that expected by Marx that his analysis became almost worthless, and his system had to be imposed by force in a most backward industrial country (Russia) instead of occurring inevitably in the most advanced industrial country as he had expected.

The Shift of Control

The social developments which made Marx's theories obsolete were the result of technological and economic developments which Marx had not foreseen. The energy for production was derived more and more from inanimate sources of power and less and less from human labor. As a result, mass production required less labor. But mass production required mass consumption so that the products of the new technology had to be distributed to the working groups as well as to others so that rising standards of living for the masses made the proletariat fewer and fewer and richer and richer. At the same time, the need for managerial and white-collar workers of the middle levels of the economic system raised the proletariat into the middle class in large numbers. The spread of the corporate form of industrial enterprise allowed control to be separated from ownership and allowed the latter to be dispersed over a much wider group, so that, in effect, owners became more and more numerous and poorer and poorer. And, finally, control shifted from owners to managers. The result was that the polarized two-class society envisaged by Marx was, after 1900, increasingly replaced by a mass middle-class society, with fewer poor and, if not fewer rich, at least a more numerous group of rich who were relatively less rich than in an earlier period. This process of leveling up the poor and leveling down the rich originated in economic forces but was speeded up and extended by governmental policies in regard to taxation and social welfare, especially after 1945.

The Religious and Intellectual Stages of Culture

When we turn to the higher levels of culture, such as the religious and intellectual aspects, we can discern a sequence of stages similar to those which have been found in the more material levels. We shall make no extended examination of these at this time except to say that the religious level has seen a shift from a basically secularist, materialist, and antireligious outlook in the late nineteenth century to a much more spiritualist and religious point of view in the course of the twentieth century. At the same time a very complex development on the intellectual level has shown a profound shift in outlook from an optimistic and scientific point of view in the period 1860-1890 to a much more pessimistic and irrationalist point of view in the period following 1890. This shift in point of view, which began in a rather restricted group forming an intellectual vanguard about 1890, a group which included such figures as Freud, Sorel, Bergson, and Proust, spread downward to larger and larger sections of Western society in the course of the new century as a result of the devastating experience of two world wars and the great depression. The results of this process can be seen in the striking contrast between the typical outlook of Europe in the nineteenth century and in the twentieth century as outlined in the preceding chapter.

Chapter 5—European Economic Developments

Commercial Capitalism

Western Civilization is the richest and most powerful social organization ever made by man. One reason for this success has been its economic organization. This, as we have said, has passed through six successive stages, of which at least four are called "capitalism." Three features are notable about this development as a whole.

In the first place, each stage crated the conditions which tended to bring about the next stage; therefore we could say, in a sense, that each stage committed suicide. The original economic organization of self-sufficient agrarian units (manors) was in a society organized so that its upper ranks—the lords, lay and ecclesiastical—found their desires for necessities so well met that they sought to exchange their surpluses of necessities for luxuries of remote origin. This gave rise to a trade in foreign luxuries (spices, fine textiles, fine metals) which was the first evidence of the stage of commercial capitalism. In this second stage, mercantile profits and widening markets created a demand for textiles and other goods which could be met only by application of power to production. This gave the third stage: industrial capitalism. The stage of industrial capitalism soon gave rise to such an insatiable demand for heavy fixed capital, like railroad lines, steel mills, shipyards, and so on, that these investments could not be financed from the profits and private fortunes of individual proprietors. New instruments for financing industry came into existence in the form of limited-liability corporations and investment banks. These were soon in a position to control the chief parts of the industrial system, since they provided capital to it. This gave rise to financial capitalism. The control of financial capitalism was used to integrate the industrial system into ever-larger units with interlinking financial controls. This made possible a reduction of competition with a resulting increase in profits. As a result, the industrial system soon found that it was again able to finance its own expansion from its own profits, and, with this achievement, financial controls were weakened, and the stage of monopoly capitalism arrived. In this fifth stage, great industrial units, working together either directly or through cartels and trade associations, were in a position to exploit the majority of the people. The result was a great economic crisis which soon developed into a struggle for control of the state—the minority hoping to use political power to defend their privileged position, the majority hoping to use the state to curtail the power and privileges of the minority. Both hoped to use the power of the state to find some solution to the economic aspects of the crisis. This dualist struggle dwindled with the rise of economic and social pluralism after 1945.

A Depression Accompanies Transition to Various Stages

The second notable feature of this whole development is that the transition of each stage to the next was associated with a period of depression or low economic activity. This was because each stage, after an earlier progressive phase, became later, in its final phase, an organization of vested interests more concerned with protecting its established modes of action than in continuing progressive changes by the application of resources to new, improved methods. This is inevitable in any social organization, but is peculiarly so in regard to capitalism.

The Primary Goal of Capitalism

The third notable feature of the whole development is closely related to this special nature of capitalism. Capitalism provides very powerful motivations for economic activity because it associates economic motivations so closely with self-interest. But this same feature, which is a source of strength in providing economic motivation through the pursuit of profits, is also a source of weakness owing to the fact that so self-centered a motivation contributes very readily to a loss of economic coordination. Each individual, just because he is so powerfully motivated by self-interest, easily loses sight of the role which his own activities play in the economic system as a whole, and tends to act as if his activities were the whole, with inevitable injury to that whole. We could indicate this by pointing out that capitalism, because it seeks profits as its primary goal, is never primarily seeking to achieve prosperity, high production, high consumption, political power, patriotic improvement, or moral uplift. Any of these may be achieved under capitalism, and any (or all) of them may he sacrificed and lost under capitalism, depending on this relationship to the primary goal of capitalist activity—the pursuit of profits. During the nine-hundred-year history of capitalism, it has, at various times, contributed both to the achievement and to the destruction of these other social goals.

Commercial Capitalism

The different stages of capitalism have sought to win profits by different kinds of economic activities. The original stage, which we call commercial capitalism, sought profits by moving goods from one place to another. In this effort, goods went from places where they were less valuable to places where they were more valuable, while money, doing the same thing, moved in the opposite direction. This valuation, which determined the movement both of goods and of money and which made them move in opposite directions, was measured by the relationship between these two things. Thus the value of goods was expressed in money. and the value of money was expressed in goods. Goods moved from low-price areas to high-price areas, and money moved from high-price areas to low-price areas, because goods were more valuable where prices were high and money was more valuable where prices were low.

Money and Goods Are Different

Thus, clearly, money and goods are not the same thing but are, on the contrary, exactly opposite things. Most confusion in economic thinking arises from failure to recognize this fact. Goods are wealth which you have, while money is a claim on wealth which you do not have. Thus goods are an asset; money is a debt. If goods are wealth; money is not wealth, or negative wealth, or even anti-wealth. They always behave in opposite ways, just as they usually move in opposite directions. If the value of one goes up, the value of the other goes down, and in the same proportion. The value of goods, expressed in money, is called "prices," while the value of money, expressed in goods, is called "value."

The Rise of Commercial Capitalism

Commercial capitalism arose when merchants, carrying goods from one area to another, were able to sell these goods at their destination for a price which covered original cost, all costs of moving the goods, including the merchant's expenses, and a profit. This development, which began as the movement of luxury goods, increased wealth because it led to specialization of activities both in crafts and in agriculture, which increased skills and output, and also brought into the market new commodities.

The Development of Mercantilism

Eventually, this stage of commercial capitalism became institutionalized into a restrictive system, sometimes called "mercantilism," in which merchants sought to gain profits, not from the movements of goods but from restricting the movements of goods. Thus the pursuit of profits, which had earlier led to increased prosperity by increasing trade and production, became a restriction on both trade and production, because profit became an end in itself rather than an accessory mechanism in the economic system as a whole.

The way in which commercial capitalism (an expanding economic organization) was transformed into mercantilism (a restrictive economic organization) twice in our past history is very revealing not only of the nature of economic systems, and of men themselves, but also of the nature of economic crisis and what can be done about it.

Merchants Restrict Trade to Increase Profits

Under commercial capitalism, merchants soon discovered that an increasing flow of goods from a low-price area to a high-price area tended to raise prices in the former and to lower prices in the latter. Every time a shipment of spices came into London, the price of spices there began to fall, while the arrival of buyers and ships in Malacca gave prices there an upward spurt. This trend toward equalization of price levels between two areas because of the double, and reciprocal, movement of goods and money jeopardized profits for merchants, however much it may have satisfied producers and consumers at either end. It did this by reducing the price differential between the two areas and thus reducing the margin within which the merchant could make his profit. It did not take shrewd merchants long to realize that they could maintain this price differential, and thus their profits, if they could restrict the flow of goods, so that an equal volume of money flowed for a reduced volume of goods. In this way, shipments were decreased, costs were reduced, but profits were maintained.

Two things are notable in this mercantilist situation. In the first place, the merchant, by his restrictive practices, was, in essence, increasing his own satisfaction by reducing that of the producer at one end and of the consumer at the other end; he was able to do this because he was in the middle between them. In the second place, so long as the merchant, in his home port, was concerned with goods, he was eager that the prices of goods should be, and remain, high.

Merchants Became Concerned with Lending of Money

In the course of time, however, some merchants began to shift their attention from the goods aspect of commercial interchange to the other, monetary, side of the exchange. They began to accumulate the profits of these transactions, and became increasingly concerned, not with the shipment and exchange of goods, but with the shipment and exchange of moneys. In time they became concerned with the lending of money to merchants to finance their ships and their activities, advancing money for both, at high interest rates, secured by claims on ships or goods as collateral for repayment.

The New Bankers Were Eager for High Interest Rates

In this process the attitudes and interests of these new bankers became totally opposed to those of the merchants (although few of either recognized the situation). Where the merchant had been eager for high prices and was increasingly eager for low interest rates, the banker was eager for a high value of money (that is, low prices) and high interest rates. Each was concerned to maintain or to increase the value of the half of the transaction (goods for money) with which he was directly concerned, with relative neglect of the transaction itself (which was of course the concern of the producers and the consumers).

The Operations of Banking and Finance Were Concealed So

They Appeared Difficult to Master

In sum, specialization of economic activities, by breaking up the economic process, had made it possible for people to concentrate on one portion of the process and, by maximizing that portion, to jeopardize the rest. The process was not only broken up into producers, exchangers, and consumers but there were also two kinds of exchangers (one concerned with goods, the other with money), with almost antithetical, short-term, aims. The problems which inevitably arose could be solved and the system reformed only by reference to the system as a whole. Unfortunately, however, three parts of the system, concerned with the production, transfer, and consumption of goods, were concrete and clearly visible so that almost anyone could grasp them simply by examining them, while the operations of banking and finance were concealed, scattered, and abstract so that they appeared to many to be difficult. To add to this, bankers themselves did everything they could to make their activities more secret and more esoteric. Their activities were reflected in mysterious marks in ledgers which were never opened to the curious outsider.

The Relationship Between Goods and Money

Is Clear to Bankers

In the course of time the central fact of the developing economic system, the relationship between goods and money, became clear, at least to bankers. This

relationship, the price system, depended upon five things: the supply and the demand for goods, the supply and the demand for money, and the speed of exchange between money and goods. An increase in three of these (demand for goods, supply of money, speed of circulation) would move the prices of goods up and the value of money down. This inflation was objectionable to bankers, although desirable to producers and merchants. On the other hand, a decrease in the same three items would be deflationary and would please bankers, worry producers and merchants, and delight consumers (who obtained more goods for less money). The other factors worked in the opposite direction, so that an increase in them (supply of goods, demand for money, and slowness of circulation or exchange) would be deflationary.

Inflationary and Deflationary Prices Have Been a Major

Force in History for 600 Years

Such changes of prices, either inflationary or deflationary, have been major forces in history for the last six centuries at least. Over that long period, their power to modify men's lives and human history has been increasing. This has been reflected in two ways. On the one hand, rises in prices have generally encouraged increased economic activity, especially the production of goods, while, on the other hand, price changes have served to redistribute wealth within the economic system. Inflation, especially a slow steady rise in prices, encourages producers, because it means that they can commit themselves to costs of production on one price level and then, later, offer the finished product for sale at a somewhat higher price level. This situation encourages production because it gives confidence of an almost certain profit margin. On the other hand, production is discouraged in a period of falling prices, unless the producer is in the very unusual situation where his costs are falling more rapidly than the prices of his product.

Bankers Obsessed With Maintaining Value of Money

The redistribution of wealth by changing prices is equally important but attracts much less attention. Rising prices benefit debtors and injure creditors, while falling prices do the opposite. A debtor called upon to pay a debt at a time when prices are higher than when he contracted the debt must yield up less goods and services than he obtained at the earlier date, on a lower price level when he borrowed the money. A creditor, such as a bank, which has lent money—equivalent to a certain quantity of goods and services—on one price level, gets back the same amount of money—but a smaller quantity of goods and services—when repayment comes at a higher price level, because the money repaid is then less valuable. This is why bankers, as creditors in money terms, have been obsessed with maintaining the value of money, although the reason they have traditionally given for this obsession—that "sound money" maintains "business confidence"—has been propagandist rather than accurate.

The Two Major Goals of Bankers

Hundreds of years ago, bankers began to specialize, with the richer and more influential ones associated increasingly with foreign trade and foreign-exchange transactions. Since these were richer and more cosmopolitan and increasingly concerned with questions of political significance, such as stability and debasement of currencies, war and peace, dynastic marriages, and worldwide trading monopolies, they became the financiers and financial advisers of governments. Moreover, since their relationships with governments were always in monetary terms and not real terms, and since they were always obsessed with the stability of monetary exchanges between one country's money and another, they used their power and influence to do two things: (1) to get all money and debts expressed in terms of a strictly limited commodity—ultimately gold; and (2) to get all monetary matters out of the control of governments and political authority, on the ground that they would be handled better by private banking interests in terms of such a stable value as gold.

These efforts ... [were accelerated] with the shift of commercial capitalism into mercantilism and the destruction of the whole pattern of social organization based on dynastic monarchy, professional mercenary armies, and mercantilism, in the series of wars which shook Europe from the middle of the seventeenth century to 1815. Commercial capitalism passed through two periods of expansion each of which deteriorated into a later phase of war, class struggles, and retrogression. The first stage, associated with the Mediterranean Sea, was dominated by the North Italians and Catalonians but ended in a phase of crisis after 1300, which was not finally ended until 1558. The second stage of commercial capitalism, which was associated with the Atlantic Ocean, was dominated by the West Iberians, the Netherlanders, and the English. It had begun to expand by 1440, was in full swing by 1600, but by the end of the seventeenth century had become entangled in the restrictive struggles of state mercantilism and the series of wars which ravaged Europe from 1667 to 1815.

Supremacy of Charter Companies

The commercial capitalism of the 1440-1815 period was marked by the supremacy of the Chartered Companies, such as the Hudson's Bay, the Dutch and British East Indian companies, the Virginia Company, and the Association of Merchant Adventurers (Muscovy Company). England's greatest rivals in all these activities were defeated by England's greater power, and, above all, its greater security derived from its insular position.

Industrial Capitalism 1770-1850

Britain's victories over Louis XIV in the period 1667-1715 and over the French Revolutionary governments and Napoleon in 1792-1815 had many causes, such as its insular position, its ability to retain control of the sea, its ability to present itself to the world as the defender of the freedoms and rights of small nations and of diverse social and religious groups. Among these numerous causes, there were a financial one and an economic one. Financially, England had discovered the secret of credit. Economically, England had embarked on the Industrial Revolution.

The Founding of the Bank of England Is One of the

Great Dates in World History

Credit had been known to the Italians and Netherlanders long before it became one of the instruments of English world supremacy. Nevertheless, the founding of the Bank of England by William Paterson and his friends in 1694 is one of the great dates in world history. For generations men had sought to avoid the one drawback of gold, its heaviness, by using pieces of paper to represent specific pieces of gold. Today we call such pieces of paper gold certificates. Such a certificate entitles its bearer to exchange it for its piece of gold on demand, but in view of the convenience of paper, only a small fraction of certificate holders ever did make such demands. It early became clear that gold need be held on hand only to the amount needed to cover the fraction of certificates likely to be presented for payment; accordingly, the rest of the gold could be used for business purposes, or, what amounts to the same thing, a volume of certificates could be issued greater than the volume of gold reserved for payment of demands against them. Such an excess volume of paper claims against reserves we now call bank notes.

Bankers Create Money Out of Nothing

In effect, this creation of paper claims greater than the reserves available means that bankers were creating money out of nothing. The same thing could be done in another way, not by note-issuing banks but by deposit banks. Deposit bankers discovered that orders and checks drawn against deposits by depositors and given to third persons were often not cashed by the latter but were deposited to their own accounts. Thus there were no actual movements of funds, and payments were made simply by bookkeeping transactions on the accounts. Accordingly, it was necessary for the banker to keep on hand in actual money (gold, certificates, and notes) no more than the fraction of deposits likely to be drawn upon and cashed; the rest could be used for loans, and if these loans were made by creating a deposit for the borrower, who in turn would draw checks upon it rather than withdraw it in money, such "created deposits" or loans could also be covered adequately by retaining reserves to only a fraction of their value. Such created deposits also were a creation of money out of nothing, although bankers usually refused to express their actions, either note issuing or deposit lending, in these terms. William Paterson, however, on obtaining the charter of the Bank of England in 1694, to use the moneys he had won in privateering, said, "The Bank hath benefit of interest on all moneys which it creates out of nothing." This was repeated by Sir Edward Holden, founder of the Midland Bank, on December 18, 1907, and is, of course, generally admitted today.

The Creation of Credit

This organizational structure for creating means of payment out of nothing, which we call credit, was not invented by England but was developed by her to become one of her chief weapons in the victory over Napoleon in 1815. The emperor, as the last great mercantilist, could not see money in any but concrete terms, and was convinced that his

efforts to fight wars on the basis of "sound money," by avoiding the creation of credit, would ultimately win him a victory by bankrupting England. He was wrong, although the lesson has had to be relearned by modern financiers in the twentieth century.

Britain's Victory Over Napoleon

Britain's victory over Napoleon was also helped by two economic innovations: the Agricultural Revolution, which was well established there in 1720, and the Industrial Revolution, which was equally well established there by 1776, when Watt patented his steam engine. The Industrial Revolution, like the Credit Revolution, has been much misunderstood, both at the time and since. This is unfortunate, as each of these has great significance, both to advanced and to underdeveloped countries, in the twentieth century. The Industrial Revolution was accompanied by a number of incidental features, such as growth of cities through the factory system, the rapid growth of an unskilled labor supply (the proletariat), the reduction of labor to the status of a commodity in the competitive market, and the shifting of ownership of tools and equipment from laborers to a new social class of entrepreneurs. None of these constituted the essential feature of industrialism, which was, in fact, the application of nonliving power to the productive process. This application, symbolized in the steam engine and the water wheel, in the long run served to reduce or eliminate the relative significance of unskilled labor and the use of human or animal energy in the productive process (automation) and to disperse the productive process from cities, but did so, throughout, by intensifying the vital feature of the system, the use of energy from sources other than living bodies.

The Rise of Large Industrial Enterprises in Britain

In this continuing process, Britain's early achievement of industrialism gave it such great profits that these, combined with the profits derived earlier from commercial capitalism and the simultaneous profits derived from the unearned rise in land values from new cities and mines, made its early industrial enterprises largely self-financed or at least locally financed. They were organized in proprietorships and partnerships, had contact with local deposit banks for short-term current loans, but had little to do with international bankers, investment banks, central governments, or corporative forms of business organization.

This early stage of industrial capitalism, which lasted in England from about 1770 to about 1850, was shared to some extent with Belgium and even France, but took quite different forms in the United States, Germany, and Italy, and almost totally different forms in Russia or Asia. The chief reason for these differences was the need for raising funds (capital) to pay for the rearrangement of the factors of production (]and, labor, materials, skill, equipment, and so on) which industrialism required. Northwestern Europe, and above all England, had large savings for such new enterprises. Central Europe and North America had much less, while eastern and southern Europe had very little in private hands.

The Role of the International Investment Banker

The more difficulty an area had in mobilizing capital for industrialization, the more significant was the role of investment bankers and of governments in the industrial process. In fact, the early forms of industrialism based on textiles, iron, coal, and steam spread so slowly from England to Europe that England was itself entering upon the next stage, financial capitalism, by the time Germany and the United States (about 1850) were just beginning to industrialize. This new stage of financial capitalism, which continued to dominate England, France, and the United States as late as 1930, was made necessary by the great mobilizations of capital needed for railroad building after 1830. The capital needed for railroads, with their enormous expenditures on track and equipment, could not be raised from single proprietorships or partnerships or locally, but, instead, required a new form of enterprise—the limited-liability stock corporation—and a new source of funds—the international investment banker who had, until then, concentrated his attention almost entirely on international flotations of government bonds. The demands of railroads for equipment carried this same development, almost at once, into steel manufacturing and coal mining.

Financial Capitalism, 1850 - 1931

This third stage of capitalism is of such overwhelming significance in the history of the twentieth century, and its ramifications and influences have been so subterranean and even occult, that we may be excused if we devote considerate attention to its organization and methods. Essentially what it did was to take the old disorganized and localized methods of handling money and credit and organize them into an integrated system, on an international basis, which worked with incredible and well-oiled facility for many decades. The center of that system was in London, with major offshoots in New York and Paris, and it has left, as its greatest achievement, an integrated banking system and a heavily capitalized—if now largely obsolescent—framework of heavy industry, reflected in railroads, steel mills, coal mines, and electrical utilities.

This system had its center in London for four chief reasons. First was the great volume of savings in England, resting on England's early successes in commercial and industrial capitalism. Second was England's oligarchic social structure (especially as reflected in its concentrated landownership and limited access to educational opportunities) which provided a very inequitable distribution of incomes with large surpluses coming to the control of a small, energetic upper class. Third was the fact that this upper class was aristocratic but not noble, and thus, based on traditions rather than birth, was quite willing to recruit both money and ability from lower levels of society and even from outside the country, welcoming American heiresses and central-European Jews to its ranks, almost as willingly as it welcomed monied, able, and conformist recruits from the lower classes of Englishmen, whose disabilities from educational deprivation, provincialism, and Nonconformist (that is non-Anglican) religious background generally excluded them from the privileged aristocracy. Fourth (and by no means last) in significance was the skill in financial manipulation, especially on the international scene, which the small group of merchant bankers of London had acquired in the period of commercial and

industrial capitalism and which lay ready for use when the need for financial capitalist innovation became urgent.

The Dynasties of International Bankers

The merchant bankers of London had already at hand in 1810-1850 the Stock Exchange, the Bank of England, and the London money market when the needs of advancing industrialism called all of these into the industrial world which they had hitherto ignored. In time they brought into their financial network the provincial banking centers, organized as commercial banks and savings banks, as well as insurance companies, to form all of these into a single financial system on an international scale which manipulated the quantity and flow of money so that they were able to influence, if not control, governments on one side and industries on the other. The men who did this, looking backward toward the period of dynastic monarchy in which they had their own roots, aspired to establish dynasties of international bankers and were at least as successful at this as were many of the dynastic political rulers. The greatest of these dynasties, of course, were the descendants of Meyer Amschel Rothschild (1743-1812) of Frankfort, whose male descendants, for at least two generations, generally married first cousins or even nieces. Rothschild's five sons, established at branches in Vienna, London, Naples, and Paris, as well as Frankfort, cooperated together in ways which other international banking dynasties copied but rarely excelled.

The Financial Activities of International Bankers

In concentrating, as we must, on the financial or economic activities of international bankers, we must not totally ignore their other attributes. They were, especially in later generations, cosmopolitan rather than nationalistic.... They were usually highly civilized, cultured gentlemen, patrons of education and of the arts, so that today colleges, professorships, opera companies, symphonies, libraries, and museum collections still reflect their munificence. For these purposes they set a pattern of endowed foundations which still surround us today.

The Key International Banking Families

The names of some of these banking families are familiar to all of us and should he more so. They include Raring, Lazard, Erlanger, Warburg, Schroder, Seligman, the Speyers, Mirabaud, Mallet, Fould, and above all Rothschild and Morgan. Even after these banking families became fully involved in domestic industry by the emergence of financial capitalism, they remained different from ordinary bankers in distinctive ways: (1) they were cosmopolitan and international; (2) they were close to governments and were particularly concerned with questions of government debts, including foreign government debts, even in areas which seemed, at first glance, poor risks, like Egypt, Persia, Ottoman Turkey, Imperial China, and Latin America; (3) their interests were almost exclusively in bonds and very rarely in goods, since they admired "liquidity" and regarded commitments in commodities or even real estate as the first step toward bankruptcy; (4) they were, accordingly, fanatical devotees of deflation (which they called

"sound" money from its close associations with high interest rates and a high value of money) and of the gold standard, which, in their eyes, symbolized and ensured these values; and (5) they were almost equally devoted to secrecy and the secret use of financial influence in political life. These bankers came to be called "international bankers" and, more particularly, were known as "merchant bankers" in England, "private bankers" in France, and "investment bankers" in the United States. In all countries they carried on various kinds of banking and exchange activities, but everywhere they were sharply distinguishable from other, more obvious, kinds of banks, such as savings banks or commercial banks.

The International Banking Fraternity Operates

As Secretive Private Firms

One of their less obvious characteristics was that they remained as private unincorporated firms, usually partnerships, until relatively recently, offering no shares, no reports, and usually no advertising to the public. This risky status, which deprived them of limited liability, was retained, in most cases, until modern inheritance taxes made it essential to surround such family wealth with the immortality of corporate status for tax-avoidance purposes. This persistence as private firms continued because it ensured the maximum of anonymity and secrecy to persons of tremendous public power who dreaded public knowledge of their activities as an evil almost as great as inflation. As a consequence, ordinary people had no way of knowing the wealth or areas of operation of such firms, and often were somewhat hazy as to their membership. Thus, people of considerable political knowledge might not associate the names Walter Burns, Clinton Dawkins, Edward Grenfell, Willard Straight, Thomas Lamont, Dwight Morrow, Nelson Perkins, Russell Leffingwell, Elihu Root, John W. Davis, John Foster Dulles, and S. Parker Gilbert with the name "Morgan," yet all these and many others were parts of the system of influence which centered on the J. P. Morgan office at :3 Wall Street. This firm, like others of the international banking fraternity, constantly operated through corporations and governments, yet remained itself an obscure private partnership until international financial capitalism was passing from its deathbed to the grave. J. P. Morgan and Company, originally founded in London as George Peabody and Company in 1838, was not incorporated until March 21, 1940, and went out of existence as a separate entity on April 24, 1959, when it merged with its most important commercial bank subsidiary, the Guaranty Trust Company. The London affiliate, Morgan Grenfell, was incorporated in , and still exists.

International Bankers Felt Politicians Could Not Be Trusted

With Control of the Monetary System

The influence of financial capitalism and of the international bankers who created it was exercised both on business and on governments, but could have done neither if it had not been able to persuade both these to accept two "axioms" of its own ideology. Both of these were based on the assumption that politicians were too weak and too subject to

temporary popular pressures to be trusted with control of the money system; accordingly, the sanctity of all values and the soundness of money must be protected in two ways: by basing the value of money on gold and by allowing bankers to control the supply of money. To do this it was necessary to conceal, or even to mislead, both governments and people about the nature of money and its methods of operation.

The Gold Standard

For example, bankers called the process of establishing a monetary system on gold "stabilization," and implied that this covered, as a single consequence, stabilization of exchanges and stabilization of prices. It really achieved only stabilization of exchanges, while its influence on prices were quite independent and incidental, and might be un-stabilizing (from its usual tendency to force prices downward by limiting the supply of money). As a consequence, many persons, including financiers and even economists, were astonished to discover, in the twentieth century, that the gold standard gave stable exchanges and unstable prices. It had, however, already contributed to a similar, but less extreme, situation in much of the nineteenth century.

Exchanges were stabilized on the gold standard because by law, in various countries, the monetary unit was made equal to a fixed quantity of gold, and the two were made exchangeable at that legal ratio. In the period before 1914, currency was stabilized in certain countries as follows:

In Britain: 77s. 10 ½ d. equaled a standard ounce (11/12 pure gold).

In the United States: $20.67 equaled a fine ounce (12/12 pure gold).

In France: 3,447.74 francs equaled a fine kilogram of gold.

In Germany: 2,790 marks equaled a fine kilogram of gold.

These relationships were established by the legal requirement that a person who brought gold, gold coins, or certificates to the public treasury (or other designated places) could convert any one of these into either of the others in unlimited amounts for no cost. As a result, on a full gold standard, gold had a unique position: it was, at the same time, in the sphere of money and in the sphere of wealth. In the sphere of money, the value of all other kinds of money was expressed in terms of gold: and, in the sphere of real wealth, the values of all other kinds of goods were expressed in terms of gold as money. If we regard the relationships between money and goods as a seesaw in which each of these was at opposite ends, so that the value of one rose just as much as the value of the other declined, then we must see gold as the fulcrum of the seesaw on which this relationship balances, but which does not itself go up or down.

It Is Impossible to Understand World History Without an

Understanding of Money

Since it is quite impossible to understand the history of the twentieth century without some understanding of the role played by money in domestic affairs and in foreign affairs, as well as the role played by bankers in economic life and in political life, we must take at least a glance at each of these four subjects.

Central Banks Were Private Institutions Owned by Shareholders

In each country the supply of money took the form of an inverted pyramid or cone balanced on its point. In the point was a supply of gold and its equivalent certificates; on the intermediate levels was a much larger supply of notes; and at the top, with an open and expandable upper surface, was an even greater supply of deposits. Each level used the levels below it as its reserves, and, since these lower levels had smaller quantities of money, they were "sounder." A holder of claims on the middle or upper level could increase his confidence in his claims on wealth by reducing them to a lower level, although, of course, if everyone, or any considerable number of persons, tried to do this at the same time the volume of reserves would be totally inadequate. Notes were issued by "banks of emission" or "banks of issue," and were secured by reserves of gold or certificates held in their own coffers or in some central reserve. The fraction of such a note issue held in reserve depended upon custom, banking regulations (including the terms of a bank's charter), or statute law. There were formerly many banks of issue, but this function is now generally restricted to a few or even to a single "central bank" in each country. Such banks, even central banks, were private institutions, owned by shareholders who profited by their operations. In the 1914-1939 period, in the United States, Federal Reserve Notes were covered by gold certificates to 40 percent of their value, but this was reduced to 25 percent in 1945. The Bank of England, by an Act of 1928, had its notes uncovered up to [250 million, and covered by gold for 100 percent value over that amount. The Bank of France, in the same year, set its note cover at 35 percent. These provisions could always be set aside or changed in an emergency, such as war.

Determining the Volume of Money in the Community

Deposits on the upper level of the pyramid were called by this name, with typical bankers' ambiguity, in spite of the fact that they consisted of two utterly different kinds of relationships: (1) "lodged deposits," which were real claims left by a depositor in a bank, on which the depositor might receive interest, since such deposits were debts owed by the bank to the depositor; and (2) "created deposits," which were claims created by the bank out of nothing as loans from the bank to "depositors" who had to pay interest on them, since these represented debt from them to the bank. In both cases, of course, checks could be drawn against such deposits to make payments to third parties, which is why both were called by the same name. Both form part of the money supply. Lodged deposits as a form of savings are deflationary, while created deposits, being an addition to the money supply, are inflationary. The volume of the latter depends on a number of factors of which the chief are the rate of interest and the demand for such credit. These two play a very significant role in determining the volume of money in the community, since a large portion of that volume, in an advanced economic community, is made up of checks

drawn against deposits. The volume of deposits banks can create, like the amount of notes they can issue, depends upon the volume of reserves available to pay whatever fraction of checks are cashed rather than deposited. These matters may be regulated by laws, by bankers' rules, or simply by local customs. In the United States deposits were traditionally limited to ten times reserves of notes and gold. In Britain it was usually nearer twenty times such reserves. In all countries the demand for and volume of such credit was larger in time of a boom and less in time of a depression. This to a considerable extent explains the inflationary aspect of a depression, the combination helping to form the so-called "business cycle."

Central Banks Surrounded by Invisible Private

Investment Banking Firms

In the course of the nineteenth century, with the full establishment of the gold standard and of the modern banking system, there grew up around the fluctuating inverted pyramid of the money supply a plethora of financial establishments which came to assume the configurations of a solar system; that is, of a central bank surrounded by satellite financial institutions. In most countries the central bank was surrounded closely by the almost invisible private investment banking firms. These, like the planet Mercury, could hardly be seen in the dazzle emitted by the central bank which they, in fact, often dominated. Yet a close observer could hardly fail to notice the close private associations between these private, international bankers and the central bank itself. In France, for example, in 1936 when the Bank of France was reformed, its Board of Regents (directors) was still dominated by the names of the families who had originally set it up in 1800; to these had been added a few more recent names, such as Rothschild (added in 1819); in some cases the name might not be readily recognized because it was that of a son-in-law rather than that of a son. Otherwise, in 1914, the names, frequently those of Protestants of Swiss origin (who arrived in the eighteenth century) or of Jews of German origin (who arrived in the nineteenth century), had been much the same for more than a century.

The Bank of England and Its Private Banking Firms

In England a somewhat similar situation existed, so that even in the middle of the twentieth century the Members of the Court of the Bank of England were chiefly associates of the various old "merchant banking" firms such as Baring Brothers, Morgan Grenfell, Lazard Brothers, and others.

Commercial Banks Operate Outside Central Banks and Private Banking Firms

In a secondary position, outside the central core, are the commercial banks, called in England the "joint-stock banks," and on the Continent frequently known as "deposit banks." These include such famous names as Midland Bank, Lloyd's Bank, Barclays Bank in England, the National City Bank in the United States, the Credit Lyonnais in France, and the Darmstädter Bank in Germany.

Savings Banks, Insurance Funds and Trust Companies

Operate on the Outside Ring

Outside this secondary ring is a third, more peripheral, assemblage of institutions that have little financial power but do have the very significant function of mobilizing funds from the public. This includes a wide variety of savings banks, insurance firms, and trust companies.

Naturally, these arrangements vary greatly from place to place, especially as the division of banking functions and powers are not the same in all countries. In France and England the private bankers exercised their powers through the central bank and had much more influence on the government and on foreign policy and much less influence on industry, because in these two countries, unlike Germany, Italy, the United States, or Russia, private savings were sufficient to allow much of industry to finance itself without recourse either to bankers or government. In the United States much industry was financed by investment bankers directly, and the power of these both on industry and on government was very great, while the central bank (the New York Federal Reserve Bank) was established late (1913) and became powerful much later (after financial capitalism was passing from the scene). In Germany industry was financed and controlled by the discount banks, while the central bank was of little power or significance before 1914. In Russia the role of the government was dominant in much of economic life, while in Italy the situation was backward and complicated.

The Supply of Money

We have said that two of the five factors which determined the value of money (and thus the price level of goods) are the supply and the demand for money. The supply of money in a single country was subject to no centralized, responsible control in most countries over recent centuries. Instead, there were a variety of controls of which some could be influenced by bankers, some could be influenced by the government, and some could hardly be influenced by either. Thus, the various parts of the pyramid of money were but loosely related to each other. Moreover, much of this looseness arose from the fact that the controls were compulsive in a deflationary direction and were only permissive in an inflationary direction.

This last point can be seen in the fact that the supply of gold could be decreased but could hardly be increased. If an ounce of gold was added to the point of the pyramid in a system where law and custom allowed To percent reserves on each level, it could permit an increase of deposits equivalent to $2067 on the uppermost level. If such an ounce of gold were withdrawn from a fully expanded pyramid of money, this would compel a reduction of deposits by at least this amount, probably by a refusal to renew loans.

The Money Power Persuaded Governments to Establish a

Deflationary Monetary Unit

Throughout modern history the influence of the gold standard has been deflationary, because the natural output of gold each year, except in extraordinary times, has not kept pace with the increase in output of goods. Only new supplies of gold, or the suspension of the gold standard in wartime, or the development of new kinds of money (like notes and checks) which economize the use of gold, have saved our civilization from steady price deflation over the last couple of centuries. As it was, we had two long periods of such deflation from 1818 to 1850 and from 1872 to about 1897. The three surrounding periods of inflation (1790-1817, 1850-1872, 1897-1921) were caused by (1) the wars of the French Revolution and Napoleon when most countries were not on gold; (2) the new gold strikes of California and Alaska in 1849-1850, followed by a series of wars, which included the Crimean War of 1854-1856, the Austrian-French War of 1859, the American Civil War of 1861-1865, the Austro-Prussian and Franco-Prussian wars of 1866 and 1870, and even the Russo-Turkish War of 1877; and (3) the Klondike and Transvaal gold strikes of the late 1890's, supplemented by the new cyanide method of refining gold (about 1897) and the series of wars from the Spanish-American War of 1898-1899, the Boer War of 1899-1902, and the Russo-Japanese War of 1904-1905, to the almost uninterrupted series of wars in the decade 1911-1921. In each case, the three great periods of war ended with an extreme deflationary crisis (1819, 1873, 1921) as the influential Money Power persuaded governments to reestablish a deflationary monetary unit with a high gold content.

Money Power Is More Concerned With Money Than Goods

The obsession of the Money Power with deflation was partly a result of their concern with money rather than with goods, but was also founded on other factors, one of which was paradoxical. The paradox arose from the fact that the basic economic conditions of the nineteenth century were deflationary, with a money system based on gold and an industrial system pouring out increasing supplies of goods, but in spite of falling prices (with its increasing value of money) the interest rate tended to fall rather than to rise. This occurred because the relative limiting of the supply of money in business was not reflected in the world of finance where excess profits of finance made excess funds available for lending. Moreover, the old traditions of merchant banking continued to prevail in financial capitalism even to its end in 1931. It continued to emphasize bonds rather than equity securities (stocks), to favor government issues rather than private offerings, and to look to foreign rather than to domestic investments. Until 1825, government bonds made up almost the whole of securities on the London Stock Exchange. In 1843, such bonds, usually foreign, were 80 percent of the securities registered, and in 1875 they were still 68 percent. The funds available for such loans were so great that there were, in the nineteenth century, sometimes riots by subscribers seeking opportunities to buy security flotations; and offerings from many remote places and obscure activities commanded a ready sale. The excess of savings led to a fall in the price necessary to hire money, so that the interest rate on British government bonds fell from 4.42 percent in 1820 to 3.11 in 1850 to 2.76 in 1900. This tended to drive savings into foreign fields where, on the whole, they continued to seek government issues and fixed

interest securities. All this served to strengthen the merchant bankers' obsession both with government influence and with deflation (which would increase value of money and interest rates).

Banker Policies Lead to Inflation and Deflation

Another paradox of banking practice arose from the fact that bankers, who loved deflation, often acted in an inflationary fashion from their eagerness to lend money at interest. Since they make money out of loans, they are eager to increase the amounts of bank credit on loan. But this is inflationary. The conflict between the deflationary ideas and inflationary practices of bankers had profound repercussions on business. The bankers made loans to business so that the volume of money increased faster than the increase in goods. The result was inflation. When this became clearly noticeable, the bankers would flee to notes or specie by curtailing credit and raising discount rates. This was beneficial to bankers in the short run (since it allowed them to foreclose on collateral held for loans), but it could be disastrous to them in the long run (by forcing the value of the collateral below the amount of the loans it secured). But such bankers' deflation was destructive to business and industry in the short run as well as the long run.

Changing the Quality of Money

The resulting fluctuation in the supply of money, chiefly deposits, was a prominent aspect of the "business cycle." The quantity of money could be changed by changing reserve requirements or discount (interest) rates. In the United States, for example, an upper limit has been set on deposits by requiring Federal Reserve member banks to keep a certain percentage of their deposits as reserves with the local Federal Reserve Bank. The percentage (usually from 7 to 26 percent) varies with the locality and the decisions of the Board of Governors of the Federal Reserve System.

Central Banks Vary Money in Circulation

Central banks can usually vary the amount of money in circulation by "open market operations" or by influencing the discount rates of lesser banks. In open market operations, a central bank buys or sells government bonds in the open market. If it buys, it releases money into the economic system; if it sells it reduces the amount of money in the community. The change is greater than the price paid for the securities. For example, if the Federal Reserve Bank buys government securities in the open market, it pays for these by check which is soon deposited in a bank. It thus increases this bank's reserves with the Federal Reserve Bank. Since banks are permitted to issue loans for several times the value of their reserves with the Federal Reserve Bank, such a transaction permits them to issue loans for a much larger sum.

Central Banks Raise and Lower Interest Rates

Central banks can also change the quantity of money by influencing the credit policies of other banks. This can be done by various methods, such as changing the re-discount

rate or changing reserve requirements. By changing the re-discount rate we mean the interest rate which central banks charge lesser banks for loans backed by commercial paper or other security which these lesser banks have taken in return for loans. By raising the re-discount rate the central bank forces the lesser bank to raise its discount rate in order to operate at a profit; such a raise in interest rates tends to reduce the demand for credit and thus the amount of deposits (money). Lowering the re-discount rate permits an opposite result.

Central Banks Force Local Banks to Decrease Credit

Changing the reserve requirements as a method by which central banks can influence the credit policies of other banks is possible only in those places (like the United States) where there is a statutory limit on reserves. Increasing reserve requirements curtails the ability of lesser banks to grant credit, while decreasing it expands that ability.

It is to be noted that the control of the central bank over the credit policies of local banks are permissive in one direction and compulsive in the other. They can compel these local banks to curtail credit and can only permit them to increase credit. This means that they have control powers against inflation and not deflation—a reflection of the old banking idea that inflation was bad and deflation was good.

The Powers of Government Over Money

The powers of governments over the quantity of money are of various kinds, and include (a) control over a central bank, (b) control over public taxation, and (c) control over public spending. The control of governments over central banks varies greatly from one country to another, but on the whole has been increasing. Since most central banks have been (technically) private institutions, this control is frequently based on custom rather than on law. In any case, the control over the supply of money which governments have through centra! banks is exercised by the regular banking procedures we have discussed. The powers of the government over the quantity of money in the community exercised through taxation and public spending are largely independent of banking control. Taxation tends to reduce the amount of money in a community and is usually a deflationary force; government spending tends to increase the amount of money in a community and is usually an inflationary force. The total effects of a government's policy will depend on which item is greater. An unbalanced budget will be inflationary; a budget with a surplus will be deflationary.

A government can also change the amount of money in a community by other, more drastic, methods. By changing the gold content of the monetary unit they can change the amount of money in the community by a much greater amount. If, for example, the gold content of the dollar is cut in half, the amount of gold certificates will be able to be doubled, and the amount of notes and deposits reared on this basis will be increased many fold, depending on the customs of the community in respect to reserve requirements. Moreover, if a government goes off the gold standard completely—that is, refuses to exchange certificates and notes for specie—the amount of notes and deposits can be

increased indefinitely because these are no longer limited by limited amounts of gold reserves.

The Money Power—Controlled by International Investment Bankers—

Dominates Business and Government

In the various actions which increase or decrease the supply of money, governments, bankers, and industrialists have not always seen eye to eye. On the whole, in the period up to 1931, bankers, especially the Money Power controlled by the international investment bankers, were able to dominate both business and government. They could dominate business, especially in activities and in areas where industry could not finance its own needs for capital, because investment bankers had the ability to supply or refuse to supply such capital. Thus, Rothschild interests came to dominate many of the railroads of Europe, while Morgan dominated at least 26,000 miles of American railroads. Such bankers went further than this. In return for flotations of securities of industry, they took seats on the boards of directors of industrial firms, as they had already done on commercial banks, savings banks, insurance firms, and finance companies. From these lesser institutions they funneled capital to enterprises which yielded control and away from those who resisted. These firms were controlled through interlocking directorships, holding companies, and lesser banks. They engineered amalgamations and generally reduced competition, until by the early twentieth century many activities were so monopolized that they could raise their noncompetitive prices above costs to obtain sufficient profits to become self-financing and were thus able to eliminate the control of bankers. But before that stage was reached a relatively small number of bankers were in positions of immense influence in European and American economic life. As early as 1909, Walter Rathenau, who was in a position to know (since he had inherited from his father control of the German General Electric Company and held scores of directorships himself), said, "Three hundred men, all of whom know one another, direct the economic destiny of Europe and choose their successors from among themselves."

The Power of Investment Bankers Over Governments

The power of investment bankers over governments rests on a number of factors, of which the most significant, perhaps, is the need of governments to issue short-term treasury bills as well as long-term government bonds. Just as businessmen go to commercial banks for current capital advances to smooth over the discrepancies between their irregular and intermittent incomes and their periodic and persistent outgoes (such as monthly rents, annual mortgage payments, and weekly wages), so a government has to go to merchant bankers (or institutions controlled by them) to tide over the shallow places caused by irregular tax receipts. As experts in government bonds, the international bankers not only handled the necessary advances but provided advice to government officials and, on many occasions, placed their own members in official posts for varied periods to deal with special problems. This is so widely accepted even today that in 1961 a Republican investment banker became Secretary of the Treasury in a Democratic Administration in Washington without significant comment from any direction.

The Money Power Reigns Supreme and Unquestioned

Naturally, the influence of bankers over governments during the age of financial capitalism (roughly 1850-1931) was not something about which anyone talked freely, but it has been admitted frequently enough by those on the inside, especially in England. In 1852 Gladstone, chancellor of the Exchequer, declared, "The hinge of the whole situation was this: the government itself was not to be a substantive power in matters of Finance, but was to leave the Money Power supreme and unquestioned." On September 26, 1921, The Financial Times wrote, "Half a dozen men at the top of the Big Five Banks could upset the whole fabric of government finance by refraining from renewing Treasury Bills." In 1924 Sir Drummond Fraser, vice-president of the Institute of Bankers, stated, "The Governor of the Bank of England must be the autocrat who dictates the terms upon which alone the Government can obtain borrowed money."

Montagu Norman and J. P. Morgan Dominate the Financial World

In addition to their power over government based on government financing and personal influence, bankers could steer governments in ways they wished them to go by other pressures. Since most government officials felt ignorant of finance, they sought advice from bankers whom they considered to be experts in the field. The history of the last century shows, as we shall see later, that the advice given to governments by bankers, like the advice they gave to industrialists, was consistently good for bankers, but was often disastrous for governments, businessmen, and the people generally. Such advice could be enforced if necessary by manipulation of exchanges, gold flows, discount rates, and even levels of business activity. Thus Morgan dominated Cleveland's second administration by gold withdrawals, and in 1936-1938 French foreign exchange manipulators paralyzed the Popular Front governments. As we shall see, the powers of these international bankers reached their peak in the last decade of their supremacy, 1919-1931, when Montagu Norman and J. P. Morgan dominated not only the financial world but international relations and other matters as well. On November I l, 1927, the Wall Street Journal called Mr. Norman "the currency dictator of Europe." This was admitted by Mr. Norman himself before the Court of the Bank on March Zl, 1930, and before the Macmillan Committee of the House of Commons five days later. On one occasion, just before international financial capitalism ran, at full speed, on the rocks which sank it, Mr. Norman is reported to have said, "I hold the hegemony of the world." At the time, some Englishmen spoke of "the second Norman Conquest of England" in reference to the fact that Norman's brother was head of the British Broadcasting Corporation. It might be added that Governor Norman rarely acted in major world problems without consulting with J. P. Morgan's representatives, and as a consequence he was one of the most widely traveled men of his day.

The Development of Monopoly Capitalism

This conflict of interests between bankers and industrialists has resulted in most European countries in the subordination of the former either to the latter or to the

government (after 1931). This subordination was accomplished by the adoption of "unorthodox financial policies"—that is, financial policies not in accordance with the short-run interests of bankers. This shift by which bankers were made subordinate reflected a fundamental development in modern economic history—a development which can be described as the growth from financial capitalism to monopoly capitalism. This took place in Germany earlier than in any other country and was well under way by 1926. It came in Britain only after 1931 and in Italy only in 1934. It did not occur in France to a comparable extent at all, and this explains the economic weakness of France in 1938-1940 to a considerable degree.

International Financial Practices

The financial principals which apply to the relationships between different countries are an expansion of those which apply within a single country. When goods are exchanged between countries, they must be paid for by commodities or gold. They cannot be paid for by the notes, certificates, and checks of the purchaser's country, since these are of value only in the country of issue. To avoid shipment of gold with every purchase, bills of exchange are used. These are claims against a person in another country which are sold to a person in the same country. The latter will buy such a claim if he wants to satisfy a claim against himself held by a person in the other country. He can satisfy such a claim by sending to his creditor in the other country the claim which he has bought against another person in that other country, and let his creditor use that claim to satisfy his own claim. Thus, instead of importers in one country sending money to exporters in another country, importers in one country pay their debts to exporters in their own country, and their creditors in the other country receive payment for the goods they have exported from importers in their own country. Thus, payment for goods in an international trade is made by merging single transactions involving two persons into double transactions involving four persons. In many cases, payment is made by involving a multitude of transactions, frequently in several different countries. These transactions were carried on in the so-called foreign-exchange market. An exporter of goods sold bills of exchange into that market and thus drew out of it money in his own country's units. An importer bought such bills of exchange to send to his creditor, and thus he put his own country's monetary units into the market. Since the bills available in any market were drawn in the monetary units of many different foreign countries, there arose exchange relationships between the amounts of money available in the country's own units (put there by importers) and the variety of bills drawn in foreign moneys and put into the market by exporters. The supply and demand for bills (or money) of any country in terms of the supply and demand of the country's own money available in the foreign-exchange market determined the value of the other countries' moneys in relation to domestic money. These values could fluctuate—widely for countries not on the gold standard, but only narrowly (as we shall see) for those on gold.

The Foreign Exchange Market Acted as Regulator of International Trade

Under normal conditions a foreign-exchange market served to pay for goods and services of foreigners without any international shipment of money (gold). It also acted as

a regulator of international trade. If the imports of any country steadily exceeded exports to another country, more importers would be in the market offering domestic money for bills of exchange drawn in the money of their foreign creditor. There thus would be an increased supply of domestic money and an increased demand for that foreign money. As a result, importers would have to offer more of their money for these foreign bills, and the value of domestic money would fall, while the value of the foreign money would rise in the foreign-exchange market. This rise (or fall) on a gold relationship would be measured in terms of "par" (the exact gold content equivalent of the two currencies).

As the value of the domestic currency sagged below par in relationship to that of some foreign currency, domestic exporters to that foreign country will increase their activities, because when they receive payment in the form of a bill of exchange they can sell it for more of their own currency than they usually expect and can thus increase their profits. A surplus of imports, by lowering the foreign-exchange value of the importing country's money, will lead eventually to an increase in exports which, by providing more bills of exchange, will tend to restore the relationship of the moneys back toward par. Such a restoration of parity in foreign exchange will reflect a restoration of balance in international obligations, and this in turn will reflect a restored balance in the exchange of goods and services between the two countries. This means, under normal conditions, that a trade disequilibrium will create trade conditions which will tend to restore trade equilibrium.

Wide Fluctuations in Foreign Exchange Market

When countries are not on the gold standard, this foreign-exchange disequilibrium (that is, the decline in the value of one monetary unit in relation to the other unit) can go on to very wide fluctuations—in fact, to whatever degree is necessary to restore the trade equilibrium by encouraging importers to buy in the other country because its money is so low in value that the prices of goods in that country are irresistible to importers in the other country.

Foreign Exchange Market Does Not Fluctuate on the Gold Standard

But when countries are on the gold standard, the result is quite different. In this case the value of a country's money will never go below the amount equal to the cost of shipping gold between the two countries. An importer who wishes to pay his trade partner in the other country will not offer more and more of his own country's money for foreign-exchange bills, but will bid up the price of such bills only to the point where it becomes cheaper for him to buy gold from a bank and pay the costs of shipping and insurance on the gold as it goes to his foreign creditor. Thus, on the gold standard, foreign-exchange quotations do not fluctuate widely, but move only between the two gold points which are only slightly above (gold export point) and slightly below (gold import point) parity (the legal gold relationship of the two currencies).

Since the cost of packing, shipping and insuring gold used to be about ½ percent of its value, the gold export and import points were about this amount above and below the

parity point. In the case of the dollar-pound relationship, when parity was at £ 1 = $4.866, the gold export point was about $4.885 and the gold import point was about $4.845. Thus:

Gold export point $4.885

(excess demand for bills by importers)

Parity $4.866

Gold import point $4.845

(excess supply of bills by exporters)

The situation which we have described is overly simplified. In practice the situation is made more complicated by several factors. Among these are the following: (1) middlemen buy and sell foreign exchange for present or future delivery as a speculative activity; (2) the total supply of foreign exchange available in the market depends on much more than the international exchange of commodities. It depends on the sum total of all international payments, such as interest, payment for services, tourist spending, borrowings, sales of securities, immigrant remittances, and so on; (3) the total exchange balance depends on the total of the relationships of all countries, not merely between two.

Elimination of the Gold Standard

The flow of gold from country to country resulting from unbalanced trade tends to create a situation which counteracts the flow. If a country exports more than it imports so that gold flows in to cover the difference, this gold will become the basis for an increased quantity of money, and this will cause a rise of prices within the country sufficient to reduce exports and increase imports. At the same time, the gold by flowing out of some other country will reduce the quantity of money there and will cause a fall in prices within that country. These shifts in prices will cause shifts in the flow of goods because of the obvious fact that goods tend to flow to higher-priced areas and cease to flow to lower-priced areas. These shifts in the flow of goods will counteract the original unbalance in trade which caused the flow of gold. As a result, the flow of gold will cease, and a balanced international trade at slightly different price levels will result. The whole process illustrates the subordination of internal price stability to stability of exchanges. It was this subordination which was rejected by most countries after 1931. This rejection was signified by (a) abandonment of the gold standard at least in part, (b) efforts at control of domestic prices, and (c) efforts at exchange control. All these were done because of a desire to free the economic system from the restricting influence of a gold-dominated financial system.

Major Countries Forced to Abandon Gold Standard

This wonderful, automatic mechanism of international payments represents one of the greatest social instruments ever devised by man. It requires, however, a very special group of conditions for its effective functioning and, as we shall show, these conditions were disappearing by 1900 and were largely wiped away as a result of the economic changes brought about by the First World War. Because of these changes it became impossible to restore the financial system which had existed before 1914. Efforts to restore it were made with great determination, but by 1933 they had obviously failed, and all major countries had been forced to abandon the gold standard and automatic exchanges.

When the gold standard is abandoned, gold flows between countries like any other commodity, and the value of foreign exchanges (no longer tied to gold) can fluctuate much more widely. In theory an unbalance of international payments can be rectified either through a shift in exchange rates or through a shift in internal price levels. On the gold standard this rectification is made by shifts in exchange rates only between the gold points. When the unbalance is so great that exchanges would be forced beyond the gold points, the rectification is made by means of changing internal prices caused by the fact that gold flows at the gold points, instead of the exchanges passing beyond the gold points. On the other hand, when a currency is off the gold standard, fluctuation of exchanges is not confined between any two points but can go indefinitely in either direction. In such a case, the unbalance of international payments is worked out largely by a shift in exchange rates and only remotely by shifts in internal prices. In the period of 1929-1936, the countries of the world went off gold because they preferred to bring their international balances toward equilibrium by means of fluctuating exchanges rather than by means of fluctuating price levels. They feared these last because changing (especially falling) prices led to declines in business activity and shifts in the utilization of economic resources (such as labor, land, and capital) from one activity to another.

Reestablishing the Balance of International Payments

The reestablishment of the balance of international payments when a currency is off gold can be seen from an example. If the value of the pound sterling falls to $4.00 or $3.00, Americans will buy in England increasingly because English prices are cheap for them, but Englishmen will buy in America only with reluctance because they have to pay so much for American money. This will serve to rectify the original excess of exports to England which gave the great supply of pound sterling necessary to drive its value down to $3.00. Such a depreciation in the exchange value of a currency will cause a rise in prices within the country as a result of the increase in demand for the goods of that country.

The Situation before 1914

The key to the world situation in the period before 1914 is to be found in the dominant position of Great Britain. This position was more real than apparent. In many fields (such as naval or financial) the supremacy of Britain was so complete that it almost never had to be declared by her or admitted by others. It was tacitly assumed by both. As an

unchallenged ruler in these fields, Britain could afford to be a benevolent ruler. Sure of herself and of her position, she could be satisfied with substance rather than forms. If others accepted her dominance in fact, she was quite willing to leave to them independence and autonomy in law.

The Supremacy of Britain

This supremacy of Britain was not an achievement of the nineteenth century alone. Its origins go back to the sixteenth century—to the period in which the discovery of America made the Atlantic more important than the Mediterranean as a route of commerce and a road to wealth. In the Atlantic, Britain's position was unique, not merely because of her westernmost position, but much more because she was an island. This last fact made it possible for her to watch Europe embroil itself in internal squabbles while she retained freedom to exploit the new worlds across the seas. On this basis, Britain had built up a naval supremacy which made her ruler of the seas by 1900. Along with this was her preeminence in merchant shipping which gave her control of the avenues of world transportation and ownership of 39 percent of the world's oceangoing vessels (three times the number of her nearest rival).

To her supremacy in these spheres, won in the period before 1815, Britain added new spheres of dominance in the period after 1815. These arose from her early achievement of the Industrial Revolution. This was applied to transportation and communications as well as to industrial production. In the first it gave the world the railroad and the steamboat; in the second it gave the telegraph, the cable, and the telephone; in the third it gave the factory system.

The Industrial Revolution

The Industrial Revolution existed in Britain for almost two generations before it spread elsewhere. It gave a great increase in output of manufactured goods and a great demand for raw materials and food; it also gave a great increase in wealth and savings. As a result of the first two and the improved methods of transportation, Britain developed a world trade of which it was the center and which consisted chiefly of the export of manufactured goods and the import of raw materials and food. At the same time, the savings of Britain tended to flow out to North America, South America, and Asia, seeking to increase the output of raw materials and food in these areas. By 1914 these exports of capital had reached such an amount that they were greater than the foreign investments of all other countries put together. In 1914 British overseas investment was about $20 billion (or about one-quarter of Britain's national wealth, yielding about a tenth of the total national income). The French overseas investment at the same time was about $9 billion (or one-sixth the French national wealth, yielding 6 percent of the national income), while Germany had about $5 billion invested overseas (one-fifteenth the national wealth, yielding 3 percent of the national income). The United States at that time was a large-scale debtor.

The World's Great Commercial Markets Were in Britain

The dominant position of Britain in the world of 1913 was, as I have said, more real than apparent. In all parts of the world people slept more securely' worked more productively, and lived more fully because Britain existed. British naval vessels in the Indian Ocean and the Far East suppressed slave raiders, pirates, and headhunters. Small nations like Portugal, the Netherlands, or Belgium retained their overseas possessions under the protection of the British fleet. Even the United States, without realizing it, remained secure and upheld the Monroe Doctrine behind the shield of the British Navy. Small nations were able to preserve their independence in the gaps between the Great Powers, kept in precarious balance by the Foreign Office's rather diffident balance-of-power tactics. Mos; of the world's great commercial markets, even in commodities like cotton, rubber, and tin, which she did not produce in quantities herself, were in England, the world price being set from the auction bidding of skilled specialist traders there. If a man in Peru wished to send money to a man in Afghanistan, the final payment, as like as not, would be made by a bookkeeping transaction in London. The English parliamentary system and some aspects of the English judicial system, such as the rule of law, were being copied, as best as could be, in all parts of the world.

Britain Was the Center of World Finance and World Trade

The profitability of capital outside Britain—a fact which caused the great export of capital—was matched by a profitability of labor. As a result, the flow of capital from Britain and Europe was matched by a flow of persons. Both of these served to build up non-European areas on a modified European pattern. In export of men, as in export of capital, Britain was easily first (over 20 million persons emigrating from the United Kingdom in the period 1815-1938). As a result of both, Britain became the center of world finance as well as the center of world commerce. The system of international financial relations, which we described earlier, was based on the system of industrial, commercial, and credit relationships which we have just described. The former thus required for its existence a very special group of circumstances—a group which could not be expected to continue forever. In addition, it required a group of secondary characteristics which were also far from permanent. Among these were the following: (1) all the countries concerned must be on the full gold standard; (2) there must be freedom from public or private interference with the domestic economy of any country; that is, prices must be free to rise and fall in accordance with the supply and demand for both goods and money; (3) there must also be free flow of international trade so that both goods and money can go without hindrance to those areas where each is most valuable; (4) the international financial economy must be organized about one center with numerous subordinate centers, so that it would be possible to cancel out international claims against one another in some clearinghouse and thus reduce the flow of gold to a minimum; (5) the flow of goods and funds in international matters should be controlled by economic factors and not be subject to political, psychological, or ideological influences.

These conditions, which made the international financial and commercial system function so beautifully before 1914, had begun to change by 1890. The fundamental

economic and commercial conditions changed first, and were noticeably modified by 1910; the group of secondary characteristics of the system were changed by the events of the First World War. As a result, the system of early international financial capitalism is now only a dim memory. Imagine a period without passports or visas, and with almost no immigration or customs restrictions. Certainly the system had many incidental drawbacks, but they were incidental. Socialized if not social, civilized if not cultured, the system allowed individuals to breathe freely and develop their individual talents in a way unknown before and in jeopardy since.

Chapter 6—The United States to 1917

Just as Classical culture spread westward from the Greeks who created it to the Roman peoples who adopted and changed it, so Europe's culture spread westward to the New World, where it was profoundly modified while still remaining basically European. The central fact of American history is that people of European origin and culture came to occupy and use the immensely rich wilderness between the Atlantic and the Pacific. In this process the wilderness was developed and exploited area by area, the Tidewater, the Piedmont, the trans-Appalachian forest, the trans-Mississippi prairies, the Pacific Coast, and finally the Great Plains. By 1900 the period of occupation which had begun in 1607 was finished, but the era of development continued on an intensive rather than extensive basis. This shift from extensive to intensive development, frequently called the "closing of the frontier," required a readjustment of social outlook and behavior from a largely individualistic to a more cooperative basis and from an emphasis on mere physical prowess to emphasis on other less tangible talents of managerial skills, scientific training, and intellectual capacity able to fill the

newly occupied frontiers with a denser population, producing a higher standard of living, and utilizing more extensive leisure.

The ability of the people of the United States to make this readjustment of social outlook and behavior at the "ending of the frontier" about 1900 was hampered by a number of factors from its earlier historical experience. Among these we should mention the growth of sectionalism, past political and constitutional experiences, isolationism, and emphasis on physical prowess and unrealistic idealism.

Three Major Geographic Sections Arise in U.S.

The occupation of the United States had given rise to three chief geographic sections: a commercial and later financial and industrial East, an agrarian and later industrial West, and an agrarian South. Unfortunately, the two agrarian sections were organized quite differently, the South on the basis of slave labor and the West on the basis of free labor. On this question the East allied with the West to defeat the South in the Civil War (1861-1865) and to subject it to a prolonged military occupation as a conquered territory (1865-1877). Since the war and the occupation were controlled by the new Republican Party, the political organization of the country became split on a sectional basis: the South refused to vote Republican until 1928, and the West refused to vote Democratic until