparison with the U.S. is highly favorable to Britain. The unemployment statistics referred to above naturally spoil the picture.

It is perhaps understandable that contemporary observers should have been preoccupied with the unemployment statistics and the declining fortunes of the major export oriented industries, coal, cotton and shipbuilding. An obvious feature of the unemployment was its high concentration in those areas of the country that had depended on employment in the declining industries. [Champernowne 1938] Beveridge calculated that at the 21st June 1937, which is well into our period, the percentage of applicants for unemployment receipts

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[5] See Derek H. Aldcroft and Harry W. Richardson, The British Economy 1870-1939, Macmillan and Co. Ltd., London, 1969, Chap. 1, Tables 1,2 and 3 and the appendix below.

who had been unemployed for 3 months or more varied from 29% in London to 64% in Wales. Of the unemployed in the North West, North, Scotland and Wales 25, 40, 33 and 39 per cent had been unemployed for more than 12 months. [Beveridge 1945, p. 61] Less obvious to contemporary observers, in the absence of national income and complete balance of payments statistics, was the growth of the "new industries" and services that catered largely to domestic demand. [Aldcroft and Richardson 1969, Aldcroft, 1970]

Keynes was an early, a most persistant and undoubtedly the most persuasive critic of monetary policy and the return to gold. Keynes, as is well known, was most effective in addressing his economic theories to the public in numerous newspaper "essays in persuasion" and to policymakers in committee. Before 1925 Keynes was an advocate of managing money to control prices directly. After 1925 Keynes severely critized the "Economic Consequences of Mr. Churchill." Keynes' interpretation of the causes of unemployment could best be described as extremely Keynesian but perhaps his then regard for the "incredible power of credit policy." Keynes meant by this the power of the Bank of England to control the cash revenues of the commercial banks [6]

> "...credit restriction is an incredibly powerful instrument, and even a little of it goes a long way -- especially in circumstances where the opposite course is called for. The policy of deliberately intensifying unemployment with a view to forcing wage reductions is already partly in force, and the tragedy of our situation lies in the fact that, from the misguided standpoint which has been officially adopted, this course is theoretically justifiable. No section of labour will readily accept lower wages merely in response to sentimental speeches, however genuine, by Mr. Baldwin. We are depending for the reduction of wages on the pressure of unemployment and of strikes and lock-outs; and in order to make sure of this result we are deliberately intensifying the unemployment. (Keynes 1933 pp. 258-59)

Keynes portrayed the plight of the striking coal miners in the following sombre colors.

> "Like other victims of economic transition in past times, the miners are to be offered the choice between starvation and

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[6] See, The Return to the Gold Standard, Essays in Persuasion, Macmillan Co., Ltd., St. Martin's Street, London 1933 Part III

> submission, the fruits of their submission to accrue to the benefit of other classes. But in view of the disappearance of an effective mobility of labour and of a competitive wage level between different industries, I am not sure that they are not worse placed in some ways than their grandfathers were. (Keynes 1933, p. 260)

The economic history of the late 1960's and the 1970's is notable for uncertainty about the value of the U.S. dollar as a reserve currency and the implementation of floating exchange rates between the major currencies. Also in the 70's rates of unemployment and inflation have been on average much higher than they were in the previous two decades. These developments have, provided the stimulis for advances in economic analysis. The theoretical developments and the economic experienc provide a fresh perspective and some additional insights with which to review developments in Britain between the wars;

Some Theory

The theoretical developments which this interpretation of the inter war period will rely upon concern the impact of changes in money and the balance of payments adjustment process, the determination of exchange rates, the rationale for stabilization policy and the theory of employment and unemployment. What will be a common theme in our application of economic theory is a regard for economic agents in labor, commodity, foreign exchange, money and credit markets as attempting to maximize their expected economic welfare in an uncertain world. As a means of coping with uncertainty economic agents are understood to establish 'working hypotheses'[7] about the forces that may influence the terms at which they will buy or sell. Maximizing economic behavior will be consistent with this view of the world. Plans for the future adapt to relevant new information as it becomes available. It should not be assumed that economic agents always make appropriate

[7] The phrase is Ludwig Lachmann's. See the discussion in Kantor, Rational Expectations and Economic Thought (1978) pp. 13-18.

plans. Such an assumption is clearly inconsistent with the facts of life. While it is well understood that economic agents are by no means omniscient it is assumed that maximizing behavior applies to the use of available information. Markets are assumed to be "efficient" in that they reveal no systematic bias in the use of available information.[8] All the systematic influences on markets will be recognized and the attempt will be made to correctly interpret and anticipate likely developments.

In a certain world all economic plans would be successfully realized. In an uncertain world real profits are made and losses incurred when outcomes turn out to differ from market expectations. Implicit in any market price at any point in time is an expectation of the future value of that good consistent with information available at that same point in time. Prices at some future point in time may be higher or lower than was expected in which case surprising losses or profits are made. Reactions to the differences between expected and realized magnitudes and to the new information that may be gained from these and other independent developments are understood to form the essence of the economic adjustment process.

This "rational expectations" approach to economic analysis has very powerful implications for monetary and fiscal policy designed to stabilize the economy. The presumption of Keynesian analysis of this issue is that monetary or fiscal policy intervention takes the private sector of the economy by surprise and moreover that the surprise is a pleasant one resulting in more output and employment. Recent theoretical work proves "that the laws of motion of the economy cannot be invariant to policy intervention"(Prescott 1977 p.17) Policy actions and their likely effects become part of the information upon which economic plans are based. Only the unanticipated effects of policy actions have real effects.

[8] For a fuller discussion of the efficient market hypothesis and some applications see inter alia Pesando 1978. Poole 1976 and Hamburger and Platt 1975.

The anticipated component will be implicit in market prices. Indeed surprising policy may as easily be unpleasant as pleasant. The "market" for example may anticipate a faster rate of growth of the money supply and so of aggregate demand than in fact transpires. Expected prices, wages, interest rates, exchange rates, may be higher than can be most profitably realized. The adjustment to such inappropriate plans may result in less output and employment.

Such an approach to economic analysis becomes very market centric. The key question asked in such an approach is what can the market know and what does the market know as revealed by market activity. Such a view of the world has implications for the conduct of genuinely stabilizing economic policy. A stabilizing policy would be one from which economic agents are more easily able to draw correct inferences about future developments in the markets in which they participate. Such considerations form the basis of the case for a monetary rule. At a theoretical level there is little to choose between a money supply rule set by a fiscal constitution or a money supply made convertible into a commodity. The gold standard in its classic form served to anchor long run expectations about prices, wages, interest and exchange rates and by so doing facilitated economic planning.

This view of economic behavior and economic policy encourages a sympathetic attitude towards the attempt made by the British authorities to restore the "ancient regime" in the 20's. Sayers has described the objectives of Montague Norman and the Bank of England as follows :

> "The attention given to the international scene was never relaxed, and was inspired throughtout by the desire to establish and maintain an international monetary system that would facilitate

> the revival of international trade and international investment. It was through these that the Bank saw its major chance of promoting economic health and prosperity at home; sceptical of its power to make much impact directly on internal economic conditions, the Bank shared in the general view that the roots of trouble were in the great export trades, and held that it would and should help these by promoting world conditions propitious for their revival. This attitude persisted throughout the decade (Sayers 1976 p. 110)

The Keynesian interpretation of the inter war period rests on the presumption that unemployment was the effect of deficient demand. The source of deficient demand is found in errors by the monetary and fiscal authorities. An interpretation of economic developments in such terms is inevitably central bank centric, so to speak. This paper will present a market oriented version of economic developments between the wars. The focus of our attention will be on events between the first war and the return to gold and developments immediately preceding the suspension of gold payments in 1931.

The attempt will be made to understand what the markets knew and what they might have known. The justification for such a procedure was outlined above. It is that interest and exchange rates are determined by markets and not directly by central banks. Market behavior responds to policy actions and more particularly expected policy action. Market interest and exchange rates, prices and wages implicitly reflect expectations about the forces known to effect these variables. Policy interventions, to be effective in anything but the short run, must influence expectations.

If for example a central bank attempts to influence nominal interest rates then excess or deficient demands for credit from either the public or private sector given those interest rates may force accomdating increases or decreases in the money supply. The inflationary or deflationary implications of increases or decreases in the supply of money may further increase or decrease the demands for credit at what becomes an even more artificial level of interest rates. If such controls and nominal interest rates are combined with fixed exchange rates then the balance of payments will come under pressure necessitating either a change in exchange or interest rates. Mobile capital will speed up the process of adjustment. Nominal interest rates may be kept down and inflation perpetuated if exchange rates are allowed to depreciate. Given capital mobility, interest rate parity will hold. The difference in interest rates between countries will approximate the discount or premium on forward exchange. (Frenkel and Levich 1977) Evidence on interest parities and the relationship between spot and future exchange rates over the period is presented below.

Edwin Cannan, R. G. Hawtrey, Keynes and Sir Charles Addis participated in a celebrated symposium on monetary policy in 1924 which was reported in the Economic Journal. Addis was a Bank of England Director, a member of the Cunliffe Committee and "the Bank Director on whose advice Norman relied and whom he used most in his discussions on international cooperation with other centres." [9]

Addis remarked that

> "Whatever our opinion of stabilization policy may be we are all in favor of stability -- stability of policy as well as stability of prices. Instability of policy is no less dangerous than instability of price. Nothing can be worse than uncertainty. (Addis et al. 1924 p.)

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[9] As reported in Moggridge (op.cit) page 41)

Addis earned a characteristic rebuke

> "I am afraid (said Keynes) there is no room for agreement between us and Sir Charles Addis if Sir Charles insists on immediate deflation. On that matter the government, I think are in a contradictory position, both this and the previous governments, when they state that their object is to get back to a gold standard as soon as possible, yet also at times admit in public, as Mr. Baldwin did, that the policy of deflation has been definitely reversed. The government thinks it wise to placate Sir Charles Addis by stating that their intention is to return to the gold standard. But fortunately they are not as foolish as to take any active steps in that direction. They have in fact no clear policy..." (Addis, Keynes et al. 1924, p.)

As will be indicated Keynes' observations about economic policy were accurate. The avowed intention of policy since December 15, 1919 (Howson 1975 p. 16) was to follow the Cunliffe Committee's advice and return to gold at the pre-war parity. The actions of government were not consistent with this objective. The effect, as Addis appreciated, but Keynes did not, was to increase the uncertainty with which the markets had to cope.

Deviations on the Road to Gold

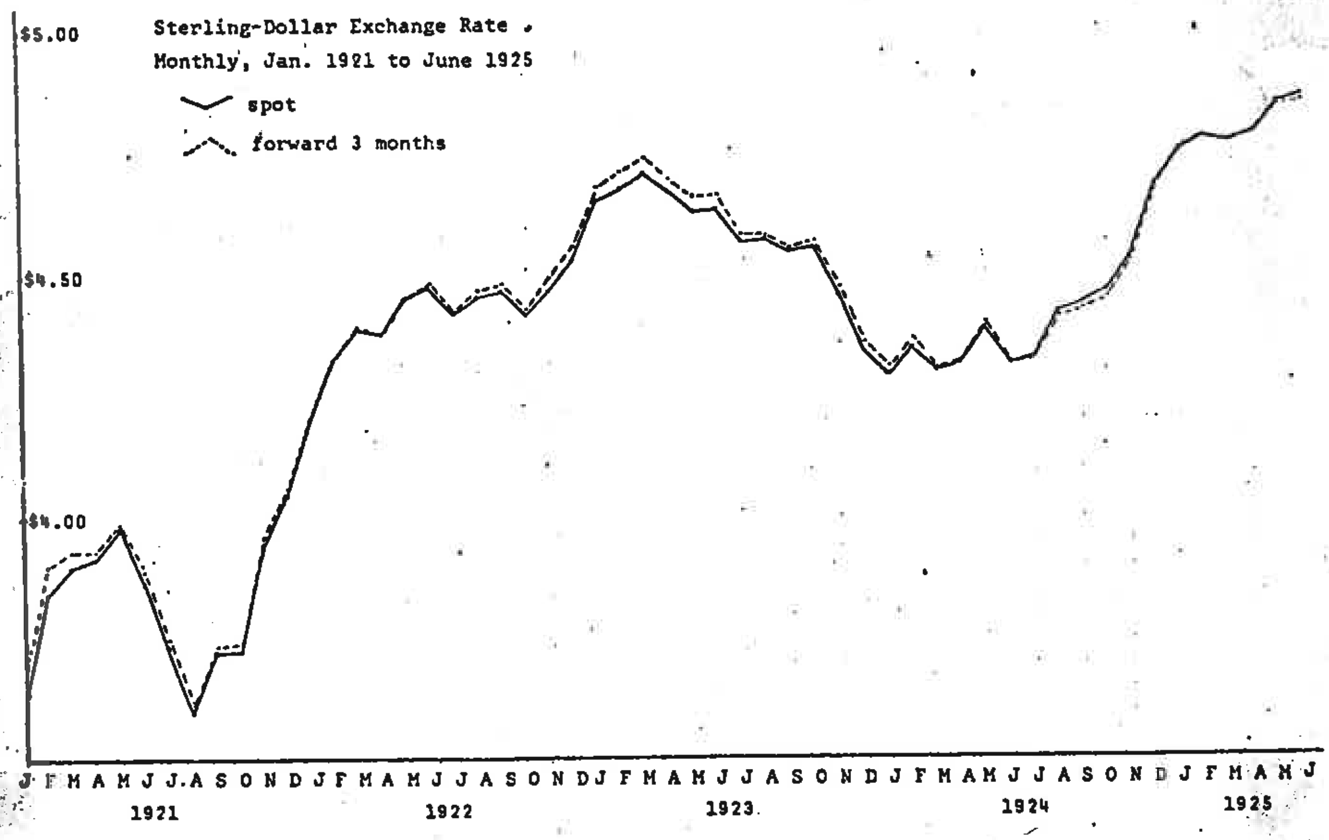
In 1915 the sterling-dollar exchange rate was pegged by official borrowing and intervention.[10] The intervention rate was finally $4.76-7/16 and supported by controls and capital movements and trade and prohibition on the melting of gold. Official support for the period between 1915-16 and 1918-19 was estimated at £2021 m. As part of planning for peace the authorities appointed a number of committees including, in January 1918, a 'Committee on Currency and Foreign Exchanges after the War' under the chairmanship of Lord Cunliffe, retiring Governor of the Bank of England.

As Moggridge reports the Committee assumed without question that Britain would return to the gold standard at the pre war parity. Interest

10 This account of foreign exchange developments, including the deliberations of the Cunliffe Committee is based on the analysis provided by Moggridge (op. cit.) Chap. 2.

Figure 1

The Relationship between the Spot Rate and the Contemporaneous Forward Rate for the Dollar vs. Sterling in the 1920's



Source Mussa (1978

in the committee concentrated upon the transition to gold and it was expected that the transition to a normal relationship of British to foreign prices would take approximately 10 years. The committee and witnesses accepted the need, 'for some measure of deflation ' but understood that the process of deflation would be difficult 'especially right at the end of the war with its reconversion demands, pressures for changes in social policy and the like, (Moggridge 1972 p. 18)

Moggridge describes the Committee to be somewhat divided and uncertain as to the best short term policy but united on long term goals, a division and uncertainty Moggridge regards as reflected in the First Interim Report which established 'broad principles upon which the currency should be regulated leaving matters of timing unresolved.' The committee reported that

> "In our opinion it is imperative that after the war the conditions necessary to the maintenance of an effective gold standard should be restored without delay. Unless the machinery which long experience has shown to be the only effective remedy for an adverse balance of trade and an undue growth of credit is once more brought into play, there will be a grave danger of a progressive credit expansion which will result in a foreign drain of gold menacing the convertibility of our note issue and so jeopardising the international trade position of the country.
>
> The pre-requisites for the restoration of an effective gold standard are:
>
> a. The cessation of Government borrowing as soon as possible after the war . . .

b. The recognised machinery, namely, the raising and making effective of the Bank of England discount rate, which before the war operated to check a foreign drain of gold and the speculative expansion of credit in this country, must be kept in working order. This necessity cannot and should not be evaded . . .

c. The issue of fiduciary notes should, as soon as practicable, once more be limited by law, and the present arrangements under which deposits at the Bank of England may be exchanged for legal tender currency without affecting the reserve of the Banking Department should be terminated at the earliest possible moment.

[Summary of report provided by Moggridge 1972 p. 21 see also Sayers 1976 appendix 7]

Sayers reports that 'for a few short weeks' hopes were high in the Bank of England of a return to gold in February-March 1919. But by the end of March" the illusion had evaporated; perhaps the change owed something to growing fears that Paris was not going to settle everything, but more immediate causes were the refusal of the government to force any substantial size in interest rates;"(Sayers 1976 p.115)

The Lloyd George government did not accept the Cunliffe Committee's recommendation or the advice of the Bank and the Treasury. Monetary policy developments in 1919 and 1920 are fully reported by Howson. The first policy steps taken in March 1919 were to unpeg the exchanges and to officially leave the gold standard. Howson reports that 'The Times' regarded this step as a defeat for the dear money party.' [Howson 1975 p.11]

Howson argues that the minutes of ministerial conferences on "Unemployment and The State of Trade" in February, March and April 1919

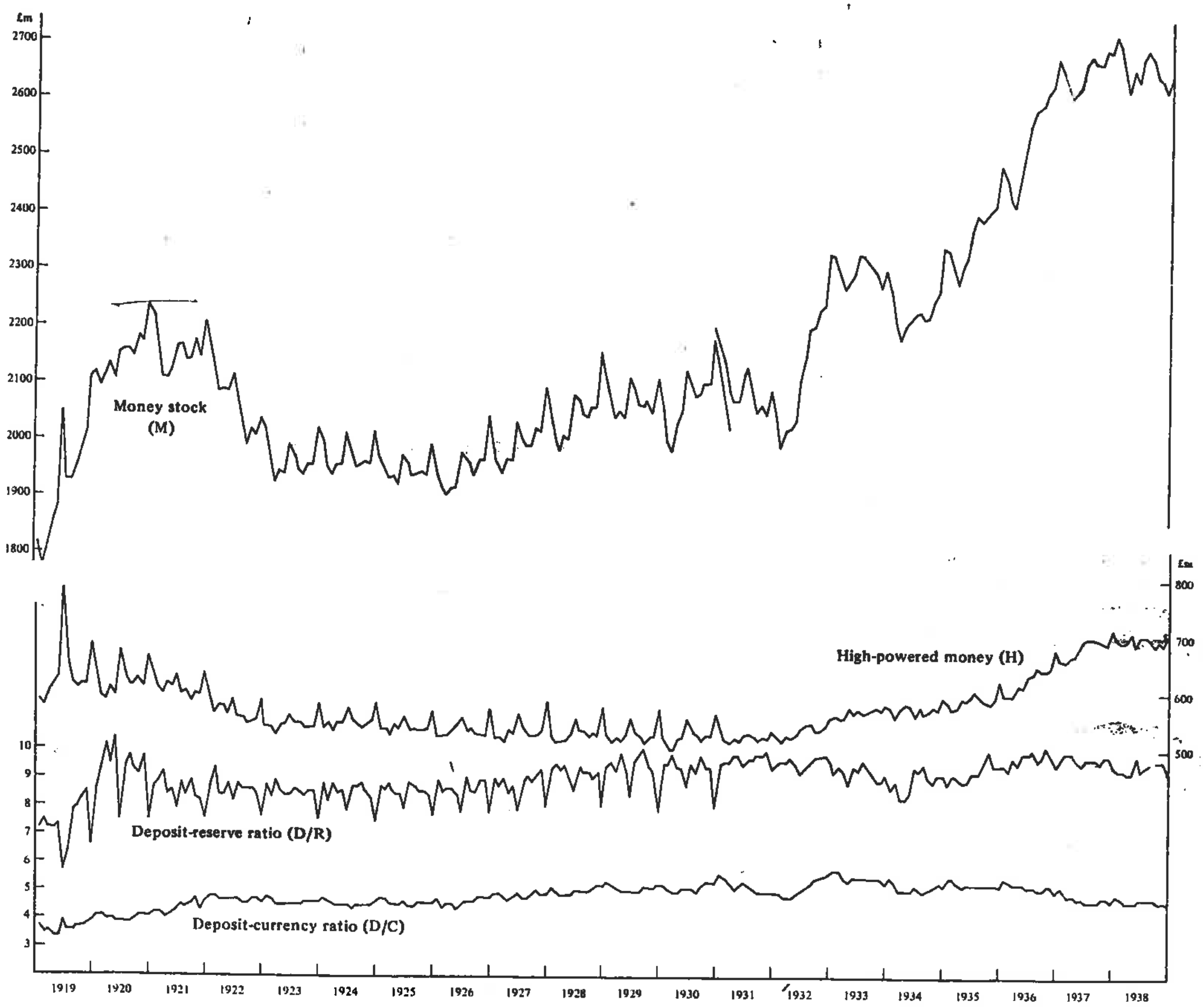
> "show that the government unpegged the exchanges and abandoned the gold standard because of the cost of support and fear of unemployment if the Bank took restrictive measures in order to avoid a heavy drain of gold once the exchange fell. They do not support the claim that the British government decided to abandon the gold standard only with the firm intention of returning to it as soon as possible. Fear of unemployment dominated the cabinets' thoughts on economic matters if only because of the unrest it would surely bring (a possibility brought home vividly to it by "Fortnightly Reports on Revolutionary Organizations in the U.K." by the head of what was later "Special Branch" of Scotland Yard) The conferences were a manifestation of this preoccupation and began on 17 February when Lloyd George confronted his ministers with the fact that "trade in the country was more or less at a standstill." Something had to be done and he wanted to know what was being done . . . . (Howson 1975 p. 11).

As Howson reports further the conflict between 'doing something about trade' and returning to gold was faced and ignored. Instead interest rates remained pegged, the budget deficit increased and the money supply, partly in the form of Treasury notes, grew rapidly in response to excess demands for credit from government and business. In April 1919 a boom set in and continued for about a year. Prices rose as did wages.

For reasons that have not yet been made apparent deflationary policies that were 'unthinkable' in early 1919 came to be implemented in response to Treasury and Bank of England advice in November 1919 [Dowie 1975]. The hitherto ineffective Bank rate was raised to 6% on the 6th November and more important the Treasury bill rate was increased to 5% the next day. On the 15th December it was announced in Parliament that the government accepted the Cunliffe Committee's recommendations on government borrowing, on economy in public expenditure and on note issue limitation In April 1920 Bank rate was increased further to a highly effective 7% (Howson 1975 p 16-17) Money supply growth decreased in November 1919 and declined absolutely after February 1921 [Howson 1975 p. 29]

Figure 3

Money Series



Source: Howson (1975) Chart 7, p. 158.

A genuinely tight monetary and fiscal policy had been instituted and was to be strenuously maintained to beyond the abandoment of gold in 1931. The budget was in substantial surplus but for marginal deficits of 8, 10, 32 and 2 million pounds incurred in 1926, 1929, 1930 and 1937 respectively. Substantial surpluses were applied to the redemption of some £ 595 m of government debt between 1921 and 1938. The maturity structure of the debt was generally lengthened and external government debt reduced from £1293 m. in 1919 to £ 1032 m. in 1938. The money supply (bank deposits and currency) stood at £ 2129 m. in the second quarter 1920. It fell slightly and steadily to £ 1949 m by the second quarter of 1925. By the second quarter of 1929 the money stock was £ 2075 m and only began to grow more rapidly only after 1932. The money supply grew steadily by 29% between the second quarter 1932 and the second quarter of 1938. [Howson 1975 appendix I]

As we shall see the reality of tight money and the expectations of policy between 1920 and 1925 were not always consistent. Some of the mistaken expectations, as has been suggested, may be fairly attributed to misconceptions created by British governments.

Prices and wages demonstrated a wondrous flexibility in the downward direction. Wholesale prices fell by 36% in 1921 and by a further 20% in 1922. Wages fell by % . Despite this experience, when incidentally union membership was at a peak,[11a] wages soon came to be regarded as highly inflexible by both Keynes and his orthodox opponents.

11a Union membership was 3.4 million in 1912, 8.3 million in 1920 and 5.0 million on average between 1931-1938 [Glynn and Oxborrow 1976 Table 6.1 p. 168]

This flexibility did not prevent a sharp contraction in economic activity (11) The reference cycle of the Natural Bureau of Economic Research indicates that the contraction phase of the cycle began in March 1920 and ended in June 1921. The subsequent expansion extended to November 1924 (Howson 1975 p. 54)

From approximately mid 1921 the U.S. dollar value of the pound began to appreciate. From a 1921 low value of \$3.59 the pound appreciated almost continuously to reach a level of \$4.71 in February 1923. Thereafter the pound depreciated reaching a low of \$4.27 in 1924. Clearly it cannot be actual monetary and fiscal policy that can be held responsible for the decline in the dollar value of the pound in 1923. As is indicated in the 1924 quotation from Keynes, the policy intentions of government were not obvious and a return to gold at the prewar party could not have been regarded as inevitable. Indeed even Norman who regarded the date of the return to gold as the "only practical question" " . . . kept an open mind right to the crucial day 20 March 1925, - when Churchill with Norman's full support, decided that the deed should be, done in the last week of April." (Sayers 1976 p. 135)

A number of factors undermined confidence in the prospect of any immediate or indeed ultimate return to gold. Advocates of "managed money" including Keynes and Hawtrey could not be ignored. In the light of the German hyperinflation it would have been difficult to convince

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11 See appendix 1, tables 1 and 2, below.

observers that managed money a la Keynes would not be inflationary (Hancock 1960 p. 309). In addition the Bank of England was subject to increasing criticism,from organized industry among others, for what were regarded as unemployment intensifying increases in interest rates. As Sayers remarks "this new tide of criticism affected policy or at least the atmosphere in which policy decisions were taken" (see Sayers 1976 pp. 125-132).

In October 1923 a speech by the newly appointed Minister of Labor, Sir Montague Barlow understandably disturbed the exchange market. The minister discussed "the possibility of the adoption of a policy of inflation as a means of financing schemes for the relief of unemployment" (Sayers 1976 p. 131). Sayers suggests that the effect (of the speech) was;

> magnified not simply because a breach in the Cunliffe gold standard policy had not been broached by even junior ministers before, but much more seriously because the year 1923 had been one of a distinct shift of public opinion on the objectives and possibilities of monetary policy; the persistance of unemployment above the million mark encouraged hesitations over the gold policy and afforded a better hearing to any reasoned alternative. Norman had found this when he proposed a higher Bank Rate in the summer; he won the day, but the agitation went on. A Federation of British Manufacturers memorandum (July 1923) stressed stabilization of prices as more urgent than a return to gold. (Sayers 1976, p. 131).

The Bank of England did nothing to steady the market and agreed that the Cunliffe policy should not be reconsidered until the reperations and war debt issues were settled. Minister Barlow was repudiated by the Prime Minister but 'the unemployment precipitated a general election and the market liked neither the political unsettlement . . . . . . nor the advent of the first Labor government' (Sayers 1976 p. 132)

According to Cook's interpretation of political events the decision to go to the country in December 1923 was Prime Minister Baldwins. It was a decision taken against the advice of many party leaders and was an unhappy surprize to many members of Parliament coming soon after the election in November 1922 of a substantial Conservative majority. The 1922 election was precipitated by the Conservatives withdrawing their support for the coalition government of Liberals and Conservatives led by Lloyd George.

Baldwin with a cure for unemployment in mind fought the 1923 election on the issue of tariffs. Opposition to tariffs reunited the fractious wings of the Liberal Party who did just well enough at the polls to enable a minority Labor government to assume office for the first time. The Labor government under MacDonald made no concessions for continued Liberal support. The government was also determined to prove its political responsibility and the policies adopted with respect to the gold standard were highly consistent with this strategy (Cook 1975).

Figure 4

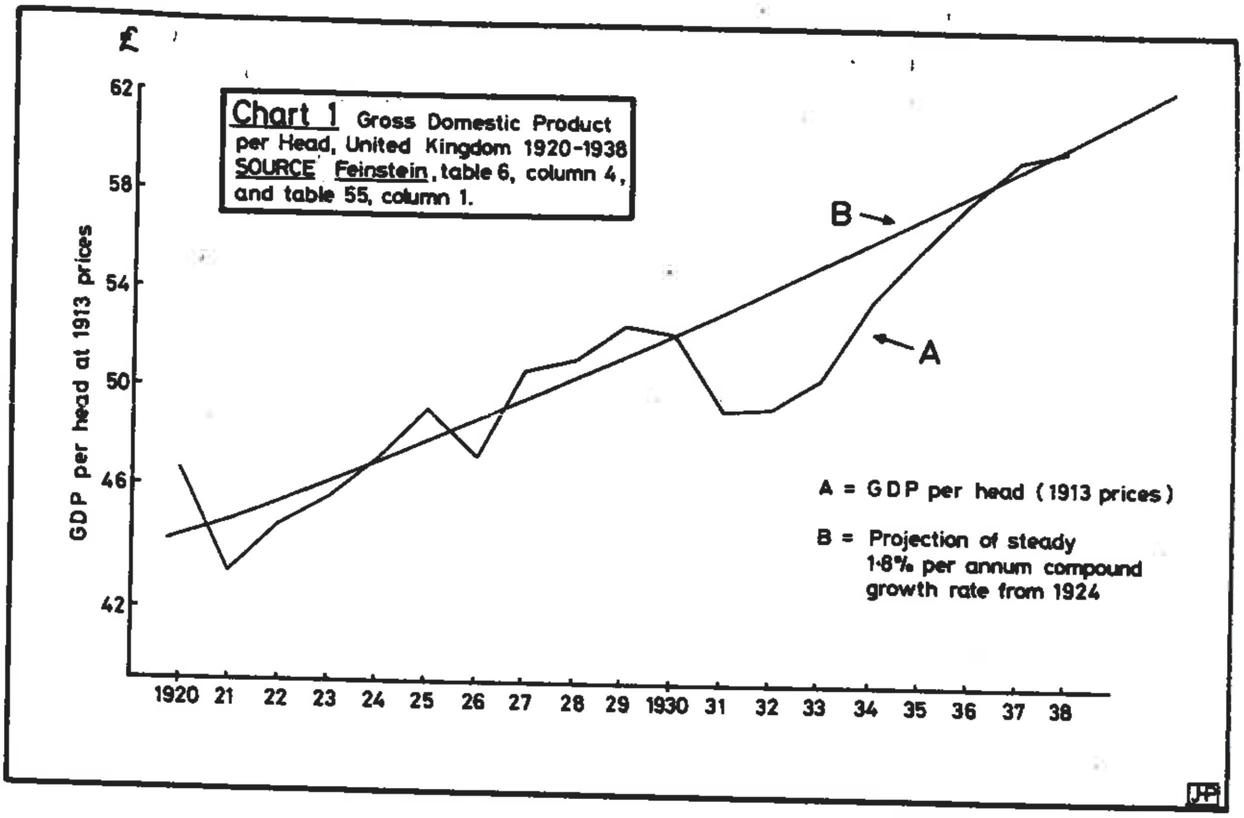

Chart 1 Gross Domestic Product per Head, United Kingdom 1920-1938
SOURCE Feinstein, table 6, column 4, and table 55, column 1.

Therefore despite the emphasis of the Labor Party on the policies of unemployment the new government on February 24, 1924 declared that it would be 'guided by the conclusions of the Committee on Currency and Foreign Exchanges, commonly called the Cunliffe Committee (Sayers 1976, p. 136).

Two weeks later the Chancellor of the Exchequer, Snowden, appointed a committee to 'consider whether the time has now come to analgamate the Treasury note issue with the Bank of England Note Issue, and, if so, on what terms and conditions the amalgamation should be carried out? These terms of reference were intended to disguise 'a review of "the basic problem, that of restoring the gold standard" (Sayers 1976 p. 137).

The run up to the eventual return to gold had begun in earnest. The market apparently was not easily convinced of the sincerity of the government's intention to return to gold. It was only with the return of a Conservative government in October 1924 that the market appeared to regard the return as likely.

What is important about the twists and turns of economic policy between 1919 and 1925 is the uncertainty it generated. Moreover realized monetary policy was very tight and consistently tighter than was expected.

Inflationary Expectations

Purchasing power theories of the determination of exchange rates were well established during the twenties. If exchange rate expectations were conditional on differences in expected price movements then it may be possible to draw inferences about expected price movements and by further implication, expected money supply policies from the exchange market. Supporting inferences may be drawn from interest rate developments.

The accuracy of exchange rate predictions is indicated by comparing the spot rate of exhange with its predicted value. An estimate of the spot rate at time t is the forward rate at time t-n. Such a comparison of the spot rate with the forward rate ruling 3 months previously is made in figure 2 . The general pattern that emerges is that the forward rate usually underestimated both the appreciation and depreciation of the pound as may be seen in figure 2. This is a corollory of the continuously small forward discount on the dollar and the persistant movement of the spot rate in first the one and then the other direction. The ratio of the forward to the spot rate has been used as an indicator of the "turbulence " of a floating exchange rate regime By comparison with the seventies the early twenties seemed rather tranquil. [Frenkel and Levich 1977]

Intimations of inflationary expectations may also be found in the level and structure of interest rates. Nominal interest rates however incorporate an expectation of both inflation and the real productivity of capital. However if capital is mobile it is the "world" average expected real rate of return that will influence interest rates in any particular country. One of the features of the pre-1914 gold standard in Britain was the extraordinary stability of long term interest rates both absolutely and relatively to short term rates, as may be seen in figure 6. As a result the value of long term government debt was thought highly predictable. Consols were regarded as the first line of bank reserves after cash itself [Goodhart 1968 Chap. 8]. Shorter interest rates were frequently manupilated by the Bank of England to protect the balance of payments. Increase in Bank rate and with it other short term rates were expected to be temporary. This observation is consistent with the observed stability of the long rate. The long rate is the weighted average of expected short term rates over the forecasting horizon. [Pesando 1978]

The inflation and inflationary expectations during and after the first war sharply raised long term interest rates and sharply reduced the value of consols and their like. In Keynes inimitable words

> 'The effect of the war, and of the monetary policy which has accompanied and followed it, has been to take away a large part of the real value of the possessions of the investing class. The loss has been so rapid and so intermixed in the time of its occurrence with other worse losses that its full measure is not yet separately apprehended. But it has effected, nevertheless, a far-searching change in the relative position of different classes. Throughout the Continent the pre-war savings of the middle class, so far as they were invested in bonds, mortages, or bank deposits, have been largely or entirely wiped out. Nor can it be doubted that this experience must modify social psychology towards the practice of saving and ivestment. What was deemed most secure has proved least so. He who neither spent nor "speculated", who made "proper provision for his family", who sang hymns to security and observed most straitly the morals of the edified and the respectable injunction of the wordly wise - he, indeed, who gave fewest pledges to Fortune has yet suffered her heaviest visitations.'
> [Keynes 1973 Vol. IV p. 16]

Fears of inflation clearly lingered on through the twenties. Even after the return to gold in 1925 the return on 2 1/2% consols remained well above 4%, which was very high compared to yields available before 1913. The consol rate first fell below 4% in the second quarter of 1932. It fell further to a low of 2.88% in the second quarter of 1935. After allowing for the deflation in the 20's and the inflation in the late 30's the realized real long term rates of interest were very high in the period before the return to gold and very low in the period after gold was abandoned.

The term structure of interest rates may also give some indication of deflationary or inflationary expectations. In general a positively sloped term structure, long term rates higher then short, indicates inflationary or expansionary expectations and shorts higher then longs deflationary or contractionary expectations. Hawson has calculated a yield gap between 2 1/2% consols and average short rates in London between 1919 and 1938. The yield gap is indicated in table 3. Same interesting patterns emerge. The market clearly anticipates deflation in the final quarter of 1919. Expectations of expansion or inflation are implicit by the second quarter of 1921. The yield gap is at its widest in 1922 and 1923 and falls by the end of 1924. Between 1925 and 1928 the term structure is practically flat. The term structure in 1929 correctly portends the depression but inflationary expectations are once again apparent in 1930 and 1931. From the second quarter of 1932 the term structure is positively sloped because short term rates fall much further than long rates for most of the period to 1938. These very low short term rates, consistently with interest parity theories, reflect the appreciation of the pound against the dollar and depression in the U.S.

Was the Pound Overvalued at 4.86?

As part of the conventional criticism of the decision to return to gold at the pre-war parity attempts were made in the twenties and also more recently to measure the extent of the 'over valuation'of the pound by comparison with purchasing power parity. Keynes regarded the dollar value of the pound as 10% two high. In the Macmillan Committee Report of 1931 the over valuation was regarded as of the order of 10 - 15 percent.[12a]

Moggridge takes the Bank of England to task for having no professional economic and statistical advice of its own to provide purchasing power calculations. The govenor is understood to have utilized a crude average of a number of independent calculations.

12a The Committee on Finance and Industry Report Cmnd. 3897 London 1931. (See Sayers 1976 Chap. 16.)

More recent experience with floating exchange rates have provided additional information about the behavior of floating exchange rates and their relationship to price trends and to the balance of trade. We shall follow Mussa's interpretation of the evidence. [Mussa 1978]

Mussa notes a number of empirical regularities which hold for both the 1920-1025 period and more recently. Some of the regularities are indicated above and in figure 1. Part of the evidence may be summarized as follows. Changes in spot and forward rates are highly correllated. While the forward rate is an unbiased predictor of the corresponding furture spot rate, perhaps the best predictor, it is not a good predictor. Mussa explains that the forward rate over long periods of time is, on average, a better predictor than the spot rate only because on average currencies that are consistently at forward discount or premia do actually move in the direction predicted. Mussa notes further that over 90% of the month to month or quarter to quarter variations in exchange rates are unexpected.

The following generalities emerge about the relationship between exchange rates and price levels. Over 'sufficiently long time periods when there have been substantial movements in relative price levels, exchange rate movements have been consistent with relative purchasing power.' But Mussa remarks further that 'while exchange rate movements are broadly consistent with relative purchasing power parity, it should be emphasized that there are important deviations from relative purchasing power parties in both the long run and the short run' (Mussa 1978 p. 16). One may add a further thought, not attributable to Mussa, that substantial deviations from relative purchasing power are much more likely for currencies that serve as foreign exchange reserves.

Mussa 'observes a number of instances in which substantial divergencies from relative purchasing power parties (on the order of 10%) emerge very rapidly over a period of two or three months' (Mussa 1978 p. 17). This is because exchange rates often move very rapidly by comparison with smooth movements in national price levels. Mussa suggests that the most important and most reliable relationship between interest rates and exchange rates is the interest parity relationship (Mussa 1978 p. 19) Mussa indicates further that there is at best a rather tenuous, short run, month to month, relationship between exchange rate movements and trade imbalances.

The up shot of the observed empirical regularities is surely that any evaluation of the approriateness of the pre-war parity for Britain in 1925 on the basis of relative purchasing power can not carry much conviction. It was surely the observed unemployment that suggested overvaluation, balance of payments difficulties and a restrictive monetary policy. As we shall see much of the unemployment may have an alternative explanation. The balance of payment difficulties, to the extent there were serious difficulties, may also have an alternative explanation.

Stock Markets and Bank Rate Technique

As Mussa demonstrates the evidence on exchange rate movements cannot be reconciled with the traditional supply and demand model of flows of exports and imports. The foreign exchange market, and especially so for reserve currencies, is a stock market. Like other stock markets the value of spot prices will be functionally related to expectations of future spot prices. Spot and future prices change as expectations change when additional information becomes widely available. Stock markets are efficient in that all the relevant news is implicit in market prices.

Governments can permanently influence the price of assets by changing expectations. However markets learn to distinguish the symbol from the substance in governments attempts to move markets in one direction or another. Government credability is gained by way of consistency in word and action. Innumerable recent examples reveal the inability of governments to control exchange rates or interest rates by announcement. Market determined interest and exchange rates are consistent with interest rate parity and conditional upon inflationery expectations which depend in turn on anticipated money supply and demand developments.

The international gold-sterling standard worked so smoothly before 1914 because it was very confidently expected that the link between sterling and gold would be maintained. This confident expectation made temporary increases in bank rate and with it short term market rates so effective in protecting the miniscule gold reserves of the Bank of England. When bank and market rates went up they were confidently expected to come down again in the near future. The temporary advantage of high rates moved the capital account of the balance of payments in London's favor and kept gold from leaving. As indicated previously the stability of long term rates is evidence of expected price stability and consistent with the belief that bank rate increases would be temporary.

Observers in London may have been inclined to confuse the symbol of bank rate changes with the substance that ultimately made bank rate changes effective. The substance was the long run dependence of changes in the supply of money on the balance of payments. The implications of fixed exchange rates for money supply developments, well recognized by Hume, Ricardo and Thornton, have been rediscovered and further illuminated by the monetary approach to the balance of payments. (12)

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12 See inter alia Frenkel and Johnson 1976.

By observation of the statistics it is not at all obvious that the British balance of payments was in any fundamental disequilibrium between 1925 and 1931 (13) The movements in capital and current account current appear highly interdependent (see Jonson 1976). The Bank of England as before 1914 wore but a thin veil of gold. The Cunliffe Committee had regarded gold reserves of £ 150 m as a condition for returning to gold and actual gold reserves mostly exceeded this level after 1925. (Sayers 1976 appendix 37).

One important difference between monetary arrangements before 1914 and after 1925 was the relative stability of bank rate after 1925. Serious political objections to increases in bank rate had been raised before 1925 (Moggridge 1972 p. 200 & Sayers 1976 p. 132) The objections to the apparent unemployment creating effects of higher interest rates seriously inhibited the application of bank rate technique after 1925. [Sayers 1976 especially Chap. 9]

Largely denied the principal instrument of control over the foreign exchanges and with attempts at international monetary reconstruction frustrated by French-German rancour it may be understood why Norman described himself as 'under the harrow 'to the Macmillan Committee. (SAYERS 1976 Chapter 9) He was trying to play the gold standard game under very different and difficult rules.

As an alternative to Bank Rate changes the Bank of England adopted a number of measures designed to protect the gold reserve. The Bank tried to control foreign issues, it artifically widened the gold points, it disguised its foreign exchange reserves and it cooperated with the Federal Reserve Bank of New York and with the Bank of France (Sayers 1976 especially Chapter 9).

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13 See table 2 below

The Departure from Gold 1931

Why did Britain abandon the gold standard? For a Keynesian the question has been to explain the when rather than the why of the decision to float sterling. The why is regarded as implicit in the persistant unemployment intensified by restrictive monetary and fiscal policy designed unavailingly to maintain the value of sterling . Contemporary Non-Keynesian analysts also assumed that the balance of payments was chronically weak. This weakness was attributed to structural imbalances in the economy reflected by the state of the declining industries and the unemployment they associated with that decline. They thought wages were too high and needed to be reduced in order to restore British competitiveness. The inflexibility of wages was attributed to the power of the trade unions and to the unemployment benefits that enabled the Trade Unions to resist wage cuts. It should be remembered that neither national income or official and complete balance of payments statistics were available to contemporary observers.

The third quarter of 1931 was an extremely difficult period for London a major international banking centre with extensive short term liabilities. It was made difficult by the crisis in Austrian and German banking. Not independently of the banking crisis the great depression had also broken, international trade was collapsing and unemployment was increasing sharply. Nevertheless sterling's break with gold was not inevitable. Moreover it did not seem inevitable to at least one important insider both at the time and many years later. (14)

The proximate cause of the British decision to float on the 19th September 1931 was the withdrawal of private foreign owned sterling balances

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14 As Sayers tells the story, Niemeyer, earlier in the twenties a leading Treasury economist and official and then an adviser to the Bank of England wrote a memorandum that was highly critical of the defense measures taken by the Bank of England in 1931 Niemeyer held firmly to this point of view some 40 years later (Sayers 1976 p. 406).

We shall watch closely the rush of events, that undermined Britain's commitment to the gold standard; A fresh commitment was called for in a highly symbolic way. What was required was a reduction in the expected budget deficit which in the circumstances and interestingly from the perspective of this paper meant a reduction in spending on unemployment benefits. As we shall see the symbolism was well understood by both the authorities and by the market place. As we shall also see important political sacrifices were called for and made. The opposition to cuts in spending remained powerful and of greater importance was believed to be powerful. Paradoxically the Keynesian and the orthodox interpretations of the British unemployment - fixed exchange rate conflict combined to destroy the gold standard. (15) While Keynes was calling for extra demand to raise prices to lower real wages to stimulate employment Orthodox economists were calling for cuts in money wages. It would have been difficult to have been complacent about the possibility of achieving such cuts given the perceived in flexibility of wages and the history of strike action and the strength of the Labor Party. (16)

It remains debateable, even after the final week-end rush on sterling, whether the Bank of England was defeated or surrendered despite adequate reserves. It is ironical that the leading fighter for the old order, Montague Norman was sick and absent from the Bank. It is striking that throughout the crisis the Bank of England

15 Coincidentally on the day August 13 of the German banking crisis the Macmillan report appeared. The majority report was largely written by Keynes. It paid obsequience to the gold standard but called for international co-operation to raise prices without changing exchange rates. It is however not obvious that the Macmillan report had much independent influence on market sentiment one way or the other. The exchange markets were preoccupied with other developments.

16 See below for example the discussion in the 'Economist'.

did not apply established methods of dealing with a run on sterling. These methods were to raise bank rates as high as necessary and at the same time to let gold go. On July 30 bank rates were raised from 3 1/2 to 4 1/2%, anything but a crisis rate, and maintained there throughout the crisis. Bank rate was raised to 6% only after Britain left gold. While sterling was extensively supported with the aid of foreign credits raised for the purpose the Bank of England held on to its gold reserve till very near the last moment and did not allow sterling to fall to the gold export point. We shall follow the events through the pages of the Economist supplemented by Sayers' description of developments inside the Bank of England.

The Economist of the July 4 in a summary of the preceeding monetary half year noticed two distinct phases, though "idle funds and low rates" were common to both. The first phase from mid, January to early May was

> 'characterized by the steps which the Bank of England was constrained to take through the exercise of its indirect influence over the market, to correct the persistant underlying weakness of sterling and to check the drain on its gold holdings. The second phase, inaugurated by the relaxation of market control and the reduction of Bank Rate to the lowest point reached since October 1909, (2 1/2%) was one in which the dominant factor was no longer the quotation for sterling in Paris and New York, but the growing financial crisis in Central Europe, the decline in the value of the Reichs mark and the outflow from Germany of disquietingly large sums in gold both to London and other centres [Economist Vol CXIII No. 4584 July 5 p.5]

Sayers, with the help of hindsight, puts a somewhat different interpretation on events

> 'The circumstance that made the crisis possible was the illiquid position of London as an international financial centre. The development of the international capital position in the late twenties and in 1930-31, a period in which the UK balance of trade was chronically (but not catastrophically weak, had left London with short liabilities greatly in excess of the gold and foreign exchange reserves in the Bank. This vulnerability was probably generally sensed in international financial

> circles before every 1931, but it had not been allowed to impede the Bank in its effort to ease the strains of the slump by bringing down Bank Rate: . . . (Sayers 1976 p. 389)

It is hard to understand how London could have been an international banking centre without 'short liabilities greatly in excess of the gold and foreign exchange reserves' of the the Bank of England. The success of a bank and of a banking centre relies on maintaining absolutely the confidence of its creditors.

A decline in confidence in Britains attachment to gold was not apparent in the exchange market. Confidence is in fact implicit in the decline in interest rates during the first half of 1931. At the close of business on Friday May 16 the spot dollar rate stood at $4.86 1/4 and the one month and three month forward sterling-dollar rates stood at a premium in favor of sterling of 7/32¢ and 5/8¢ respectively. [Einzig 1937 appendix 1] Extraordinarily enough forward sterling is consistently at a premium over the spot rate throughout the crisis. Does this imply that speculators were selling spot and buying forward?

Sayers notes that 'on or after 5 August, the Bank of England held both the New York and the Paris spot rates practically pegged above the gold export points' (Sayers 1976 p. 407) The Bank, according to Sayers, did not intervene directly in the forward market (Sayers 1976 Chap. 17)

This is running ahead of our story somewhat but reinforces the issue raised earlier about the unorthodox treatment of the crisis in the form of no increases in bank rate and no gold outflow. Sayers regards the disadvantage of this policy of supporting the pound as

> 'drawing attention to the fact that the Bank was in the market all the time itself a 'bear'point though leaving domestic observers under the impression that was no danger of gold losses and therefore no need for rushing into extreme measures of reform'

This is surely to underestimate the effects of much policy in the particular circumstances. The policy gave sellers of sterling an easy one way option. If in the circumstances there was little possibility of sterling appreciating much and every possibility of a depreciation, the policy of low bank rate and a high pound was bound to sustain a run on sterling in the midst of crisis.

The international monetary crisis intensified in the second week of July with the failure on the 13th July of an important Bank in Germany. The Reichsbank came under increasing pressure of foreign withdrawals of gold and the President of that Bank travelled to London, París and Basle in search of further support. On the Friday 10th July the British Government had invited countries involved in the Hoover Plan to a conference in London on the 17th July to deal with the crisis. The conference met on the 20th July. A diary of the crisis published in the Economist on July 18 reports that on Monday 13th the Central Bank chiefs met at Basle and at midnight issued a comminique to quote the Economist, declaring that 'the German Government having approached various governments with a view to obtaining financial assistance on their markets, the B.I.S. (Bank for International Settlements) is prepared to collaborate . . . . and to strengthen the assistance [to Germany] by all the means at the disposal of the Central Banks.' The Economist went on to report that the 'absence of figure of any new credit correctly interpreted to mean that Central Bankers, finding the situation too much involved with politics, hand back the problem to the Governments concerned but B.I.S. authorized to prolong the rediscount credit to the Reichs bank repayable July 16th.'

Sufficient additional credit was not forthcoming and the German crisis was not resolved. The 'Seven Power' conference which the Economist on July 25th described 'as the most representative and influential body of world statesmen that has assembled since the was' was judged to have made ...

> 'no very dramatic or definite contribution towards the solution of the very grave difficulties which beset us all. What it has done is to give us a further breathing space. It is clearly urgent that between now and the meeting of the league in September unremitting efforts must be made to deal with the underlying causes in both the political and economic sphere.'

The political problems were of course unremitting French-German hostility or as the Economists described the situation.

> The month has been one of considerable irritation and of ragged nerves in both France and Germany. The former, doubting the genuineness of German difficulties, felt the Hoover Plan as a severe rebuff, while the latter, though facing the present situation with admirable restraint, is in the grip of an acute crisis which threatens to produce increased unemployment and fresh hardships in the coming months, and is disposed to regard France as an obstacle to measures of assistance. Even the steps taken to summon this improvised and ill-prepared Conference were a minor cause of irritation. We believe, however, that most of the public in both countries profoundly desire peace. On the whole, the meeting has tended to improve the political atmosphere and by so doing has contributed towards the restoration of confidence. [Economist July 25th 1931 p. 159]

The French sought reassurence in gold and gold came to be withdrawn in significant quantities from London. The Bank of England had begun to lose gold on the 13th July. According to Sayers

> 'on the 16th, a rise in Bank Rate was considered, but Norman thought the task was one for the politicians, scheduled to meet on the following Monday. His hope was dissapointed and on the 23rd the Bank initiated orthodox defensive measures: it began to sell in the market its rather small remainder of foreign currencies and it raised Bank Rate from 2 1/2 to 3 1/2.' (Sayers 1976 p. 391)

The increase in Bank Rate did not stem the decline in Reserves. In the Bank, two methods of dealing with the problem were considered The one view placed an

> 'emphasis on gold standard behaviour by openly allowing gold to go and stepping up Bank Rate sharply . . . .' The other and prevailing view was to 'repeat the 1925 reliance on

credits . . . . with the optimistic suggestion that the knowledge of their existence would be sufficient to stop withdraws.' (Sayers 1976 p. 392)

Sayers reports that the lows of reserves continued Reserves decreased by Ƚ 55m between the 13th and 31st July out of reserves of gold and foreign exchange that had totaled Ƚ193m on the 30th June. (Sayers 1976 Appen.37)

On the 30th July Bank Rate was increased to 4 1/2% and the Chancellor persuaded to accept the arrangement the Bank of England had concluded to borrow Ƚ25m from banks in local currency in both Paris and New York. The Bank also asked for authority to increase the Fiduciary Issue 'in order to assure the Federal Reserve that gold from the Bank would be available if required, for repayment of the credit' (Sayers 1976 p. 393)

On the Saturday after the formal announcement of the credits the Economist greeted the decision with considerable enthusiasm as follows

THE EXCHANGE CRISIS.

On Saturday the Bank of England made the following official announcement:—" The Bank of France and the Federal Reserve Bank of New York have each placed at the disposal of the Bank of England a credit in their respective currencies for the equivalent of £25 millions, making a total equivalent of £50 millions. On the application of the Bank of England, the Treasury has issued a Minute in accordance with the procedure laid down in the Currency and Bank Notes Act, 1928, authorising an increase of £15 millions in the fiduciary note issue for a period of three weeks, thus raising the total of the authorised fiduciary issue to £275 millions." This news put an end to the crop of rumours of the previous week, some of which received notice in the *Economist* of August 1st, and led to an immediate improvement in the foreign exchanges.

The increase in the fiduciary note issue can be dealt with very shortly. Gold withdrawals and the holiday expansion in the note circulation would, according to this week's Bank return, have reduced the Reserve to £29.6 millions and the proportion to 27¾ per cent. had it not been for the increase. Such figures would have been adequate, but might have left little margin in hand for future emergencies. The expansion in the note circulation is purely seasonal and temporary and the recent gold losses are largely due to special and, it is to be hoped, non-recurrent causes. It was to meet, first, such an emergency as this that the relevant clause was inserted in the 1928 Act, and it will be recalled that the powers contained in this clause were intended to be used whenever advisable, and that their application was not to be regarded as evidence of a major financial crisis akin to the suspension of the Bank Act in pre-war days. It may be said at once that, had these powers not been made use of in the circumstances of last week-end, the Bank and Treasury authorities would have been open to criticism.

Nor is it unprecedented for the Bank of England to obtain help from abroad. In 1925, to go no further back, the Bank, on the re-establishment of the gold standard, obtained a $200,000,000 credit from the New York Reserve Bank, which was buttressed by the option on a further credit secured from Messrs J. P. Morgan and Company by the Treasury. It is perhaps to-day a happy omen that it was never necessary to draw upon these credits. The size of the credits need not arouse any surprise or misgivings. If such credits are to be opened at all, it is best for them to be so big as to make it clear beyond question that they are able to give the protection they promise. As our experience of 1925 showed, the bigger such credits are the less is the likelihood that they will have to be used.

In the same issue of the Economist a leading article referred to the report of the 'Committee on National Expenditure' of the House of (the May Committee Report) that had been issued that week. This report was to have the most profound effects on the fate of the British Government and of the pound. It was this 'May Committee' that demanded the cut in the expected budget deficit as a solution to Britain's financial and economic difficulties. The cuts proposed were to prove difficult to make and came to be symbolic of Britians determination to stay on gold. All this was recognized by the Economist despite it regarding the Report as unnecessarily sensational and somewhat naive. The Economists response 'A New Axe' is worth repeating at length.

A NEW AXE.

WHEN four years after the war Sir Eric Geddes and his colleagues sharpened their economy axe, their eyes may well have gloated over the spreading branches of war-time expenditure ready and waiting for extensive lopping. The prospect which Sir George May and his colleagues this year faced on the Committee on National Expenditure, which has just reported,* was very different. The only obvious and substantial excrescences inviting their attention were those created by the recent extravagant policies of the last two Governments—policies from which radical departure would be extremely controversial and unpalatable to large sections of the population. Before the Committee was appointed in March the Chancellor of the Exchequer himself regarded the field for economy as so limited that he told the House of Commons that he could write the Report himself in advance. It is something of a surprise, therefore, to find the Majority of the Committee recommend immediate cuts in expenditure affecting the next Budget amounting to nearly £100 millions, and also frame a network of proposals designed to safeguard future Budgets from their natural tendency to swell.

As was almost inevitable, there is a Minority as well as a Majority Report. The latter, which is signed by the Chairman and four colleagues, opens sensationally with a calculation suggesting that, even without allowing for the £11 millions cost to the Treasury of the application of the Hoover moratorium, the Chancellor of the Exchequer will be faced next April with a prospective deficit of nearly £120 millions. The need for radical retrenchment is so urgent that we sympathise with the obvious aim of the Committee to make the public's flesh creep. Nevertheless, for the sake of those who are not closely conversant with financial statistics, it is necessary to point out that this suggested figure of £120 millions deficit rather seriously overpaints the gloom of the immediate budgetary prospect. The casual reader might deduce that actual national expenditure threatens to exceed actual national revenue by £120 millions in 1932-33. Happily the position is not anything like as bad as that. For, accepting the Committee's own figures, £50 millions of the threatened deficit is accounted for by sinking fund applications and £40 millions by borrowings for the Unemployed Insurance Fund, which the Committee—in profound disagreement on this point with the Chancellor of the Exchequer—insist upon regarding as equivalent to Treasury borrowings for current expenditure.

The gap, then, which the Committee set out to bridge is £120 millions, and they suggest means of saving £96 millions. Details of the method by which they reach this figure will be found in a summary of the Report given on later pages of this issue. Over two-thirds of the whole of these economies they seek to achieve in the realm of unemployment insurance. Travelling far beyond the interim recommendations of the Royal Commission, which is still sitting, they recommend the raising of contributions, the wholesale application of means tests for transitional beneficiaries, and the extension of the scheme to bring in new classes of insured. Next in size among the projected cuts comes a figure of £13.6 millions to be saved by a reduction of 20 per cent. in teachers' salaries, while nearly £8 millions is to be saved by postponement and slowing down of road schemes and maintenance. The Majority would cut police pay by 12½ per cent.; Development expenditure is to be slowed down; Civil Servants' leave shortened; capitation payments to doctors under the National Health Insurance Act reduced; and among a host of other minor recommendations are the abolition of the Empire Marketing Board and a cut in the State grant to the British Broadcasting Corporation.

The signatories of the Minority Report, Mr Arthur Pugh and Mr Latham, recognise the need for economy, concede the justice of a cut of, say, 12½ per cent. in teachers' salaries, and accept various minor recommendations of the Majority, but they join issue with the Main Report both with regard to its conception of the whole problem of economy and with the principle of what they appear to regard as indiscriminate lopping. The line of thought running through the Majority Report is that, while general equality of sacrifice is desirable, the immediate problem of planning the next Budget cannot be delayed, and that, therefore, it is necessary to lop off as much expenditure as is justly possible and fill up any remaining gap by taxation. The Minority argue, on the other hand, that, if the situation is as serious as is made out, it calls for general sacrifices, and in such sacrifices the whole community must share, including the *rentier*. With the general principle that in times of national emergency demanding sacrifice, such sacrifice should be planned so as to be shared in proper proportions by all forms of income, no one, we think, will quarrel, and, although the *rentiers*—specially those with the higher incomes—may retort that they have already been called upon to sacrifice much through higher taxation and the collapse of income from what were hitherto regarded as steady fixed-interest securities, the principle of common sacrifice is one that must, in one form or another, be ultimately achieved. Just so far we have considerable sympathy with the signatories of the Minority Report, but the awkward fact remains that no one has yet devised—and the Majority of the Economy Committee apparently regard it as outside their mandate to devise—efficient machinery for ensuring general equality of sacrifice, and, meanwhile, the difficult Budget position has got to be faced without delay. It is in the light of that fact that the proposals of the Majority must be examined, and, in passing, we may say that too much importance should not be attached to the argument of the Minority that the reduction of benefits and wages reduces the purchasing power of the public and thereby contributes to trade depression. This view is a popular one on the Socialist benches to-day, but it does not take into account the fact that unjustifiable expenditure of the taxpayers' money merely represents an unjustifiable transfer of purchasing power, not a diminution, and, further, that what we may call "anomaly" expenditure tends to aggravate the unemployment problem, and, in so far as it is curtailed, the situation may be proportionately improved.

The Report was issued on the eve of the summer recess, and it is, therefore, difficult to estimate its political effects and its chances of becoming a basis for action. With the Report in his hands, the Chancellor of the Exchequer gave a grave warning as to the Budget position to the House of Commons on July 30th. While pointing out with justice that our own Budget position is better than that of most other countries, Mr Snowden said, "I tell the House quite frankly that the outlook for the Budget of next year, unless very considerable economies can be effected, is a very serious prospect indeed," and later he went on to say, "It is, of course, absolutely essential for the maintenance of the credit of this country that there should be a balanced Budget." These phrases, falling from the lips of a Chancellor who has already stated his view that any increase in the tax burden on industry would be "the last straw," must be taken to mean a determination to effect all possible economies. Another favourable omen is the Prime Minister's immediate acceptance of the recommendation of the Main Report that financial control should be strengthened by the formation of a Cabinet Finance Committee on the lines of the Committee of Imperial Defence. But when one looks calmly at the facts, hopes of reduced expenditure on anything like the scale proposed by the Committee begin to fade rapidly. The bulk of it depends upon the Government's willingness to accept unemployment insurance reforms twice as drastic as those proposed by a Commission upon whose urgent advice they have, in the main, refused to act. With this aspect of the situation in their minds, the Members of Parliament broke up for their holidays in an atmosphere of rumour. ~~It was freely suggested that Parliament would~~

* Cmd. 3920. 1931. (London.) H.M. Stationery Office. 4s.

The Bank of England in its discussions with the Treasury at this time was also emphasizing the necessity for 'self help' in the form of immediate action on the budget deficit.As Sayers reports 'the Ball was for the moment at the feet of Ministers. In response, the Chancellor made a firm but conventional statement in the House, (on July 30) and Parliament dispersed, turning its back until October (so it was intended) on the disagreeable tack of belt tightening' [Sayers 1976 p. 394]

In its summary of market conditions in the week ending August 8, the Economist reported;

> Early in the week the market was hoping that the opening of the credits would steady the exchanges and prevent further gold losses, but on Wednesday there was a sudden slump in the pound originating in Paris to Frs. 123.30 and $4.84 3/8. This slump only lasted a short time, for a few hours later sterling recovered to more reasonable levels, though still remaining below the gold point against all important currencies except the dollar. It is not easy to find an adequate explanation of this flurry, to which too much importance should not be attached. At the beginning of last week sterling was receiving special support. It appears that, following upon the opening of the credits, it was thought expedient to withdraw this support, and the flurry began when it became known in Paris that the Banque de France had ceased to support the pound. This gave rise to the mistaken idea that a hitch had occurred in the arrangements for the credit, and a drive against sterling followed, but was suddenly checked as soon as support was forthcoming. The amount of business that passed during this period of nervousness was inconsiderable. [Economist August 8, 1931 p. 254]

The accuracy of the Economists' interpretation of there events is confirmed by Sayers.As soon as the credits were brought into action the gold flow stopped. [Sayers 1976 p. 396]

By the end of the following week the Economist was altogether more sanguine

> The revival in the Continental demand shows that the 4 1/2% Bank rate is taking effect, and the foreign exchange market is also steadier. The New York and Paris rates are now well within the export gold point, and the Amsterdam rate, at Fl.

> 12.04 7/8, is not far below it. The exchange on Zurich still remains obstinately at Frs. 24.90 or well below the gold point. Still, this week's return of gold movements shows that the outflow of gold has been, for the moment, checked. The withdrawal of 2,520,627 from the Bank on August 6th was the last big movement, and since then daily losses have first fallen to the order of 3000,000 and since ceased. The arrival of £614,000 in soverigns from Australia, and subsequent releases from earmark amounting to 1,250,000, and the receipt of £200,000 in sovereigns from South Africa, have further minimised the net gold losses, so that for the week ended August 11th they only amounted to 1.524,000, against weekly losses of 17,000,000 and 15,000,000 towards the end of July. Finally, the price of Cape gold in the London market has fallen sharply from 84s. 11 1/2d. (the Bank's selling price) to 84s. 10 5/8d. per fine ounce, which is evidence of a definite alleviation of the foreign pressure on our gold.
>
> One point of interest is how far this relief has been obtained at the expense of drawing upon the 50,000,000 credits opened in New York and Paris at the beginning of this month. On this matter, of course, no definite information is forthcoming, nor can anything be gleaned from the Bamk return. The steadiness of the exchanges and the present revival in confidence suggests that if the credits have been touched at all, the total draft is a comparatively small one. It must be emphasised, however, that fundamentally the position has not altered, and that the presence of a temporary calm is no justification for any relaxation, but rather an opportunity for redoubling the efforts needed to rectify the position of the national finances. Money market opinion agrees that the revelations of the Economy Report imply no immediate threat to the stability of sterling, and that foreign centres that take a contrary view fail to realise that the danger is still very remote. Still, as the recent experience of other centres has shown, it is easy to impair confidence, and while for that reason every care must be taken not to exaggerate the situation, it must be realised that the centre of pressure has for the moment been transferred from Berlin to London and that evidence of national determination to deal immediately and effectively with the threatened Budget deficit is from the monetary standpoint the most urgent need of the moment. [Economist August 15, 1931 p.298]

In the same issue of the Economist a leading article provided a perspective on the emerging political battle over the May Committee recommendations. The article 'Democracy And Economy ' was introduced as follows

> In the concluding sentences of their report the Majority of the May Economy Committee pose the question whether democracy is to be shipwrecked on the hard rock of finance They might with equal force have put the question the other way round Is sound finance to be shipwrecked upon the hard rock of democracy? That is the key question which faces the Cabinet to-day. How with the present working of democratic machinery and with the present composition of the House of Commons, can unavoidable measures of economy be carried into force? [Economist Aug. 15 1931 p. 299]

The article concluded

> One thing at any rate has been gained. The temporary damage to the prestige of British credit wrought by the publication of the May Report has been offset by its effect at home. It has awakened the public at last to a general recognition that quick economy is essential, and it has 'created a general temper in which a real national effort is possible, given bold leadership from the top.' Mr. MacDonald is presented with a big opportunity to capture the imagination of the country and to show the world beyond a peradventure that whatever Budgetary disorder exists in the British household-and in what national household is it absent? -it will be firmly and effectively set straight. If he seizes that opportunity, he will have the leaders of thought in every party and every walk of life behind him.

The Economist had very accurately set the stage for the ensuing battle over spending cuts and without doubt the foreign exchange market was watching developments closely. Keynes also writing on August 15 highlighted the issue as follows

> The Report of the Economy Committee can be considered from several points of view. It is an exceedingly valuable document because it is a challenge to us to make up our minds one way or the other on certain vital matters of policy. In particular it invites us to decide whether it is our intention to make the Deflation effective by transmitting the reduction of international prices to British salaries and wages; though if this is our intention, it would be absurd to pretend that the process can stop with school-teachers and policemen. The Committee's Report goes too far or not far enough. But this is not the question which I wish to discuss here. [Keynes 1933 p. 157]

By the 22nd August the strains within the British Labor government were clearly showing. The editorial in the Economist dated that day spoke of a 'British crisis'.

> After a week of prolonged sessions of the Economy Committee of Ministers, and finally of the full Cabinet, followed by consultations between the Government and the leaders of the two Oppositions, and culminating, on Thursday, in a conference between the Economy Committee, the General Council of the Trade Union Congress and the Labor Party Executive, we go to press without knowing of the definite shape which the Government's plans the meeting the present and prospective financial difficulties of the country will finally take. Before these lines

> are read details of the programme whose contents rumour has so assiduously and variously forecast may well be public property. We do not propose to add any contribution to the fabric of guesswork.
>
> In any attempt, however, to appraise the merits of a policy propounded as a solution to a problem it is important that the precise character of the problem itself should be correctly appreciated. In the hope, therefore, that we may thereby assist our readers to make up their minds about such plans as Mr. MacDonald may shortly enclose, we propose briefly to recapitulate what appear to us to be the essential factors in the domestic, as opposed to the international, situation with which His Majesty's Government have been confronted during the present month. In the first place, to ensure that our power for political leadership internationally should be maintained through the critical days still ahead, it was essential that all doubts should be allayed as to our ability to hold firmly to the gold standard, notwithstanding the strain placed, directly and indirectly, on London by the Central European crisis (Economist August 22, 1931 p. 339)

The Economist summaries of developments in exchange markets over this period were consistantly optimistic. Characteristic is the report of August 22.

> While the market is still awaiting political developments, in some respects a better tone is noticeable. The exchanges have been steadier, and even the Swiss rate is at last moving in favour of sterling. The Bank, too, has gained 1.6 millions of gold, raising the Issue Department's holding to 133.6 millions. This increase was mainly due to the receipt of 1,000,000 in sovereigns from Australia at the end of last week, but a further 200,000 in sovereigns were received from abroad on Monday, while later in the week 350,000 in sovereigns was released from earmark. Of the Cape gold on offer in the market on Tuesday, 540,000 was bought on Dutch account, and the remaining 330,000 by an unknown buyer. The price paid was 84s. 11 3/8d. per ounce. It is believed that there is a direct connection between the foreign purchases of bar gold in the market, and the release of sovereigns to the Bank, and that what is happening is that in order to avoid any addition to their gold holdings, certain foreign interests are offsetting purchases of bar gold by disposals of sovereigns to the Bank. The same thing is believed to have happened last week. [Economist August 22 1931, p. 338]

The Economist would no doubt have been less optimistic had it been fully aware of the extent to which the pound and the gold price were being supported by the Bank of England.

The disagreement over spending cuts within the government could not be resolved. The Prime Minister abandoned the bulk of his Party, that weekend, and formed a "National Government" with Conservative and Liberal Party support for an economyprogramme.

The Economist while strongly commending Mr. MacDonald's leadership could not fail to notice the strength of the opposition ... .

> To begin with, the fact must be frankly appreciated that, in contrast with Mr. Lloyd George's war-time Coalition, the present "emergency" Government of Cooperation has not only the attacks of a numerically strong Opposition to face; it holds within itself the seeds of its own disintegration. The importance and the implications of these two factors require to be carefully weighed. In the first place, though the meeting of the Parlimentary Labour Party has yet to be held as we write, the attitude adopted on Wednesday by the Party Executive in joint session with the General Council of the T.U.C. points unmistakably to all the forces of Labour being mobilised by the political and industrial sections of the Party machine in uncompromising hostility to the only sort of programme which the Government can conceivably announce, or which will satisfy the vital needs of the case. Mr. MacDonald obviously cannot count on the support of more than a handful of adherents in the ranks either of the Parliamentary Party or of trade union officialdom. Nor is this all. It would be idle to ignore the danger that the Labour Party, freed from the responsibilities of office and lacking the guidance of two of its main "moderate" leaders, may allow itself to drift insensibly Leftwards - away from realist policies to counsels of intransigeant extremism. On Mr. Henderson, to whose great work as Foreign Secretary we pay elsewhere a merited tribute, and who will now presumably lead the Party in Mr. MacDonald's stead, there rests a heavy responsibility. That he will use his influence in favour of sane, patriotic policy we are reluctant to doubt: but he will have explosive material under his hands, and though we may discount the malicious, irresponsible propaganda alleging a "bankers' ramp" already emitted by the official Labour newspaper and honourably refuted by the Prime Minister, there may be an irrestible temptation for the Labour Party to make electioneering capital out of the national emergency by arraigning Mr. MacDonald's administration as a "hard-faced Government," subservient to financial interests and bent on the exploitation of the working class. Unless Labour is wisely led, it may be only too easy for the Left Wing to organise, irrespective of the real views of the mass of the nation, such an outwardly formidable-looking opposition to the Government that a Cabinet not wholly united in its conception of right policy might be led to lose faith in its mission and to question whether it held sufficiently the country's confidence. [Economist August 29 1931, p. 379]

The Economists' market summaries for that week noticed 'a general feeling of nervousness' on the Monday and 'some widespread movement of funds.' By Tuesday 'still greater stringency prevailed' on the Wednesday the situation was thought to have 'changed definitely for the better'. [Economist August 29 p. 378]

The nervousness was attributable to the largely accurate report in the Times of the Monday, before the formation of the new government, that the first credits were 'approaching exhaustion'. As Sayers reports the dollars were 4/5 ths and the francs 3/5ths gone [Sayers 1976 p. 399]

The Economist of the 29th August was aware 'of further assistance that may have to be sought abroad to ensure the absolute stability of the pound until such time as the proposals of the new government came into force . . . ' [Economist August 29 1931 p. 378]

The assistance was sought and forthcoming in the form of £80m borrowed, by the British government this time, in Paris and New York. News of the credit favourably influenced the exchange markets. So much so that the Economist could prognosticate in the following terms;

> With the gradual easing of money, there has this week been a tendency for Discount rates to fall away, and if the low rates mentioned above are representative, the decline is beginning to go too far. With the change in the political situation and the arrangement of new support for sterling, it is comprehensible that the market should begin to think that it no longer has the same need to maintain rates as it had; but this is too narrow as view. It is clear that even when the budget is balanced and foreign confidence restored, it will take much time and effort to restore the national balance of payments, and that in the interval it may become desirable to attract a reasonable amount of foreign money to London. This process, of course, could be carried out to an excessive degree, and care will have to be taken that an unsound "short" position does not again develop. Nevertheless, pending the rectification of the national balance of payments, it is undoubtedly desirable that market rates should not fall too far below Bank rate. While it is necessary to retain a 4 1/2 percent. Bank rate, caution suggests that market rate should be in the neighbourhood of 4 4 1/4 per cent. [Economist September 5, 1931 p. 418]

The budget proposals of the national government were still to be made to Parliament and there was no certainty as to how they would fare . There was also the possibility of a general election that the now opposition Labor Party might win.

In the week ending 12th September the Economist described conditions in the foreign exchange market as 'unchanged' feeling being somewhat hesitant pending political developments. The Economist took encouragement from the Bank of England gold purchases that week [Economist Sept. 12 1931, p. 458].

The following week the Budget proposals were presented and enthusiastically endured by the House of Commons. On September 19th the Economist wrote in a leading article 'Restoring the Balance'.

> The first objective of the National Government has been achieved, for the reception in foreign centres of the emergency Budget introduced by Mr. Snowden last week reveals a general and well-founded conviction that, in so far as the public finances are concerned, effective measures are being taken to secure a real and proper balance in the accounts both of this year and of next. Moreover, the course of events in Parliament and the country has shown both that the necessary measures are assured of a safe passage and that the general public have, on the whole, accepted Mr. Snowden's onerous programme of economies and taxes with philosophic resignation. In some quarters, it is true, complaints are heard that this or that section of the community has been unjustly treated. This is inevitable. It may or may not be that complete equality of sacrifice is never obtainable. But it is certainly true that no emergency programme, framed in the short space of a fortnight, to meet a great national necessity, could possibly avoid inequalities and naomalies; and there is no reason why the Government, in the course of working out essential details of administrative procedure, should not succeed in smoothing out these excrescences without impairing the effectiveness of their cohesive plan. The new taxation, described in our last issue, has been sanctioned by the House of Commons, and the Government have been granted powers to proceed by means of Orders-in-Council during the next month to the task of making the economy side of their programme actively operative. These powers will be promptly and energetically used. Of that there is no doubt. But it is obvious that until the whole administrative machinery has been put into action, and, further, until the actual fruition of the Budget proposals has been definitely assured, the National Government will not have finally

> performed even the initial task for which it was created. In these circumstances, it is quite unthinkable that the leaders of the Government should stultify an excellent and courageous beginning by failure to recognize that their duty is to carry on and tackle the successive phases of the problem which confronts us. [Economist, Sept. 19 1931]

Keynes was consistently contemptuous of the governments attempts at economies. Also writing on September 19 he complained bitterly that "The Budget and the Economy Bill are replete with folly and injustice. It is a tragedy that the moral energies and enthusiam of many truly self-sacrificing and well wishing people should be so mid-directed. . ." [Keynes 1933 p. 162-163]

Ironically by the time this Economist had appeared the decision to abandon the gold standard had been taken. On the 18th the Bank of England informed the Government that they regarded the exchange position as untenable and it was agreed to suspend the gold standard. It was also agreed, as a gesture to foreign creditors, to finally let some gold flow out and to raise bank rate to 6% after the suspension as a signal of the intention to avoid inflation. As the announcement of the suspension put it "It is one thing to go off the gold standard with an unbalanced budget and uncontrolled inflation, it is quite another thing to take this measure, not because of internal financial difficulties, but because of excessive withdrawals of borrowed capital..." (quoted in Sayers 1976, p. 413)

Sayers reports a perfunctory attempt by the Bank of England to raise further credits. After the decision to suspend gold payments had been agreed "Enquiries were then sent to the French and German governments, as to the feasibility of further borrowing, and the expected negatives were duly received." (Sayers 1976, p. 412)

Sayers agrees with the Bank of England officials responsible that the decision to suspend gold payments was inescapable. The final straws are throught to have been the fear of a general election and the resistance to the agreed government wage cuts -- most ominously in the Navy. The Times on the 16th September reported a " mutiny in the British Navy." (Sayers 1976, p. 404)

Sayers points particularly to the state of reserves on the 14th September. The Bank told the government that they could survive the 3 to 4 weeks at the current rate of withdrawal. On the Wednesday the reserve position stood at £147 m and declined a further £43 m by the time the market closed on the Saturday. Clearly this rate of outflow could not have been sustained for very much longer without further loans. The policy of supporting the rate had clearly not engendered the appropriate degree of confidence. Had the rate been allowed to fall to the gold export point and bank rate increased, a different result may have emerged.

Paradoxically the spending cuts budgeted were sustained and the national government survived easily in Parliament. The general election called later that year overwhelmingly confirmed the popularity of the National government. A genuinely restrictive monetary and fiscal policy was applied for a further 12 months. The foreign exchange market however at first believed differently. The pound fell to $3.36 dollars on December 12. The pound recovered somewhat to $3.76 - 3/4 by April 16 only to fall steadily to $3.19 by December 17, 1932. Thereafter a long sustained recovery ensued. $4.86 was reached in the second week of November 1933 and a post 1914 high of $5.25 established on November 18, 1933.

The foreign exchange market clearly believed Keynes who, despite his support for the gold standard in the Macmillan Report, greeted the decision to suspend gold payments was great enthusiasm.

There are few Englishmen who do not rejoice at the breaking of our gold fetters. We feel that we have at last a free hand to do what is sensible. The romantic phase is over, and we can begin to discuss realistically what policy is for the best.

It may seem surprising that a move which had been represented as a disastrous catastrophe should have been received with so much enthusiasm. But the great advantages to British trade and industry of our ceasing artificial efforts to maintain our currency above its real value were quickly realised.

The division of inside opinion was largely on a different point. The difficult question to decide was one of honour. The City of London considered that it was under an obligation of *honour* to make every possible effort to maintain the value of money in terms of which it had accepted large deposits from foreigners, even though the result of this was to place an intolerable strain on British industry. At what point—that was the difficult problem—were we justified in putting our own interests first?

As events have turned out, we have got the relief we needed, and, at the same time, the claims of honour have been, in the judgement of the whole world, satisfied to the utmost. For the step was not taken until it was unavoidable. In the course of a few weeks the Bank of England paid out £200,000,000 in gold or its equivalent, which was about half the total claims of foreigners on London, and did this at a time when the sums which London had re-lent abroad were largely frozen. No banker could do more. Out of the ashes the City of London will rise with undiminished honour. For she has played the game up to the limits of quixotry, even at the risk of driving British trade almost to a standstill.

No wonder, then, that we feel some exuberance at the release, that Stock Exchange prices soar, and that the dry bones of industry are stirred. For if the sterling exchange is depreciated by, say, 25 per cent, this does as much to restrict our imports as a tariff of that amount; but whereas a tariff could not help our exports, and might hurt them, the depreciation of sterling affords them a bounty of the same 25 per cent by which it aids the home producer against imports.

(Keynes 1933, p. 288-289)

The Causes of Unemployment

We now turn to the denouemont of our study. It is in the form of a supply of labor explanation of the high average level of unemployment over the entire inter-war period, in Britain. But it is an explanation significantly different from the position taken by orthodox economists of the time. The story has been recently told elsewhere by Daniel Benjamin and Levis Kochin. Many of the details will not be repeated here. Some of the theory will be stated and a number of supplementary observations made and additional evidence cited. In addition, the attempt will be made to extend the period of observation to after the second world war when the level of unemployment in Britain remained exceptionally low especially by inter war comparisions.

Some modern theories of employment and unemployment regard workers, employed and unemployed, as reasoning economic agents who exercise choice in attempting to maximize life time utility. The Keynesian notion of "involuntary unemployment" is a contradiction of this theory. The unemployed are not regarded as the helpless victims of circumstances beyond their control. They are instead regarded as "choosing to supply labor at sharply irregular rates through time." (Lucas 1977 p. 12)

The theory attempts to explain why the characteristic labor market adjustment process is one of quantities of labor supplied rather than of fluctuations in market clearing wages. This theory of labor market behavior cannot rely on "market frictions" or "search costs" as explanations of persistant unemployment. Rigid wages in the face of prolonged unemployment would be recognized by the unemployed as inconsistent with maximizing behavior. Temporary fluctuations in employment can be explained generally as a response to uncertainty about the future implications of current labor market developments.

> Fluctuations in aggregate economic activity and employment result from changes in the aggregate demand for and supply of output. The timing of the changes is uncertain. The changes may be positive or negative, and may be temporary or persistent. Workers and employers in individual firms do not know whether shocks or changes are temporary or long-lasting, real or nominal.
>
> The uncertainty that affects employment is summarized by the four way classification of shocks as real and nominal, temporary and persistent. Uncertainty arises because of the inability of workers and employers to distinguish promptly, between the four categories. Here we assume that there is no way to extract from available data fully reliable information about the type of shock that has occurred. We examine the way in which the labor market absorbs uncertainty and the implications for wages and employment. We start with a discussion of shocks, then analyze the demand and supply curves and draw their implications.
>
> (Brunner & Meltzer 1978, p. 4.12)

The speed of reaction to new information will depend on the nature of the market in which economic agents participate. In some markets the transaction costs of taking a new position are relatively low, for others relatively high. Financial and some commodity markets provide low cost opportunities to adjust portfolios and buying or selling plans. In labor markets the nature of the employment contract makes the cost of mistaken choice very high by comparision. Positions cannot necessarily be easily reversed.

The decision problem for employees and empoyers is seen as that of maximizing the (present) value of an expected income and output stream. Workers are assumed to be aware of seasonal and cyclical fluctuations in receipts and that occupations differ in this respect. Variations in receipts from day to day, week to week, month to month, or year to year may be consistent with expectations and life time income and eonsumption plans.

The labor market is not cleared by an auctioneer at the labor exchange because such a system does not best serve the interests of most workers and firms. The absence of these clearing arrangements is not attributed to the power of trade unions or to government intervention. The incentive to innovate employment practices is as great as anywhere else in the economy. If there were profitable opportunities to ease rigidities in labor markets it can be assumed they would be discovered and utilized. Labor markets are more quantity than price flexible for good reason.

If the mean of the expected distribution of income is considered unchanged then workers respond to fluctuations in demand by supplying more labor when demand is considered temporarily high and less when temporarily low. Over a working life leisure and work may be substituted in response to expected fluctuations in demand.

It is only the recognition of permanent shocks to the output and labor markets that are cause to change expectations. Workers and firms will sooner or later write off some of their capital. Until they do so their capital will be unemployed.

Clearly much of the unemployment measured in Britain between the wars cannot be regarded as a temporary response to unexpected changes in demand. Unemployment that averaged 14% requires an alternative explanation. The other obvious place to look is on the supply side of the labor market. The possibility must be conceded that men and women may prefer leisure to work depending on a comparision between the income and disutility from work and the cost of leisure

A characteristic of developing countries is the comparatively large numbers of able bodied men and women who do not participate in the developed sectors of the economy. The alternative to earning money incomes is subsistence off the land. Real wages in the modern sector may not offer sufficient inducement to abandon the land. The availability of subsistence in the traditional sector sets a floor to money wages. One response modern sector employers may make is the offer of temporary or seasonal work.[16]

One of the alternatives to regular work in a modern welfare state is access to welfare benefits. Recent economic research efforts have been directed at the disincentive effects of welfare benefits on employment.

In a pioneering study of this kind Benjamin and Kochin (B&K) have "searched for an explanation of unemployment in inter war Britain" (Benjamin and Kochin 1978) and have found a convincing explanation for much of the unemployment as a voluntary withdrawal of labor. B&K examined the relationship between the unemployment benefits and average incomes. An unemployment insurance system was first made available to some 2-1/4 million, mainly skilled workers, in 1911. The unemployment insurance scheme was greatly extended and the unemployment benefits substantially increased from 7 shillings per week to 11 shillings in December 1919 and 15 shillings per week per unemployed man in November 1920. About 11 million workers were covered. Over the period 1920-1938 the real benefits were improved and the coverage widened. In 1922 the benefits were related to the number of dependents and

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16 For a discussion of these issues in a South African context see B. S. Kantor and H. F. Kenney. The Poverty of Neo-Marxisim: the Case of South Africa, Journal of Southern African Studies, Vol. 3, No. 1, October 1976, pp. 20-40.

this principle was maintained. There were periods, as for example after the budget cuts of 1921 and 1931, when benefits and coverage were reduced.[17]

B&K describe the system as "an extraordinarily generous and poorly safeguarded system of unemployment insurance," (Benjamin and Kochin 1978, p. 303). With very few exceptions the registered unemployed qualified for unemployment benefits or for the equivalent national assistance. Much to the regret of William Beveridge, one of the more important British welfare reformers, the principle of insurance was soon abandoned. The relationship between contributions and benefits became increasingly tenuous when the unemployment remained persistently high and the period for which unemployment benefits were provided was extended, for most practical purposes, in perpetuity. Beatrice Webb wrote to Beveridge in 1929 that "the relaxation of both Poor Law and insurance," had come about "not from any process of thought but from a vague drift into what is considered philanthropic and advanced" (her emphasis) (Harris, p. 355)

Mrs. Webb may be underestimating the political factor in the extension of the unemployment benefits. She is correct in the inference that the benefits were welfare rather than insurance. There was however general reluctance to make this admission as is evident in the discussion on the May committee report considered above. In October 1932 the de facto welfare nature of unemployment benefits were regularized. Two authorities were established. An Unemployment Assistance Board was appointed to administer means tested

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[17] The primary authority for the Unemployment Insurance System and its operation during the inter war period is Eveline M. Burns, British Unemployment Programs, 1920-1938, Social Science Research Council, Washington, 1941.

relief which was to be charged directly to the exchequer while an Unemploy- Insurance Statutory Committee was established to manage the unemployment insurance fund (Harris 1976 p. 357). This fund was expected to be self financing, out of the levies imposed on employers and workers and after 1934 consistently enjoyed a surplus of income. Accordingly Beveridge,who was appointed chairman of the fund,was able to recommend extensions of the benefits. These recommendations were only rejected on one occasion.(Harris 1976, p. 357-359). Benefits and contributions were related to income only in 1967 (Maki and Spindler 1977 George 1968). Furthermore contributions were not, as Beveridge would, have preferred related to the expected incidence of lay off per industry (Harris p. 357-359).

What is particularly important is that by far the major proportion of public charity during the inter war period was unemployment related. The 1948 Beveridge inspired British welfare system completely changed the basis for income transfers. Harris describes the system as Beveridge found it in 1934

> "as Beveridge had discovered as chairman of the Unemployment Insurance Statutory Committee, the benefits payable under the various systems varied widely in size and scope. Thus, a man entitled to workmen's compensation received a benefit proportionate to previous earnings. A man supported by unemployment insurance received a benefit related to subsistence needs, a plus an allowance for wife and children. A man out of work through sickness. . .received no statutory allowance for dependents, and his benefits were deliberately fixed below subsistence in order to encourage voluntary thrift. [Harris 1976, p 378]

We shall consider below what effects the 1948 reforms may have had on measured unemployment

The unemployed in Britain between the wars were measured as the average per month and per year percentage of the insured work force.

By the end of the period this covered about 70% of the work force. Agricultural workers were included in a separate scheme in October 1936. We shall see below in a consideration of the post 1948 system which groups of employees had been left out of the schemes. It is not clear what the net effects on average measured unemployment would have been had the coverage been wider. Including agricultural workers surely raised measured average unemployment in 1936. Including government workers would have reduced the average. What is more important is that the limited coverage surely discouraged the mobility of labor. To qualify for welfare an unemployed person had to maintain a formal connection or establish a connection with an insured industry. Employment in an uninsured sector would preclude access to the unemployment benefits.

B & K calculate the ratio of benefits for an unemployed married man with a dependent wife and two children as increasing from 15 per cent of average weekly wages in 1920 to 56 per cent in 1938. The only decreases are from 54 per cent of weekly wages in 1931 to 50 per cent in 1932 and from 57 per cent in 1936 to 56 per cent in 1937.

One of the important characteristics of unemployment in Britain was its concentration among lower paid manual or unskilled workers attached to the declining export industries. In an analysis of the "special areas" of high average unemployment made in 1937 it was found that of the unemployed in coal mining, shipbuilding, engineering and building, 63% were unskilled. (Routh 1965 p. 127)

(B&K) use regression analysis to measure the effects of the unemployment benefits on measured unemployment. They find a statistically significant effect on the unemployment percentage of the ratio of benefits to average money incomes. The business cycle, as measured by deviations between the trend and the actual level of output, is also shown to effect unemployment. The estimates suggest that the unemployment rate would on average be a third lower had the dole been no more generous than it was in 1911. Interestingly enough they suggest that unemployment, but for the effects of the dole, would have been at about their lowest between 1927 and 1929.

B and K concern themselves with the possibility that high unemployment caused high unemployment benefits. They suggest a number of reasons why this was not the case. One important reason was the effects of the state of government finances on the level of benefits. We saw above how a more favorable relationship between contributions and benefits could lead to the payment of increased benefits. We saw also that the costs of financing benefits at unexpectedly high levels of unemployment led to reductions in benefits. This occurred in 1921 and 1931. As B and K suggest it is difficult to test a theory about the relationship between unemployment and unemployment benefits. Nevertheless the unemployed were undoubtedly an important political constituency in Britain especially after the extension of the franchise in 1918 to include all manual workers 17(a)
The Labor Party as the political arm of the Trade Unions had every good reason to advocate improved benefits Higher benefits necessitated other things equal, higher wages to discourage a preference for unemployment.

17(a) Universal male suffrage for those over 21 was introduced in 1918. Women over 30 were also enfranchised. As a result the electorate increased enormously for the general election of 1918. At the previous Dec. 1910 election the electorate numbered 7,709,981. In 1918 it numbered 21,392,322 (Cook 1975 p. 4)

Nevertheless in many important instances the causation as B and K point out does run the other way. Unexpectedly high unemployment leading to heavy charges on the exchequer leading to cuts in unemployment benefits despite considerable political opposition. The unexpectedly favorable state of unemployment finance after 1932 resulted in improved unemployment benefits.

Furthermore even if business cycle induced increases in unemployment did lead to improved unemployment benefits[18] the theory suggests that such a step would permanently reduce the supply of labor, other things again equal. As B and K concede single regression equations cannot hope to capture all the possible simultaneous effects.

B and K attempt to justify their procedure by measuring, in a similar way over the period of observation, unemployment among juveniles who did not receive unemployment benefits and unemployment among married women who after October 1931 had their benefits sharply limited. Strikingly the unemployment rate for married women sharply declined after 1931 relative to single women and the unemployment rate for all women fell from 18 to 13.6 per cent from 1931 to 1932 while that for men rose from 21 to 25.4 per cent over the same period. (B and K 1979, p. 20-22) Similarly juvenile unemployment averaged only 5% while total unemployment averaged 14.6%. Increased unemployment is seen to jump sharply at age 18 and age 21 as juveniles qualified for benefits.(B and K, 1979, p. 23)

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18 B and K suggest that only in November 1921 unemployment benefits in Britain unambiguously increased in response to perceived higher levels of unemployment. The extra benefits in November 1921 took the form of dependents allowances (B and K 1979 p. 18)

However the British welfare payments are to be explained. It is clear that there was a quantum increase in payments made after 1918. [19] The set of the poor and the set of the unemployed largely intersected between 1920 and 1939. The inability or unwillingness to recognize that unemployment was not the cause of poverty but that high unemployment benefits relative to (absolutely low) wages was the cause of unemployment disrupted the development of economics and appropriate economic policy.

Compelling direct evidence on the relationship between unemployment benefits and wages is to be found in the report of an extensive sample social survey undertaken in 1936. The survey was undertaken on behalf of the Pilgrims Trust and the Report entitled, "Men without Work." (Pilgrims' Trust 1938) On the suggestion of Beveridge the study focused on the problems of the long term unemployed. The survey sampled about 1000 people (14% women) in six towns, both depressed and prosperous, in four regions.

The survey recognized the connection between wages, unemployment benefits and unemployment. Burns understood the social problems to "which so comprehensive an unemployment program gives rise," as reflecting

> "...the conflict of two opposing principles in contemporary economic and social life. On the one hand, there is the assumption that the individual is responsible for his own material welfare and that of his family, and the threat of loss of income is relied upon as the ultimate sanction to compel participation in production on the terms dictated by the market. On the other hand, there is a growing acceptance of the view that it is the duty of the government to provide for the maintance of those who, through forces beyond their control, are deprived of income..."
> (Burns 1941, p. 238)

As B and K note Burns took spurious consolation from the thought that the disincentive effects operated only when benefits exceeded income.

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19 Peacock and Wiseman calculated British government transfers and subsidies between 1890 and 1955. Using 1900 and 1900 prices as a base the index of transfers per head stood at 134 in 1913, 562 in 1920, 648 in 1921, 820 in 1932, 706 in 1938 and 1315 in 1948. (Peacock and 1961 Table A 11, p. 174)

Burns satisfied herself that this eventuality was not important as a cause of unemployment. As Burns saw it,

> "...although the problem of the close relationship between unemployment payments and wages cannot as yet be said to be acute, for certain sections of the working population it cannot be disregarded. It is already sufficiently serious to act as a <u>deterent to increases in insurance benefit rates or assistance allowances</u>. (my emphasis)
>
> (Burns 1941, pp. 255-259)

Burns is concerned above all with poverty. Unfortunately the working were often as poor as the unemployed. "Men Without Work," understood the problem correctly as "a wages problem."

> "(W)hat this means is that there is still a large number of occupations where conditions are bad and where wages are low. (Men Without Work, p.211)

The survey found "a substantial proportion of men" in the "danger zone" where assistance from the Unemployment Assistance Board approximated the amount the applicant would earn in his normal occupation.

21% of the sample of men receiving allowances from the Board were reported as receiving 70% or more than the "stop" or normal wage as assessed by the Board. The stop wage was the limit "beyond which the allowance should not go, unless there were special circumstances." (Report 1938, p. 203) The report argued that in some cases the stop wage overestimated regular earning capacity and took no account of travelling expenses et al. incidental to work (p. 204)

The report made a "detailed analysis of Unemployment Assistance Board case records in Tonypandy in the Rhondda valley, a coal mining area of exceptionally heavy long term unemployment. In 75 of 78 cases a "close approximation between allowances and stop wages" was found for unemployed men with wives and dependent children (p. 204) These results were thought typical of the Rhondda valley. In Crook, Durham County another coal mining area, a similar pattern was observed.

In Crook, as in the Rhondda, wages of workers in the coal industry are fixed by agreement, and it is therefore possible to determine with a reasonable degree of accuracy the relation between Unemployment Assistance and potential wage. Unemployed miners in Crook with three or more children would probably find no great economic advantage in returning to work unless they were able to earn a good deal more than the fixed minimum. Ordinary shifters and labourers with three children might well find that they were at an economic disadvantage if they returned to work. Four or five children would probably make a return to employment an uneconomic proposition for every grade of work in the Durham mines, except in the infrequent cases of men who can earn considerably above the minimum wage for their grade even after being out of the mines for long periods. Very few other occupations are open to unemployed men in Crook, but in such as there are—general labouring, quarry work, brick works labouring and even retail trade—it is unusual for a man to earn much more than 45*s*. a week unless he has some special experience or skill. Local authorities work—such as County Council road work—is an exception to this rule, 56*s*. a week being a common figure, and this is the reason why this type of work was so often mentioned in the course of the sample visits as what men really wanted. The economic incentive, therefore, for a family man with three or more children cannot be very strong in this district. Most of them could and do willingly take Council work, but there is little else that would make their economic circumstances much better than the Unemployment Assistance Board has already done.

Similar observations were made of conditions in Liverpool. The general conclusion the report comes to is of the necessity for a system of family allowances as a supplement to income from work.

> "If earning families are living at something like the same level as that of the unemployed families we visited, they will be suffering comparable hardships, and (if the problem is regarded from another point of view) there is no possibility of getting back into employment a substantial proportion of the long unemployed until some such a system (of family allowances) is established. (p. 209)

A system of family allowances was part of the Beveridge plan and introduced in 1948. The Social Survey concentrated on the long term unemployed. The long term unemployed accounted for a significant proportion of total unemployed and particularly so in the depressed regions.(Beveridge 1941, Table 10, p. 68)

Unemployment benefits of the relative order of magnitude under consideration also encouraged workers in Britain to seek periodic work as an acceptable alternative to full time employment. Beveridge understood that the unemployment benefits scheme encouraged the casual labor schemes he abhorred. B and K examine schemes connived at between workers and firms to share out available work in such a way to both attach a large body of workers to the firm and to minimize the normal waiting time for unemployment benefits. (Benjamin and Kochin 1979, p. 9) B and K point to the coincidence of increasing numbers of workers attached to an industry and high and rising unemployment percentages in the docks (B&K, 1979, p. 14) A similar observation may be made of the building industry. Building, especially home building, was clearly one of the expanding industries of the inter war period. The numbers of workers attached to the industry and eligible for unemployment benefits increased from 990,400 in 1929 to 1,254,000 in 1935 while unemployment averaged 19.8% fot the industry over that period (Abstract of British Labor Statistics, Table 163)

Building work, like dock work , is characterized by a predictably large proportion of time laid off. The availability of unemployment benefits naturally decreases the average wage needed to attract labor to the building or dock working sectors.

The general effect of the generous unemployment benefits relative to wages was to encourage withdrawals of workers both permanently and temporarily from the labor force. The unemployment benefit policy, associated as it was with structural change in the British economy, seriously inhibited the mobility of labor to areas where industrial expansion occurred. The effect of the policy was to be seen in high levels of measured unemployment and increases in real wages. Increases in real wages were required, as suggested previously, to compensate for the higher opportunity cost of work.

These considerations explain why the differential between manual and non manual workers narrowed so "drastically" (Routh 1965, p. 126) in the thirties when unemployment of manual workers was so high. It also should satisfy Rouths' curiosity as to why "employers should have found it necessary to increase the pay of their manual workers in these years when, at best, one in eight of the male work force was unemployed." (Routh, p. 127)

This interpretation would not at all have surprised Cannan. Cannan believed that "at the root of the persistance of the existing unemployment was the pernicious influence of unemployment insurance. Those responsible for the scheme had not paid sufficient heed to the report of the Poor Law Commission of 1344, which had demonstrated for all to see that, if systems of relief were not to be incentives to indolence, they should leave the recipient in a condition substantially 'less eligible' than if he had undergone whatever inconvenience was attached to getting work.

(Cannan as quoted in Hancock, 1960)

It was views such as these that earned the ridicule of Hancock. Commenting on "Unemployment and the Economists" in the 1920's some 35 years later. Hancock thought that Cannon's arguments were not "based on a solid appraisal of the possibilities." (Hancock 1960, p. 309)

This of course is but a reflection of the success of the Keynesian revolution. It was Keynes who told the Committee of Economists of the Economic Advisory Council in 1930

"Thus if the rate of the dole was increased to a £5 a week out of the proceeds of borrowing and the whole of it spent on home produced goods, unemployment would disappear, provided (1) that the 'genuinely seeking work' clause was strictly enforced, (2) that the newly employed factors of production spent their earnings (like the recipients of the dole) on home-produced goods, and (3) that the government spent the money previously spent on the dole on something else and the new £5 dole would in fact cost nothing. But this, after all, is only a roundabout way of saying that, subject to the above assumptions, if the government were always prepared to step in and borrow enough money and spend it on something, however unproductive, there would never be any unemployment.

(Keynes 1973, p. 195)

Keynes did not suggest how to enforce the "genuinely seeking work" clause despite considerable public interest in this issue.

The policy of subsidising housing was first applied on a significant scale in 1919. These housing policies coupled with rent control also first applied after the first world war further helped to inhibit the mobility of labor (Pollard p. 255 and Staple 1941 p. 65)

The Housing and Town Planning Act of 1919 obliged local authorities with the aid of government subsidies to build houses to fill general needs rather than only as part of slum clearance. The effect of the policy was to encourage subsidised housing where the people were rather than where additional employment opportunities were made available. These disparities are clear from the evidence of new housing developments in England and Wales after 1921 presented by Marian Bawley. Bawley divides England and Wales into three regions. The "south" which was most prosperous, the Midlands, which in itself had a mixture of prospering and declining regions and North England and Wales, which was most seriously effected by the structural changes in the economy. Bawley estimated a relationship between building per thousand population increase between 1921 and 1931. In the South 493 extra houses per 1000 increase in population were built of which 252 were unsubsidised. In the Midlands the equivalent figures were 177 and 769 and in the North and Wales 516 and 2130. (Bawley 1937, Table IV)

Some Tentative Thoughts on Developments after 1945

Between 1948 and 1958 unemployment in Britain averaged less than 2%. We We shall attempt to explain why average unemployment fell so dramatically after 1945 in a manner consistent with our explanation of high average unemployment between the wars.

The first place to look is at the ratio of unemployment benefits to incomes. A new scale of unemployment benefits were introduced together with other welfare reforms in July 1948. Benefits paid were 26s per week per adult man plus 16s per one adult dependent and 7s 6d. for a dependent child, a total of 49s 6d. . In October 1951 additional benefits for dependent children were paid and the benefits were fairly regularly increased thereafter. In February 1958 an unemployed man supporting a wife and two children received £5 2s in unemployment benefits. This represented 43 percent of average weekly pay of all employees as calculated by E. Phelps Brown and Margaret Brown. (Brown and Brown 1968)

The equivalent ratio was 53% in 1938. In 1948 the ratio was 0.40 and by 1951 had declined further to 0.33. The regular increases after 1951 restored the relative value of unemployment benefits to their 1949 position.[20] The ratio fell because unemployment benefits did not keep up with the rate of increase in money wages. Real wages in Britain rose very rapidly during and after the second world war.

The unemployment benefits were not indexed against inflation. Unemployment benefits were made subject to review at five year intervals. (Harris, p. 463) According to Harris the 1942 Beveridge plan was based on the assumption of a 30% war time inflation and zero inflation after the war. In the light of the past first world war experiences this was a defensible position. As indicated previously unemployment benefits and contributions were first related to income in 1966. Maki and Spindler have calculated a Benefit income

[20] Average annual unemployment benefits were calculated, by adjusting for the number of weeks per year particular benefits were earned. The ratio of benefits to average incomes was 1938 .53; 1948 .40; 1949 .37; 1950 .36; 1951 .33; 1952 .37; 1953 .36; 1954 .34; 1955 .37; 1956 .35; 1957 .32; 1958 .43. The schedule of benefits is reported in the British Statistical Abstracts.

ratio for the perios 1948-1972. [21] Their calculations compare very well with our own for 1948-1958. Interestingly enough the ratio increases substantially in 1966 and 1967 and is maintained at more than 70% of incomes to 1972. (Maki and Spindler 1975, p. 444) Maki and Spindler find a statistically significient positive relationship between unemployment and unemployment benefits for the period 1948-1972. (Maki and Spindler, pp. 448-450) It would appear an obvious further step to test such a relationship over the entire period 1920 to the present. B and K make such an attempt for 1920-1966. (B and K note 85) Such a calculation is enormously complicated by the non comparability of the employment data before and after the second world war. Of additional importance is that after the war the whole basis of welfare benefits was altered as Harris puts it," . . . the relief of poverty from whatever cause rather than the relief of unemployment became the major problem and first priority of social administration." After a comparison of the pre and post war unemployment statistics we shall consider some of the possible effects of welfare reform on increased unemployment.

21

TABLE I\

Benefit relative to net income: married, 2 children

Year (Oct.)	Ben/Inc.	Year (Oct.)	Ben/Inc.
1948	0·396	1961	0·443
1949	0·383	1962	0·430
1950	0·365	1963	0·474
1951	0·360	1964	0·446
1952	0·415	1965	0·493
1953	0·393	1966	0·686
1954	0·367	1967	0·732
1955	0·394	1968	0·728
1956	0·371	1969	0·710
1957	0·355	1970	0·727
1958	0·440	1971	0·776
1959	0·419	1972	0·737
1960	0·395		

The attempt to reconcile the pre and post war statistics is made in the Historical Abstract of British Labour Statistics.[22] It is explained there that prior to 1948 the employment series was compiled from the unemployment insurance books issued which show the numbers of employees, employed and unemployed insured under the Unemployment Insurance Acts. The unemployed had to lodge their books with the labor exchanges to qualify for benefits. The number of books lodged on the first Monday of the month reflected the numbers unemployed. The National Insurance Act of 1948 had a much wider coverage than the earlier Unemployment Act. The 1948 Act covered all employees 15 and over in full or part time employment. The principle categories previously excluded were employees over insurable age, men 65 and over women 60 and over, established government workers central and local and including those permanently employed by the railway, and utilities, teachers, police, nurses, farmers' sons and daughters, domestic servents, employees earning above £420 a year, the 1948 limit laid down by the Insurance Acts and women working part time. On this new basis the number of insured employees in 1948 increased from 16,147 m under the old basis to 20,732 m under the new, an increase of approximately 25%. Furthermore the previous incentive for the unemployed to remain attached to a particular insured industry to collect benefits now disappeared. This would make a measure of employment and unemployment for a group of insured industries before and after 1948 somewhat suspect.

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22 Appendix B, British Labour Statistics 1886-1968, Department of Employment and Productivity, London. Her Majesty's Stationery Office 1971.

As indicated, after the welfare reforms of 1948 it was possible to collect welfare without being unemployed, sick or old. While the National insurance benefits were not inflation indexed the means tested non contributory benefits were regularly adjusted to take account of inflation. (Harris 1977, p. 463, George 1968, pp. 223-235) The authorities made every effort to ensure that the able bodied qualifying for National Assistance both registered as unemployed and sought work. (George 1968, p. 231) While the unemployed could legitimately claim additional funds from the superior National Assistance comparatively few appeared to qualify. There was however a material advantage to be regarded as unable to accept employment and thereby to qualify for National Assistance. The published statistics do not enable such a calculation of such effects to be made.

The National Assistance scheme which was intended by Beveridge to be only a "safety set" for a small minority , "became a necessary standby for a large number of insured persons." (Pollard 1968, p. 399) Many of the unexpected beneficiaries were pensioners whose real benefits were being reduced by the effects of inflation. How many of them and the others on the National Assistance Register would have been measured as unemployed before 1940 is impossible to determine from the statistical record.

We shall follow the account of the application of National Assistance provided by Victor George. This may give some insight as to the relevant order of magnitudes. National Assistance was paid in two forms, as single payments or weekly allowances. Single payments were made in cases of temporary need or where there was "sufficient uncertainty about the applicant's immediate financial prospects. Single payments are sometimes repeated week after week and some eventually became weekly allowances." (George 1968, p. 223)

George reports that between 1949 and 1966 on average more than a million and a half people benefitted from weekly National Assistance Allowances. The fastest rate of increases in allowances amended was between 1949 and 1952. At the end of 1949 1,157 m weekly allowances were paid and by 1966 this had increased to 2,396 m. Of the recipients of weekly assistance allowances most were to supplement insurance benefits. In December 1949, 48.2 per cent were supplementing pensions, 7.9% sickness benefits and 7.5% widows benefits. Only 2.6% were in supplement of unemployment insurance benefits. By December 1965 the supplements to pensions accounted for 59.9 per cent of all weekly assistance allowances and unemployment had decreased to 1.7 per cent. In 1949 25.2 per cent of weekly allowances were paid to persons not in receipt of other benefits. In this category were included those registered for employment. They accounted for 3.1% of all weekly allowances paid. 16.7% of all weekly allowances were paid in 1949 to persons under pension age. In 1966 this proportion was 13.1%.

In 1965 467,000 people receiving assistance allowance were not entitled to any insured benefits or old aged pension. A quarter to a third were old, mostly over 70. 138,000 were under retirement age but regarded as unfit for work. Another 108,000 were women with dependent children. George mentions altogether 154,000 women on assistance.

Large numbers of people sheltered under the umbrella of National Assistance. As indicated previously before 1940 only unemployment insurance would have provided comparable "subsistence." How many would have been classified as unemployed before 1940 remains unknown. Enough is known to suggest that any comparison of unemployment statistics before and after the first war and before and after the second war should be treated with considerable skepticism.

There is much evidence to suggest that significant influences were operating on the supply side of the labor market equation to reduce measured unemployment in Britain after 1948. The famous Phillips curve relationship between unemployment and inflation undoubtedly picked up some of this. In Britain today measured unemployment is again persistently high.[24] Though observers are perhaps less inclined to ascribe this unemployment to deficient demand than they were in the 20's and 30's.

Cannan's prophecy of 1927 that the cow of deflation has been swallowed in 1920-1922 and the historian of "fifty years on" will not waste much time over the disappearance of the tail in 1925" may be about to transpire. (Cannan 1927, p. 83 quoted in B and K, p. 40)

Conclusion

The paper has attempted to show that a great deal of uncertainty was associated with monetary policy in Britain between 1919 and 1925. It has also attempted to explain that while the pound was not necessarily overvalued at 4.86 in 1925 there seems little reason to believe that the effects of the overvaluation, if any, persisted beyond 1926. Unemployment and apparent balance of payments difficulties have an alternative explanation. The decision to abandon gold in 1931 was not regarded as inevitable but given what we now know about subsequent monetary policy developments in the major gold standard country, the United States, was perhaps a decision generally helpful to economic stability in Britain. The attempt to restore the gold standard in Britain and the world after the cataclysm of World War 1 may perhaps best be described as a glorius failure by no means entirely attributable to British policy actions but was in large part a residue of the failures of the fragile Peace of Versailles. The industrial world clearly did very much better under the system of fixed exchange rates and financial reconstruction associated with the Bretton Woods agreements and the Marshall Plan after the Second World War.

The paper argued with Benjamin and Kochin that where social policy in Britain between the wars erred was in believing that unemployment caused poverty. In unfortunate reality it was poverty that caused unemployment.

The final argument of the paper was that an important part of the reduction in unemployment observed in Britain after 1945 may be attributed to the sharp unanticipated decline in the real value of unemployment benefits. It was also tentatively suggested that a possibly large contingent of the pre 1940 volunteer army of the unemployed signed off the unemployment register and onto national assistance. Definity on this proposition was not possible.

In the circumstances of inter war Britain both Keynes and orthodox economists advocated inappropriate policies. Keynes advocated price increases to reduce real wages to stimulate unemployment while orthodox economists were recommending selective cuts in money wages to stimulate output and employment in the declining industries. It was not good economic advice to expect the workers to subsidise particular industries. The problem of persistently high unemployment in Britain between the wars should not be attributed to deficient demand or to rigid wages.

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APPENDIX

Table 1

Components of G.N.P., at constant market prices, 1919-38, £m

	Consumers expenditure	Public authorities current expenditure	Gross domestic fixed capital formation	Value of physical increase in stocks etc.	Exports of goods and services	Total final expenditure	Imports of goods and services	Gross domestic product	Net property income from abroad	Gross national product
1919	3485	830	172	80	728	5295	715	4580	72	4652
1920	3493	475	295	−60	781	4984	711	4273	73	4346
1920	3343	446	284	−60	813	4826	730	4096	70	4166
1921	3143	452	326	−70	648	4499	642	3857	96	3953
1922	3254	424	300	−63	816	4731	739	3992	102	4094
1923	3349	400	308	−45	895	4907	792	4115	121	4236
1924	3428	403	359	−4	923	5109	871	4238	129	4367
1925	3508	417	410	88	919	5342	893	4449	153	4602
1926	3496	424	397	12	843	5172	929	4243	170	4413
1927	3631	430	442	33	948	5484	945	4539	180	4719
1928	3690	435	438	14	955	5532	915	4617	178	4795
1929	3765	444	461	31	986	5687	961	4726	184	4910
1930	3822	455	463	79	849	5668	948	4720	185	4905
1931	3863	466	454	−3	684	5464	984	4480	173	4653
1932	3839	466	396	1	669	5371	878	4493	146	4639
1933	3937	471	409	−72	678	5423	879	4544	183	4727
1934	4051	482	498	34	704	5769	918	4851	192	5043
1935	4163	515	518	6	794	5996	963	5033	206	5239
1936	4285	562	565	−6	771	6177	987	5190	210	5400
1937	4357	627	584	56	810	6343	1023	5411	192	5603
1938	4392	749	592	83	757	6573	1001	5572	192	5764

Source: Feinstein, *National Income*, Table 5.
Note: From the lower figure for 1920 the estimates exclude Southern Ireland.

as compiled by Howson (1975) Table 5 p. 157.

Table 2

Table 2 *The balance of payments 1920–38 (£ millions)*

	1920	1921	1922	1923	1924	1925	1926	1927	1928	1929
Visible trade										
Imports (f.o.b.)	1,812	1,022	951	1,011	1,172	1,208	1,140	1,115	1,095	1,117
Exports (f.o.b.)	1,664	874	888	914	958	943	794	845	858	854
Visible balance	−148	−148	−63	−97	−214	−265	−346	−270	−237	−263
Invisibles										
Government services and transfers (net)	+1	+25	−11	−4	−7	+8	+10	+15	+15	+14
Other invisibles:										
Private services and transfers	+214	+117	+76	+85	+81	+53	+57	+91	+82	+78
Interest, profits and dividends:										
Private sector	+252	+183	+200	+202	+222	+254	+254	+251	+251	+250
Public sector	−4	−3	−21	−24	−24	−19	−14	−9	−7	−3
Invisible balance	+463	+322	+244	+259	+272	+296	+307	+348	+341	+339
Current balance	+315	+174	+181	+162	+58	+31	−39	+78	+104	+76
Capital movements										
Official long-term capital (net)	−97	−63	−18	−18	.	−5	−4	−6	−3	−5
U.K. new investment overseas	−53	−116	−135	−136	−134	−88	−112	−166	−143	−96
Sinking funds and repayments on existing issues	+15	+15	+15	+15	+15	+15	+27	+34	+35	+49
Other long-term investment abroad										
Net short-term liabilities / British Government stocks									+136	−84
Acceptances[a]									−61	+25
Total identified capital	−135	−164	−138	−139	−119	−78	−89	−138	−36	−111
Balancing item[b]	−132	−10	−46	−11	+67	+45	+151	+78	−86	+27
Currency flow	+48	.	−3	+12	+6	−2	+23	+18	−18	−8
Official financing										
Reserves (drawings on +/additions to −)	−48	.	+3	−12	−6	+2	−23	−18	+18	+8
Assistance	.	.	.	.	.	.	.	.	.	.
Total official financing	−48	.	+3	−12	−6	+2	−23	−18	+18	+8

Table 2 (*cont.*)

	1930	1931	1932	1933	1934	1935	1936	1937	1938
Visible trade									
Imports (f.o.b.)	953	786	641	619	683	724	786	950	849
Exports (f.o.b.)	670	464	425	427	463	541	523	614	564
Visible balance	−283	−322	−216	−192	−220	−183	−263	−336	−285
Invisibles									
Government services and transfers (net)	+19	+10	−8	−9	−9	−12	−12	−12	−19
Other invisibles:									
Private services and transfers	+60	+31	+30	+24	+25	+22	+34	+80	+40
Interest, profits and dividends:									
Private sector	+220	+169	+149	+160	+169	+183	+198	+208	+197
Public sector	−1	−2	−17	−1	+3	+3	+3	+3	+2
Invisible balance	+298	+208	+154	+174	+188	+196	+223	+279	+220
Current balance	+15	−114	−62	−18	−32	+13	−40	−57	−65
Capital movements									
Official long-term capital (net)	−2	−1	−7	−1	+5	+2	.	−4	+10
U.K. new investment overseas	−98	−41	−37	−83	−63	−51	−61	−60	−29
Sinking funds and repayments on existing issues	+39	+27	+48	+67	+42	+81	+107	+61	+39
Other long-term investment abroad	.	+10	+5	+5	−20	−50	−48	.	.
Net short-term liabilities			+37	+52	+15	+12	+113	+84	−196
British Government stocks	−26	−293	+20	+18	+27	+8	+8	+3	−14
Acceptances[a]	+15	+41	+29	+12	−2	−4	+1	+1	+8
Total identified capital	−72	−257	+95	+70	+4	−2	+120	+85	−182
Balancing item[b]	+64	+337	−4	+70	+38	+68	+131	+101	−21
Currency flow	+7	−34	+29	+122	+10	+79	+211	+129	−268
Official financing									
Reserves (drawings on +/additions to −)	−7	−48	+85	−122	−10	−79	−211	−129	+268
Assistance	.	+82	−114	.	.	.	.	.	.
Total official financing	−7	+34	−29	−122	−10	−79	−211	−129	+268

. nil or less than £½ million.

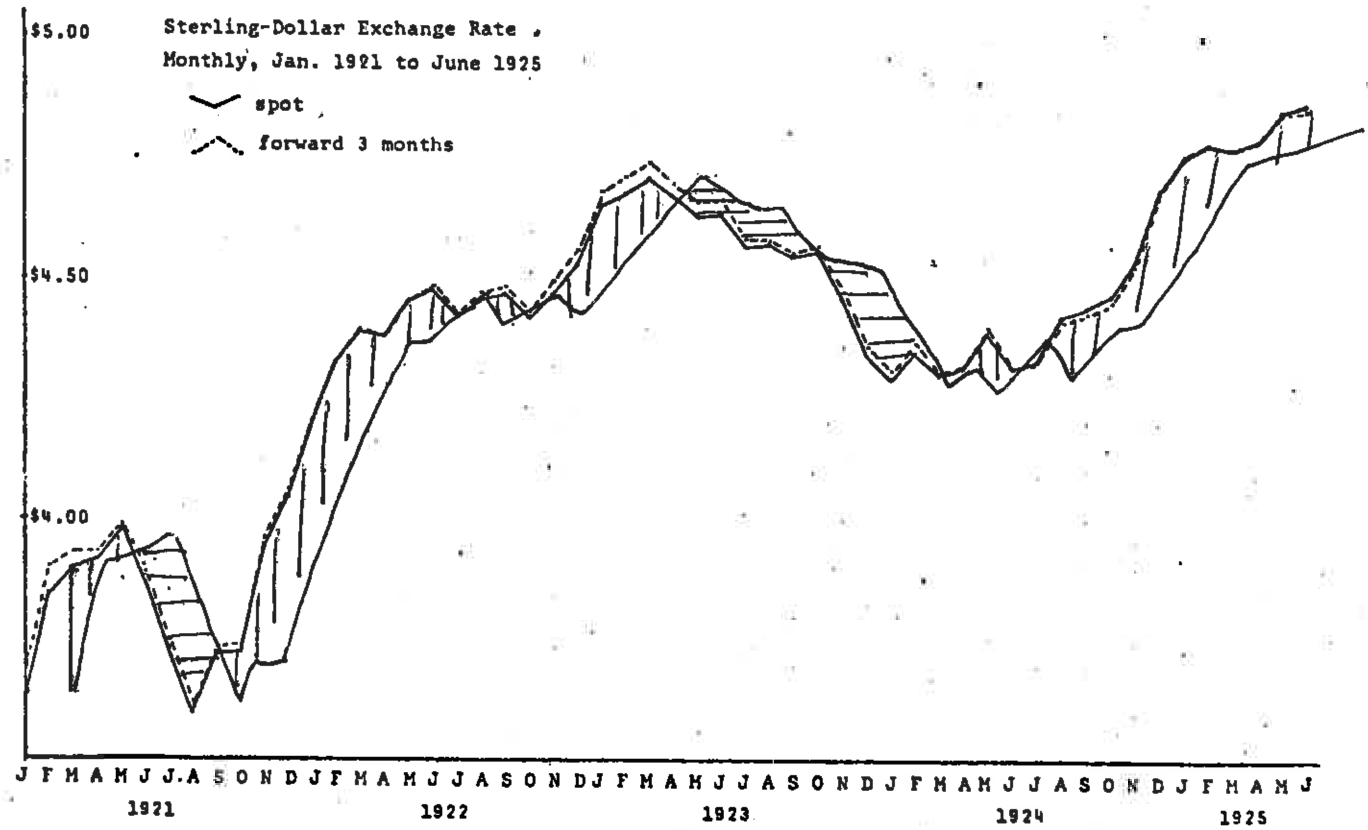
[a] Between 1928 and 1931 these figures show only changes in acceptances given on foreign account: for subsequent years the figures show the net movements in these acceptances together with those given by foreigners on U.K. account.

[b] Before 1928 this includes changes in short-term liabilities and acceptances; these are thereafter covered separately.

Source: Sayers (1976) Appendix Table C

Figure 2

The Relationship between the Spot Rate and the corresponding Forward Rate for U.S. Dollar and Sterling 1920 - 1925.



Vertical lines indicate when the expected rate was lower than the realized rate.

Horizontal lines indicate when expected rate was higher.

Source: Mussa (1978) Figure 1.

Tables 4a and 4b

Table 4A *Central Government Accounts, calendar years, 1920–38, £m*

	Receipts						Expenditure							
	Taxes on income	Taxes on expenditure	Taxes on capital	National Insurance cont.	Other	Total	Current expenditure on goods and services	National Insurance benefits	Current grants to local authorities	Debt interest	Other grants and subsidies	Capital formation	Total	Deficit – Surplus +
1920	609	334	50	28	32	1053	277	15	66	320	271	15	964	+89
1921	503	343	48	47	79	1020	259	71	77	303	252	20	982	+38
1922	431	331	59	59	54	934	214	64	77	307	189	14	865	+69
1923	377	313	54	62	53	859	181	56	77	315	138	16	783	+76
1924	351	381	62	64	45	803	180	59	79	315	118	18	769	+34
1925	344	289	58	65	60	816	186	65	82	313	126	22	794	+20
1926	308	293	65	75	71	812	187	80	84	328	121	20	820	–8
1927	296	309	76	80	80	841	185	78	87	303	116	20	789	+52
1928	286	321	83	82	85	857	181	88	88	312	116	19	804	+53
1929	295	317	79	82	91	864	182	98	104	316	118	20	838	+26
1930	303	308	81	81	99	872	180	130	128	304	117	23	882	–10
1931	328	312	72	82	80	874	181	154	132	283	134	22	906	–32
1932	352	348	73	89	50	912	177	125	125	279	162	18	886	+26
1933	310	346	87	90	48	881	176	108	124	243	171	14	836	+45
1934	291	365	78	94	50	878	184	108	126	226	169	15	828	+50
1935	284	373	87	98	48	890	209	110	134	227	171	16	867	+23
1936	288	396	86	104	47	921	252	105	139	223	166	22	907	+14
1937	326	413	93	107	48	987	322	107	139	228	164	29	989	–2
1938	383	415	78	109	50	1036	439	122	142	232	175	35	1145	109

Source: Feinstein, *National Income*, Tables 12 and 34.

Howson (1975) Table 4.

Table 4B *Budget and Sinking Fund payments, financial years, 1919–38, £m*

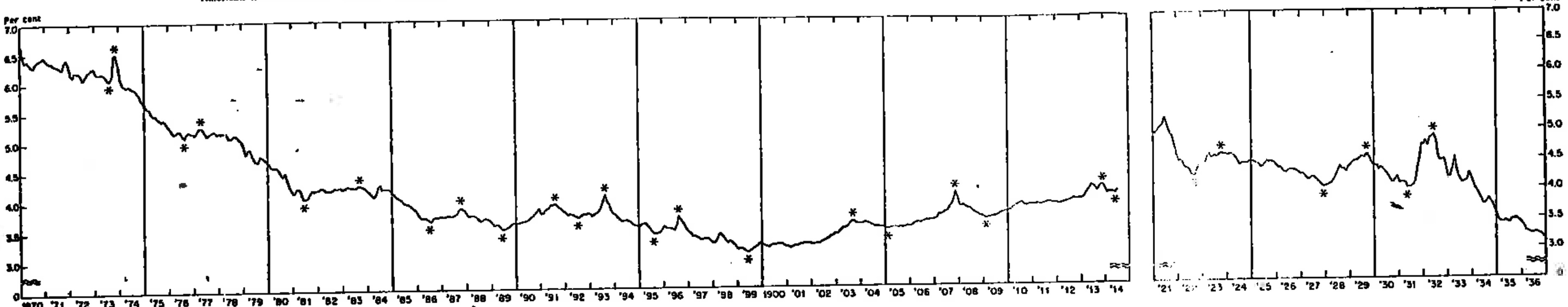
Financial year ending 31 March	Published deficit (–) or surplus (+)	Total debt charges	Interest and management	Debt redeemed out of revenue
1919	–1691	270	267	–
1920	–326	332	325	–
1921	+231	350	328	21
1922	+46	332	304	25
1923	+102	324	300	25
1924	+48	347	306	40
1925	+4	357	309	45
1926	–14	358	307	50
1927	–37	379	316	60
1928	+4	379	312	65
1929	+18	369	310	58
1930	–15	360	310	48
1931	–23	360	292	67
1932	+0.4	330	296	33
1933	–32	311	283	26
1934	+31	224	215	8
1935	+8	224	211	12
1936	+3	224	210	13
1937	–6	224	210	13
1938	+29	227	215	11

Sources: T. 171/371, Barlow to Trend, 10 October 1945; T. 175/15, "Debt payments since the War", undated but 1927; Pember and Boyle, *British Government Securities in the Twentieth Century*, pp. 522–3.

Figure 5

CHART 53 Bond Yields, Prewar and Postwar

American Railroad Bonds, 1870–1914, 1921–1936

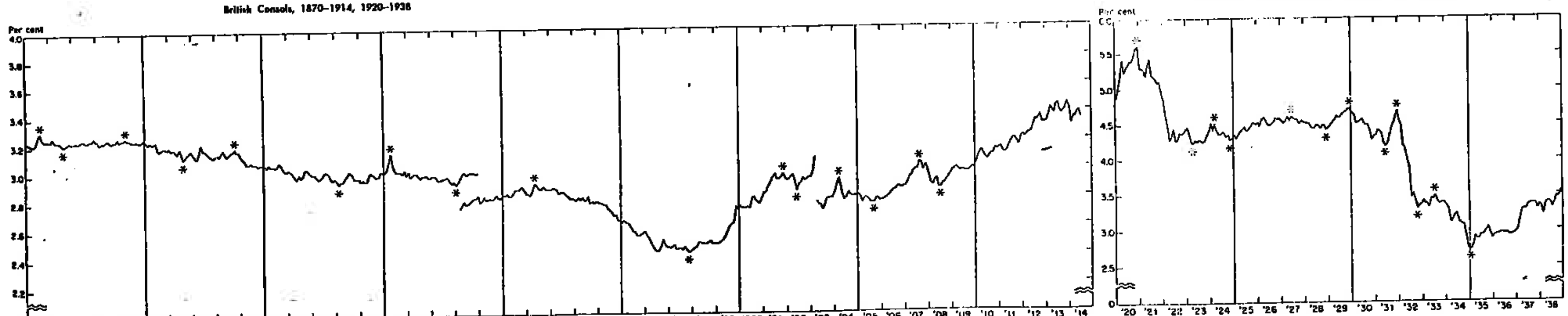


Asterisks mark turning points of specific cycles.

Source: F. R. Macaulay, *Some Theoretical Problems Suggested by the Movements of Interest Rates, Bond Yields and Stock Prices in the United States since 1856*, National Bureau of Economic Research, 1938, pp. 85 ff. For description of data see the accompanying text.

CHART 54 Bond Yields, Prewar and Postwar

British Consols, 1870–1914, 1920–1938



Asterisks mark turning points of specific cycles. Consol yields: 3% 1870–1884; 2¾% 1888–1903; 2½% 1903–1914, 1920–1938

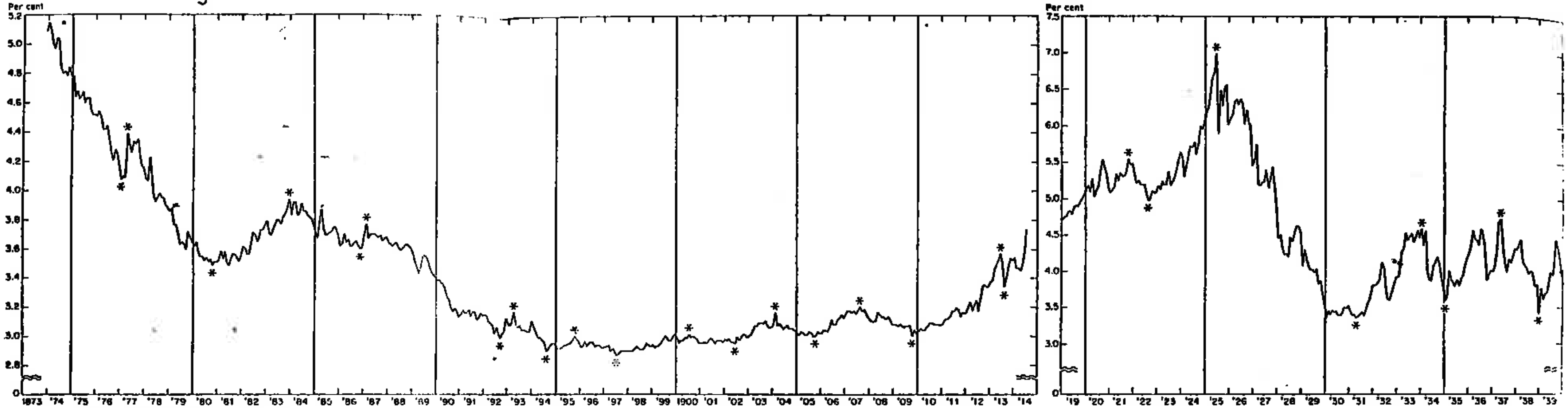
Source: Table 114; data from NBER series 13 and 41. For description of data see the accompanying text.

Source: Morgenstern (1959)

Figure 6

CHART 55 Bond Yields, Prewar and Postwar

French Perpetual Rentes, 1873–1914, 1919–1939

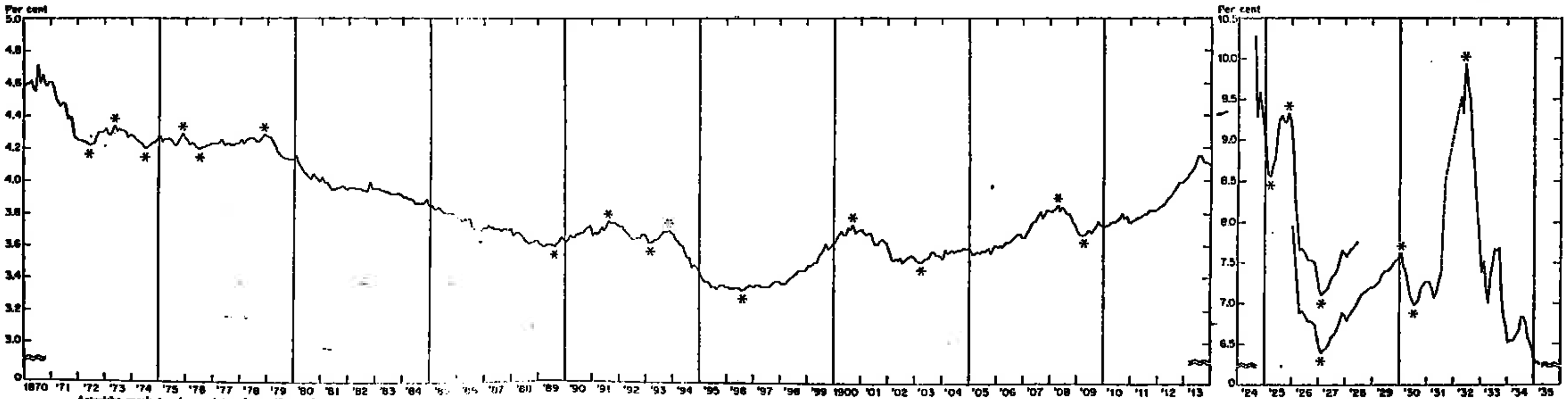


Asterisks mark turning points of specific cycles.

Source: Same as for Chart 54.

CHART 56 Bond Yields, Prewar and Postwar

German Bonds, 1870–1913, 1924–1935



Asterisks mark turning points of specific cycles.

Source: Same as figure 5.