Unfortunately, this postwar inflation, which could have accomplished much good (by increasing output of real wealth) was wasted (by increasing prices of existing goods) and had evil results (by destroying capital accumulations and savings, and overturning economic class lines). This failure was caused by the fact that the inflation, though unwanted everywhere, was uncontrolled because few persons in positions of power had the courage to take the steps necessary to curtail it. In the defeated and revolutionary countries (Russia, Poland, Hungary, Austria, and Germany), the inflation went so far that the former monetary units became valueless, and ceased to exist. In a second group of countries (like France, Belgium, and Italy), the value of the monetary unit was so reduced that it became a different thing, although the same name was still used. In a third group of countries (Britain, the United States, and Japan), the situation was kept under control.

Public Debt and Economic Depression in America

As far as Europe was concerned, the intensity of the inflation increased as one moved geographically from west to east. Of the three groups of countries above, the second (moderate inflation) group was the most fortunate. In the first (extreme inflation) group the inflation wiped out all public debts, all savings, and all claims on wealth, since the monetary unit became valueless. In the moderate-inflation group, the burden of the public debt was reduced, and private debts and savings were reduced by the same proportion. In the United States and Britain the effort to fight inflation took the form of a deliberate movement toward deflation. This preserved savings but increased the burden of the public debt and gave economic depression.

Chapter 20—The Period of Stabilization, 1922-1930

As soon as the war was finished, governments began to turn their attention to the problem of restoring the prewar financial system. Since the essential element in that system was believed to be the gold standard with its stable exchanges, this movement was called "stabilization." Because of their eagerness to restore the prewar financial situation, the "experts" closed their eyes to the tremendous changes which had resulted from the war. These changes were so great in production, in commerce, and in financial habits that any effort to restore the prewar conditions or even stabilize on the gold standard was impossible and inadvisable. Instead of seeking a financial system adapted to the new economic and commercial world which had emerged from the war, the experts tried to ignore this world, and established a financial system which looked, superficially, as much like the prewar system as possible. This system, however, was not the prewar system. Neither was it adapted to the new economic conditions. When the experts began to have vague glimmerings of this last fact, they did not begin to modify their goals, but insisted on the same goals, and voiced incantations and exhortations against the existing conditions which made the attainment of their goals impossible.

These changed economic conditions could not be controlled or exorcised by incantations. They were basically not results of the war at all, but normal outcomes of the economic development of the world in the nineteenth century. All that the war had done was to speed up the rate of this development. The economic changes which in 1925 made it so difficult to restore the financial system of 1914 were already discernible in 1890 and clearly evident by 1910.

Britain's Supremacy as the Financial Center of the World Is Threatened

The chief item in these changes was the decline of Britain. What had happened was that the Industrial Revolution was spreading beyond Britain to Europe and the United States and by 1910 to South America and Asia. As a result, these areas became less dependent on Britain for manufactured goods, less eager to sell their raw materials and food products to her, and became her competitors both in selling to and in buying from those colonial areas to which industrialism had not yet spread. By 1914 Britain's supremacy as financial center, as commercial market, as creditor, and as merchant shipper was being threatened. A less obvious threat arose from long-run shifts in demand—shifts from the products of heavy industry to the products of more highly specialized branches of production (like chemicals), from cereals to fruits and dairy products, from cotton and wool to silk and rayon, from leather to rubber, and so on. These changes presented Britain with a fundamental choice—either to yield her supremacy in the world or reform her industrial and commercial system to cope with the new conditions. The latter was difficult because Britain had allowed her industrial system to become lopsided under the influence of free trade and international division of labor. Over half the employed persons in Britain were engaged in the manufacture of textiles and ferrous metals. Textiles accounted for over one-third of her exports, and textiles, along with iron and steel, for over one-half. At the same time, newer industrial nations (Germany, the United States, and Japan) were growing rapidly with industrial systems better adapted to the trend of the times; and these were also cutting deeply into Britain's supremacy in merchant shipping.

America Becomes the World's Greatest Creditor

At this critical stage in Britain's development, the World War occurred. This had a double result as far as this subject is concerned. It forced Britain to postpone indefinitely any reform of her industrial system to adjust it to more modern trends; and it speeded up the development of these trends so that what might have occurred in twenty years was done instead in five. In the period 1910-1920, Britain's merchant fleet fell by 6 percent in number of vessels, while that of the United States went up 57 percent, that of Japan up 130 percent, and that of the Netherlands up 58 percent. Her position as the world's greatest creditor was lost to the United States, and a large quantity of good foreign credits was replaced by a smaller amount of poorer risks. In addition, she became a debtor to the United States to the amount of over $4 billion. The change in the positions of the two countries can be summarized briefly. The war changed the position of the United States in respect to the rest of the world from that of a debtor owing about $3 billion to that of a creditor owed $4 billion. This does not include intergovernmental debts of about $10 billion owed to the United States as a result of the war. At the same time, Britain's position changed from a creditor owed about $18 billion to a creditor owed about $13.5 billion. In addition, Britain was owed about $8 billion in war debts from her Allies and an unknown sum in reparations from Germany, and owed to the United States war debts of well over 54 billion. Most of these war debts and reparations were sharply reduced after 1920, but the net result for Britain was a drastic change in her position in respect to the United States.

Modification of the Basic Economic Organization of the World

The basic economic organization of the world was modified in other ways. As a result of the war, the old organization of relatively free commerce among countries specializing in different types of production was replaced by a situation in which a larger number of countries sought economic self-sufficiency by placing restrictions on commerce. In addition, productive capacity in both agriculture and industry had been increased by the artificial demand of the war period to a degree far beyond the ability of normal domestic demand to buy the products of that capacity. And, finally, the more backward areas of Europe and the world had been industrialized to a great degree and were unwilling to fall back to a position in which they would obtain industrial products from Britain, Germany, or the United States in return for their raw materials and food. This refusal was made more painful for both sides by the fact that these backward areas had increased their outputs of raw materials and food so greatly that the total could hardly have been sold even if they had been willing to buy all their industrial products from their prewar sources. These prewar sources in turn had increased their industrial capacity so greatly that the product could hardly have been sold if they had been able to recapture entirely all their prewar markets. The result was a situation where all countries were eager to sell and reluctant to buy, and sought to achieve these mutually irreconcilable ends by setting up subsidies and bounties on exports, tariffs, and restrictions on imports, with disastrous results on world trade. The only sensible solution to this problem of excessive productive capacity would have been a substantial rise in domestic standards of living, but this would have required a fundamental reapportionment of the national income so that claims to the product of the excess capacity would go to those masses eager to consume, rather than continue to go to the minority desiring to save. Such a reform was rejected by the ruling groups in both "advanced" and "backward" countries, so that this solution was reached only to a relatively small degree in a relatively few countries (chiefly the United States and Germany in the period 1925-1929)

International Bankers Began to Set Gold Aside

Changes in the basic productive and commercial organization of the world in the period 1914-1919 were made more difficult to adjust by other less tangible changes in financial practices and business psychology. The spectacular postwar inflations in eastern Europe had intensified the traditional fear of inflation among bankers. In an effort to stop rises in prices which might become inflationary, bankers after 1919 increasingly sought to "sterilize" gold when it flowed into their country. That is, they sought to set it aside so that it did not become part of the monetary system. As a result, the unbalance of trade which had initiated the flow of gold was not counteracted by price changes. Trade and prices remained unbalanced, and gold continued to flow. Somewhat similar was a spreading fear of decreasing gold reserves, so that when gold began to flow out of a country as a result of an unfavorable balance of international payments, bankers increasingly sought to hinder the flow by restrictions on gold exports. With such actions the unfavorable balance of trade continued, and other countries were inspired to take retaliatory actions. The situation was also disturbed by political fears and by the military ambitions of certain countries, since these frequently resulted in a desire for self-sufficiency (autarchy) such as could be obtained only by use of tariffs, subsidies, quotas, and trade controls. Somewhat related to this was the widespread increase in feelings of economic, political, and social insecurity. This gave rise to "flights of capital"—that is, to panic transfers of holdings seeking a secure spot regardless of economic return. Moreover, the situation was disturbed by the arrival in the foreign-exchange market of a very large number of relatively ignorant speculators. In the period before 1914 speculators in foreign exchange had been a small group of men whose activities were based on long experience with the market and had a stabilizing effect on it. After 1919 large numbers of persons with neither knowledge nor experience began to speculate in foreign exchange. Subject to the influence of rumors, hearsay, and mob panic, their activities had a very disturbing effect on the markets. Finally, within each country, the decline in competition arising from the growth of labor unions, cartels, monopolies, and so on, made prices less responsive to flows of gold or exchange in the international markets, and, as a result, such flows did not set into motion those forces which would equalize prices between countries, curtail flows of gold, and balance flows of goods.

Most Countries Leave the Gold Standard

As a result of all these factors, the system of international payments which had worked ... before 1914 worked only haltingly after that date, and practically ceased to work at all after 1930. The chief cause of these factors was that neither goods nor money obeyed purely economic forces and did not move as formerly to the areas in which each was most valuable. The chief result was a complete mal-distribution of gold, a condition which became acute after 1928 and which by 1933 had forced most countries off the gold standard.

Modifications of productive and commercial organization and of financial practices made it almost impossible after 1919 to restore the financial system of 1914. Yet this is what was attempted. Instead of seeking to set up a new financial organization adapted to the modified economic organization, bankers and politicians insisted that the old prewar system should be restored. These efforts were concentrated in a determination to restore the gold standard as it had existed in 1914.

The Money Power Seeks to Create a World System of Financial

Control in Private Hands Able to Dominate Every Nation on Earth

In addition to these pragmatic goals, the powers of financial capitalism had another far-reaching aim, nothing less than to create a world system of financial control in private hands able to dominate the political system of each country and the economy of the world as a whole. This system was to be controlled in a feudalist fashion by the central banks of the world acting in concert, by secret agreements arrived at in frequent private meetings and conferences. The apex of the system was to be the Bank for International Settlements in Basle, Switzerland, a private bank owned and controlled by the world's central banks which were themselves private corporations. Each central bank, in the hands of men like Montagu Norman of the Bank of England, Benjamin Strong of the New York Federal Reserve Bank, Charles Rist of the Bank of France, and Hjalmar Schacht of the Reichsbank, sought to dominate its government by its ability to control Treasury loans, to manipulate foreign exchanges, to influence the level of economic activity in the country, and to influence cooperative politicians by subsequent economic rewards in the business world.

International Bankers Seek and Make Agreements on

All the Major Financial Problems of the World

In each country the power of the central bank rested largely on its control of credit and money supply. In the world as a whole the power of the central bankers rested very largely on their control of loans and of gold flows. In the ... system, these central bankers were able to mobilize resources to assist each other through the B.I.S., where payments between central banks could be made by bookkeeping adjustments between the accounts which the central banks of the world kept there. The B.I.S. as a private institution was owned by the seven chief central banks and was operated by the heads of these, who together formed its governing board. Each of these kept a substantial deposit at the B.I.S., and periodically settled payments among themselves (and thus between the major countries of the world) by bookkeeping in order to avoid shipments of gold. They made agreements on all the major financial problems of the world, as well as on many of the economic and political problems, especially in reference to loans, payments, and the economic future of the chief areas of the globe.

The Bank for International Settlements Becomes the Mechanism for Allowing the

Three Financial Centers of the World to Act As One

The B.I.S. is generally regarded as the apex of the structure of financial capitalism whose remote origins go back to the creation of the Bank of England in 1694 and the Bank of France in 1803. As a matter of fact its establishment in 1929 was rather an indication that the centralized world financial system of 1914 was in decline. It was set up rather to remedy the decline of London as the world's financial center by providing a mechanism by which a world with three chief financial centers in London, New York, and Paris could still operate as one. The B.I.S. was a ... effort to cope with the problems arising from the growth of a number of centers. It was intended to be the world cartel of ever-growing national financial powers by assembling the nominal heads of these national financial centers.

Montagu Norman Was the Commander-in-Chief of the

World System of Banking Control

The commander in chief of the world system of banking control was Montagu Norman, Governor of the Bank of England, who was built up by the private bankers to a position where he was regarded as an oracle in all matters of government and business. In government the power of the Bank of England was a considerable restriction on political action as early as 1819 but an effort to break this power by a modification of the bank's charter in 1844 failed. In 1852, Gladstone, then chancellor of the Exchequer and later prime minister, 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."

The Currency Dictator of Europe

This power of the Bank of England and of its governor was admitted by most qualified observers. In January, 1924, Reginald McKenna, who had been chancellor of the Exchequer in 1915-1916, as chairman of the board of the Midland Bank told its stockholders: "I am afraid the ordinary citizen will not like to be told that the banks can, and do, create money.... And they who control the credit of the nation direct the policy of Governments and hold in the hollow of their hands the destiny of the people." In that same year, 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." 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." Vincent Vickers, who had been a director of the bank for nine years, said, "Since 1919 the monetary policy of the Government has been the policy of the Bank of England and the policy of the Bank of England has been the policy of Mr. Montagu Norman." On November Il, 1927, the Wall Street Journal called Mr. Norman "the currency dictator of Europe." This fact was admitted by Mr. Norman himself before the court of the bank on March 21, 1930, and before the Macmillan Committee five days later.

Montagu Norman's position may be gathered from the fact that his predecessors in the governorship, almost a hundred of them, had served two-year terms, increased rarely, in time of crisis, to three or even four years. But Norman held the position for twenty-four years (1920-1944), during which he became the chief architect of the liquidation of Britain's global preeminence.

Norman Viewed Governments and Democracy As

Threats to the Money Power

Norman was a strange man whose mental outlook was one of successfully suppressed hysteria or even paranoia. He had no use for governments and feared democracy. Both of these seemed to him to be threats to private banking, and thus to all that was proper and precious in human life. Strong-willed, tireless, and ruthless, he viewed his life as a kind of cloak-and-dagger struggle with the forces of ... [sound] money .... When he rebuilt the Bank of England, he constructed it as a fortress prepared to defend itself against any popular revolt, with the sacred gold reserves hidden in deep vaults below the level of underground waters which could be released to cover them by pressing a button on the governor's desk. For much of his life Norman rushed about the world by fast steamship, covering tens of thousands of miles each year, often traveling incognito, concealed by a black slouch hat and a long black cloak, under the assumed name of "Professor Skinner." His embarkations and debarkations onto and off the fastest ocean liners of the day, sometimes through the freight hatch, were about as unobserved as the somewhat similar passages of Greta Garbo in the same years, and were carried out in a similarly "sincere" effort at self-effacement.

Montagu Norman's Devoted Colleague in New York City

Norman had a devoted colleague in Benjamin Strong, the first governor of the Federal Reserve Bank of New York. Strong owed his career to the favor of the Morgan Bank, especially of Henry P. Davison, who made him secretary of the Bankers Trust Company of New York (in succession to Thomas W. Lamont) in 1904, used him as Morgan's agent in the banking rearrangements following the crash of 1907, and made him vice-president of the Bankers Trust (still in succession to Lamont) in 1909. He became governor of the Federal Reserve Bank of New York as the joint nominee of Morgan and of Kuhn, Loeb, and Company in 1914. Two years later, Strong met Norman for the first time, and they at once made an agreement to work in cooperation for the financial practices they both revered.

These financial practices were explicitly stated many times in the voluminous correspondence between these two men and in many conversations they had, both in their work and at their leisure (they often spent their vacations together for weeks, usually in the south of France).

Norman and Strong Seek to Operate Central Banks Free from

Any Political Control

In the 1920's, they were determined to use the financial power of Britain and of the United States to force all the major countries of the world to go on the gold standard and to operate it through central banks free from all political control, with all questions of international finance to be settled by agreements by such central banks without interference from governments.

Norman and Strong Were Mere Agents of the Powerful Bankers

Who Remained Behind the Scenes and Operated in Secret

It must not be felt that these heads of the world's chief central banks were themselves substantive powers in world finance. They were not. Rather, they were the technicians and agents of the dominant investment bankers of their own countries, who had raised them up and were perfectly capable of throwing them down. The substantive financial powers of the world were in the hands of these investment bankers (also called "international" or "merchant" bankers) who remained largely behind the scenes in their own unincorporated private banks. These formed a system of international cooperation and national dominance which was more private, more powerful, and more secret than that of their agents in the central banks. This dominance of investment bankers was based on their control over the flows of credit and investment funds in their own countries and throughout the world. They could dominate the financial and industrial systems of their own countries by their influence over the flow of current funds through bank loans, the discount rate, and the re-discounting of commercial debts; they could dominate governments by their control over current government loans and the play of the international exchanges. Almost all of this power was exercised by the personal influence and prestige of men who had demonstrated their ability in the past to bring off successful financial coupe, to keep their word, to remain cool in a crisis, and to share their winning opportunities with their associates. In this system the Rothschilds had been preeminent during much of the nineteenth century, but, at the end of that century, they were being replaced by J. P. Morgan whose central office was in New York, although it was always operated as if it were in London (where it had, indeed, originated as George Peabody and Company in 1838). Old J. P. Morgan died in 1913, but was succeeded by his son of the same name (who had been trained in the London branch until 1901), while the chief decisions in the firm were increasingly made by Thomas W. Lamont after 1924. But these relationships can be described better on a national basis later. At the present stage we must follow the efforts of the central bankers to compel the world to return to the gold standard of 1914 in the postwar conditions following 1918.

International Banker's Viewpoints Expressed in

Government Reports and Conferences

The bankers' point of view was clearly expressed in a series of government reports and international conferences from 1918 to 1933. Among these were the reports of the Cunliffe Committee of Great Britain (August 1918), that of the Brussels Conference of Experts (September 1920), that of the Genoa Conference of the Supreme Council (January 1922), the First World Economic Conference (at Geneva, May 1927), the report of the Macmillan Committee on Finance and Industry (of 1931), and the various statements released by the World Economic Conference (at London in 1933). These and many other statements and reports called vainly for a free international gold standard, for balanced budgets, for restoration of the exchange rates and reserve ratios customary before 1914, for reductions in taxes and government spending, and for a cessation of all government interference in economic activity either domestic or international. But none of these studies made any effort to assess the fundamental changes in economic, commercial, and political life since 1914. And none gave any indication of a realization that a financial system must adapt itself to such changes. Instead, they all implied that if men would only give up their evil ways and impose the financial system of 1914 on the world, the changes would be compelled to reverse their direction and go back to the conditions of 1914.

Restoration of the Gold Standard of 1914

Accordingly, the financial efforts of the period after 1918 became concentrated on a very simple (and superficial) goal—to get back to the gold standard—not "a" gold standard but "the" gold standard, by which was meant the identical exchange ratios and gold contents that monetary units had had in 1914.

Restoration of the gold standard was not something which could be done by a mere act of government. It was admitted even by the most ardent advocates of the gold standard that certain financial relationships would require adjustment before the gold standard could be restored. There were three chief relationships involved. These were (1) the problem of inflation, or the relationship between money and goods; (2) the problem of public debts, or the relationship between governmental income and expenditure; and (3) the problem of price parities, or the relationship between price levels of different countries. That these three problems existed was evidence of a fundamental disequilibrium between real wealth and claims on wealth, caused by a relative decrease in the former and increase in the latter.

Paying the Public Debt

The problem of public debts arose from the fact that as money (credit) was created during the war period, it was usually made in such a way that it was not in the control of the state or the community but was in the control of private financial institutions which demanded real wealth at some future date for the creation of claims on wealth in the present. The problem of public debt could have been met in one or more of several fashions: (a) by increasing the amount of real wealth in the community so that its price would fall and the value of money would rise. This would restore the old equilibrium (and price level) between real wealth and claims on wealth and, at the same time, would permit payment of the public debt with no increase in the tax rates; (b) by devaluation—that is, reduce the gold content of the monetary unit so that the government's holdings of gold would be worth a greatly increased number of monetary units. These latter could be applied to the public debt; (c) by repudiation—that is, a simple cancellation of the public debt by a refusal to pay it; (d) by taxation—that is, by increasing the tax rate to a level high enough to yield enough income to pay off the public debt; (e) by the issuance of fiat money and the payment of the debt by such money.

These methods were not mutually exclusive, and in some cases overlapped. It might, for example, be argued that devaluation or use of fiat money were forms of partial repudiation. Nor were all these methods equally practical. For example, the first (increase real wealth) was by far the soundest method to achieve a re-stabilization.... The fourth (taxation) would have put a burden on the economic system so great as to be self-defeating. In Britain, the public debt could have been paid only by a tax of 25 percent for about three hundred years. Such heavy taxes might have had such a depressing effect on production of real wealth that national income would decline faster than tax rates rose, making payment by taxation impossible. Nor were all these alternative methods of paying the public debt of equal practicality in respect to their effects on the two other financial problems occupying the minds of experts and statesmen. These other two problems were inflation and price parities. These problems were just as urgent as the public debt, and the effects upon them of the different methods for paying the public debt could have been completely different. Efforts to pay the public debt by fiat money would have made the inflation problem and perhaps the price-parity problem worse. Taxation and increasing real wealth, on the other hand, would have reduced the inflation problem at the same time as they reduced the public debt, since both would have increased the value of money (that is, they were deflationary). Their effects on the problem of price parity would differ from case to case.

Use of Taxation to Pay Public Debt

Finally, these methods of paying the public debt were not of equal value in theory. Orthodox theory rejected repudiation, devaluation, and fiat money as solutions to the problem, and, since it showed no way of increasing the production of real wealth, only taxation was left as a possible method of paying public debts. But the theorists, as we have shown, could call taxation a possible way only if they neglected the economic consequences. These consequences in most countries were so disastrous that taxation, if tried, soon had to be supplemented by other, unorthodox, methods. Great Britain and the United States were the only Great Powers which continued to use taxation as the chief method of paying the public debt.

The Problem of Inflation

The second problem which had to be faced before stabilization was possible was the problem of inflation. This was caused by the great increase in claims on wealth (money), and showed itself in a drastic increase in prices. There were three possible solutions: (a) to increase the production of real wealth; (b) to decrease the quantity of money; or (c) to devaluate, or make each unit of money equal to a smaller amount of wealth (specifically gold). The first two would have forced prices back to the lower prewar level but would have done it in entirely different ways, one resulting in prosperity and a great rise in standards of living, the second resulting in depression and a great fall in standards of living. The third method (devaluation) was essentially a recognition and acceptance of the existing situation, and would have left prices at the higher postwar level permanently. This would have involved a permanent reduction in the value of money, and also would have given different parities in foreign exchanges (unless there was international agreement that countries devaluate by the same ratio). But it would have made possible prosperity and a rising standard of living and would have accepted as permanent the redistribution of wealth from creditors to debtors brought about by the wartime inflation.

International Bankers Regarded Deflation as a Good Thing

Since the third method (devaluation) was rejected by orthodox theorists, and no one could see how to get the first (increase of real wealth), only the second (deflation) was left as a possible method for dealing with the problem of inflation. To many people it seemed axiomatic that the cure for inflation was deflation, especially since bankers regarded deflation as a good thing in itself. Moreover, deflation as a method for dealing with the problem of inflation went hand in hand with taxation as a method for dealing with the problem of public debts. Theorists did not stop to think what the effects of both would be on the production of real wealth and on the prosperity of the world.

The Problem of Price Parities

The third financial problem which had to be solved before stabilization became practical was the problem of price parities. This differed because it was primarily an international question while the other two problems were primarily domestic. By suspending the gold standard and establishing artificial control of foreign exchanges at the outbreak of war, the belligerent countries made it possible for prices to rise at different rates in different countries. This can be seen in the fact that prices in Britain rose 200 percent in seven years (1913-1920), while in the United States they rose only 100 percent. The resulting disequilibrium had to be rectified before the two countries went back on the old gold standard, or the currencies would be valued in law in a ratio quite different from their value in goods. By going back on gold at the old ratios, one ounce of fine gold would, by law, become equal to $20.67 in the United States and about 84s. 11 ½ d. in Britain. For the $20.67 in the United States you could get in 1920 about half of what you could have bought with it in 1913; for the 84s. 11 ½ d. in Britain you could get in 1920 only about a third of what it would buy in 1913. The ounce of gold in the United States would be much more valuable than in Britain, so that foreigners (and British) would prefer to buy in the United States rather than in Britain, and gold would tend to flow to the United States from Britain with goods flowing in the opposite direction. In such conditions it would be said that the pound was overvalued and the dollar undervalued. The overvaluation would bring depression to Britain, while the United States would tend to be prosperous. Such disequilibrium of price parities could be adjusted either by a fall of prices in the country whose currency was overvalued or by a rise in prices in the country whose currency was undervalued (or by both). Such an adjustment would be largely automatic, but at the cost of a considerable flow of gold from the country whose currency was overvalued.

Because the problem of price parities would either adjust itself or would require international agreement for its adjustment, no real attention was paid to it when governments turned their attention to the task of stabilization. Instead, they concentrated on the other two problems and, above all, devoted attention to the task of building up sufficient gold reserves to permit them to carry out the methods chosen in respect to these two problems.

America Returns to the Gold Standard

Most countries were in a hurry to stabilize their currencies when peace was signed in 1919. The difficulties of the three problems we have mentioned made it necessary to postpone the step for years. The process of stabilization was stretched over more than a decade from 1919 to 1931. Only the United States was able to return to the gold standard at once, and this was the result of a peculiar combination of circumstances which existed only in that country. The United States had a plentiful supply of gold. In addition it had a technological structure quite different from that of any other country, except perhaps Japan. American technology was advancing so rapidly in the period 1922-1928 that even with falling prices there was prosperity, since costs of production fell even faster. This situation was helped by the fact that prices of raw materials and food fell faster than prices of industrial products, so that production of these latter was very profitable. As a result, America achieved to a degree greater than any other country a solution of inflation and public debt which all theorists had recognized as possible, but which none had known how to obtain—the solution to be found in a great increase in real wealth. This increase made it possible simultaneously to pay off the public debt and reduce taxes; it also made it possible to have deflation without depression. A happier solution of the postwar problems could hardly have been found—for a time, at least. In the long run, the situation had its drawbacks, since the fact that costs fell faster than prices and that prices of agricultural products and raw materials fell faster than prices of industrial products meant that in the long run the community would not have sufficient purchasing power to buy the products of the industrial organization. This problem was postponed for a considerable period by the application of easy credit and installment selling to the domestic market and by the extension to foreign countries of huge loans which made it possible for these countries to buy the products of American industry without sending their own goods into the American market in return. Thus, from a most unusual group of circumstances, the United States obtained an unusual boom of prosperity. These circumstances were, however, in many ways a postponement of difficulties rather than a solution of them, as the theoretical understanding of what was going on was still lacking.

Taxation as a Cure for Public Debts

In other countries the stabilization period was not so happy. In Britain, stabilization was reached by orthodox paths—that is, taxation as a cure for public debts and deflation as a cure for inflation. These cures were believed necessary in order to go back on the old gold parity. Since Britain did not have an adequate supply of gold, the policy of deflation had to be pushed ruthlessly in order to reduce the volume of money in circulation to a quantity small enough to be superimposed on the small base of available gold at the old ratios. At the same time, the policy was intended to drive British prices down to the level of world prices. The currency notes which had been used to supplement bank notes were retired, and credit was curtailed by raising the discount rate to panic level. The results were horrible. Business activity fell drastically, and unemployment rose to well over a million and a half. The drastic fall in prices (from 307 in 1920 to 197 in 1921) made production unprofitable unless costs were driven down even faster. This could not be achieved because labor unions were determined that the burden of the deflationary policy should not be pushed onto them by forcing down wages. The outcome was a great wave of strikes and industrial unrest.

Britain Goes Back on the Gold Standard

The British government could measure the success of their deflation only by comparing their price level with world price levels. This was done by means of the exchange ratio between the pound and the dollar. At that time the dollar was the only important currency on gold. It was expected that the forcing down of prices in Britain would be reflected in an increase in the value of the pound in terms of dollars on the foreign exchange market. Thus as the pound rose gradually upward toward the pre-war rate of $4.86, this rise would measure the fall in British prices downward to the American (or the world) price level. In general terms, this was true, but it failed to take into consideration the speculators who, knowing that the value of the pound was rising, sold dollars to buy pounds, thus pushing the dollar down and the pound upward faster than was justified in terms of the changes in price levels in the two countries. Thus the pound rose to $4.86, while the British price level had not yet fallen to the American price level, but the Chancellor of the Exchequer, Winston Churchill, judging the price level by the exchange rate, believed that it had and went back on the gold standard at that point. As a result, sterling was overvalued and Britain found itself economically isolated on a price plateau above the world market on which she was economically dependent. These higher British prices served to increase imports, decrease exports, and encourage an outflow of gold which made gold reserves dangerously low. To maintain the gold reserve at all, it was necessary to keep the discount rate at a level so high (4 ½ percent or more) that business activity was discouraged. The only solution which the British government could see to this situation was continued deflation. This effort to drive down prices failed because the unions were able to prevent the drastic cutting of costs (chiefly wages) necessary to permit profitable production on such a deflationary market. Nor could the alternative method of deflation—by heavy taxation—be imposed to the necessary degree on the upper classes who were in control of the' government. The showdown on the deflationary policy came in the General Strike of 1926. The unions lost the strike—that is, they could not prevent the policy of deflation—but they made it impossible for the government to continue the reduction of costs to the extent necessary to restore business profits and the export trade.

Britain Goes into Financial Bondage to France

As a result of this financial policy, Britain found herself faced with deflation and depression for the whole period 1920-1933. These effects were drastic in 1920-1922, moderate in 1922-1929, and drastic again in -1933. The wholesale price index (1913=100) fell from 307 in 1920 to 197 in 1921, then declined slowly to 137 in 1928. Then it fell rapidly to 120 in 1929 and go in 1933. The number of unemployed averaged about 13/4 millions for each of the thirteen years of 1921-1932 and reached 3 million in 1931. At the same time, the inadequacy of the British gold reserve during most of the period placed Britain in financial subjection to France (which had a plentiful supply of gold because of her different financial policy). This subjection served to balance the political subjection of France to Britain arising from French insecurity, and ended only with Britain's abandonment of the gold standard in 1931.

Britain was the only important European country which reached stabilization through deflation. East of her, a second group of countries, including Belgium, France, and Italy, reached stabilization through devaluation. This was a far better method. It was adopted, however, not because of superior intelligence but because of financial weakness. In these countries, the burden of war-damage reconstruction made it impossible to balance a budget, and this made deflation difficult. These countries accepted orthodox financial ideas and tried to deflate in 1920-1921, but, after the depression which resulted, they gave up the task. Belgium stabilized once at 107 francs to the pound sterling, but could not hold this level and had to devaluate further to 175 to the pound (October 1926). France stabilized at 124.21 francs to the pound at the end of 1926, although the stabilization was made de jure only in June 1928. Italy stabilized at 92.46 fire to the pound sterling in December 1927.

Achieving Stabilization through Devaluation

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The group of countries which reached stabilization through devaluation prospered in contrast with those who reached stabilization through deflation. The prosperity was roughly equal to the degree of devaluation. Of the three Latin countries—Belgium, France, and Italy—Belgium devalued the most and was most prosperous. Her stabilization was at a price level below the world level so that the belga was undervalued by about one-fifth. This served to encourage exports. For an industrial country such as Belgium, this made it possible for her to profit by the misfortunes of Britain. France was in a somewhat similar position. Italy, on the contrary, stabilized at a figure which made the lira considerably overvalued. This was done for purposes of prestige—Mussolini being determined to stabilize the lira at a value higher than that of the French franc. The effects of this overvaluation of the lira on the Italian economy were extremely adverse. Italy was never as prosperous after stabilization as she had been immediately before it.

Not only did the countries which undervalued their money prosper; they decreased the disequilibrium between wealth and money; they were able to use the inflation to increase production; they escaped high taxes; they moderated or escaped the stabilization crisis and the deflationary depression; they improved their positions in the world market in respect to high-cost countries like Britain; and they replenished their gold stocks.

America Rebuilds the Industrial Structure of Germany

through the Dawes Plan

A third group of countries reached stabilization through reconstruction. These were the countries in which the old monetary unit had been wiped out and had to be replaced by a new monetary unit. Among these were Austria, Hungary, Germany, and Russia. The first two of these were stabilized by a program of international assistance worked out through the League of Nations. The last was forced to work out a financial system by herself. Germany had her system reorganized as a consequence of the Dawes Plan. The Dawes Plan, as we have seen in our discussion of reparations, provided the gold reserves necessary for a new currency and provided a control of foreign exchange which served to protect Germany from the accepted principles of orthodox finance. These controls were continued until 1930, and permitted Germany to borrow from foreign sources, especially the United States, the funds necessary to keep her economic system functioning with an unbalanced budget and an unfavorable balance of trade. In the period 1924-1929, by means of these funds, the industrial structure of Germany was largely rebuilt so that, when the depression arrived, Germany had the most efficient industrial machine in Europe and probably the second most efficient in the world (after the United States). The German financial system had inadequate controls over inflation and almost none over deflation because of the Dawes Plan restrictions on the open-market operations of the Reichsbank and the generally slow response of the German economy to changes in the discount rate. Fortunately, such controls were hardly necessary. The price level was at 137 in 1924 and at the same figure in 1929 (1913=100). In that six-year period it had reached as high as 142 (in 1925) and fallen as low as 134 (in 1926). This stability in prices was accompanied by stability in economic conditions. While these conditions were by no means booming, there was only one bad year before 1930. This was 1926, the year in which prices fell to 134 from the 1925 level of 142. In this year unemployment averaged 2 million. The best year was 1925, in which unemployment averaged 636,000. This drop in prosperity from 1925 to 1926 was caused by a lack of credit as a result of the inadequate supplies of domestic credit and a temporary decline in the supplies of foreign credit. It was this short slump in business which led Germany to follow the road to technological reorganization. This permitted Germany to increase output with decreasing employment. The average annual increase in labor productivity in the period 1924-1932 in Germany was about 5 percent. Output per labor hour in industry rose from 87.8 in 1925 to 115.6 in 1930 and 125 in 1932 (1928=100). This increase in output served to intensify the impact of the depression in Germany, so that unemployment, which averaged about three million in the year 1930, reached over six million late in 1932. The implications of this will be examined in detail in our study of the rise to power of Hitler.

The Use of the Gold Bullion Standard Instead of the

Old Gold Standard

The stabilization period did not end until about 1931, although only minor Powers were still stabilizing in the last year or so. The last Great Power to stabilize de jure was France in June, 1928, and she had been stabilized de facto much earlier. In the whole period, about fifty countries stabilized their currencies on the gold standard. But because of the quantity of gold necessary to maintain the customary reserve ratios (that is, the pre-1914 ratios) at the higher prices generally prevailing during the period of stabilization, no important country was able to go back on the gold standard as the term was understood in 1914. The chief change was the use of the "gold exchange standard" or the "gold bullion standard" in place of the old gold standard. Under the gold exchange standard, foreign exchange of gold standard countries could be used as reserves against notes or deposits in place of reserves in gold. In this way, the world's limited supplies of gold could be used to support a much greater volume of fictitious wealth in the world as a whole since the same quantity of gold could act as bullion reserve for one country and as gold exchange reserve for another. Even those countries which stabilized on a direct gold standard did so in a quite different way from the situation in 1914. In few countries was there free and gratuitous convertibility between notes, coin, and bullion. In Great Britain, for example, by the Gold Standard Act of May 1925, notes could be exchanged for gold only in the form of bullion and only in amounts of at least 400 fine ounces (that is, not less than $8,268 worth at a time). Bullion could be presented to the mint for coinage only by the Bank of England, although the bank was bound to buy all gold offered at 77s. 10 ½ d. per standard ounce. Notes could be converted into coin only at the option of the bank. Thus the gold standard of 1925 was quite different from that of 1914.

The Money Power Creates a Facade of Cardboard and Tinsel

This would indicate that even in its most superficial aspects the international gold standard of 1914 was not reestablished by 1930. The legal provisions were different; the financial necessities and practices were quite different; the profound underlying economic and commercial conditions were entirely different, and becoming more so. Yet financiers, businessmen, and politicians tried to pretend to themselves and to the public that they had restored the financial system of 1914. They had created a facade of cardboard and tinsel which had a vague resemblance to the old system, and they hoped that, if they pretended vigorously enough, they could change this facade into the lost reality for which they yearned. At the same time, while pursuing policies (such as tariffs, price controls, production controls, and so on) which drove this underlying reality ever farther from that which had existed in 1914, they besought other governments to do differently. Such a situation, with pretense treated as if it were reality and reality treated as if it were a bad dream, could lead only to disaster. This is what happened. The period of stabilization merged rapidly into a period of deflation and depression.

Financial Capitalists Focus Entirely on Wealth

As we have said, the stage of financial capitalism did not place emphasis on the exchange of goods or the production of goods as the earlier stages of commercial capitalism and industrial capitalism had done. In fact, financial capitalism had little interest in goods at all, but was concerned entirely with claims on wealth—stocks, bonds, mortgages, insurance, deposits, proxies, interest rates, and such.

Financial Capitalists Discover New Ways to Make Money Out of Nothing

It invested capital not because it desired to increase the output of goods or services but because it desired to float issues (frequently excess issues) of securities on this productive basis. It built railroads in order to sell securities, not in order to transport goods; it constructed great steel corporations to sell securities, not in order to make steel, and so on. But, incidentally, it greatly increased the transport of goods, the output of steel, and the production of other goods. By the middle of the stage of financial capitalism, however, the organization of financial capitalism had evolved to a highly sophisticated level of security promotion and speculation which did not require any productive investment as a basis. Corporations were built upon corporations in the form of holding companies, so that securities were issued in huge quantities, bringing profitable fees and commissions to financial capitalists without any increase in economic production whatever. Indeed, these financial capitalists discovered that they could not only make killings out of the issuing of such securities, they could also make killings out of the bankruptcy of such corporations, through the fees and commissions of reorganization. A very pleasant cycle of flotation, bankruptcy, flotation, bankruptcy began to be practiced by these financial capitalists. The more excessive the flotation, the greater the profits, and the more imminent the bankruptcy. The more frequent the bankruptcy, the greater the profits of reorganization and the sooner the opportunity of another excessive flotation with its accompanying profits. This excessive stage reached its highest peak only in the United States. In Europe it was achieved only in isolated cases.

Finance Capitalism Opened the Way for Centralization of World

Economic Control in the Hands of the International Banking Fraternity

The growth of financial capitalism made possible a centralization of world economic control and a use of this power for the direct benefit of financiers and the indirect injury of all other economic groups. This concentration of power, however, could be achieved only by using methods which planted the seeds which grew into monopoly capitalism. Financial control could be exercised only imperfectly through credit control and interlocking directorates. In order to strengthen such control, some measure of stock ownership was necessary. But stock ownership was dangerous to banks because their funds consisted more of deposits (that is, short-term obligations) than of capital (or long-term obligations). This meant that banks which sought economic control through stock ownership were putting short-term obligations into long-term holdings. This was safe only so long as these latter could be liquidated rapidly at a price high enough to pay short-term obligations as they presented themselves. But these holdings of securities were bound to become frozen because both the economic and the financial systems were deflationary. The economic system was deflationary because power production and modern technology gave a great increase in the supply of real wealth. This meant that in the long run the control by banks was doomed by the progress of technology. The financial system was also deflationary because of the bankers' insistence on the gold standard, with all that this implies.

The Money Power Creates an Ingenious Plan to Create and

Control Giant Monopolies

To escape from this dilemma, the financial capitalists acted upon two fronts. On the business side, they sought to sever control from ownership of securities, believing they could hold the former and relinquish the latter. On the industrial side, they sought to advance monopoly and restrict production, thus keeping prices up and their security holdings liquid.

The efforts of financiers to separate ownership from control were aided by the great capital demands of modern industry. Such demands for capital made necessary the corporation form of business organization. This inevitably brings together the capital owned by a large number of persons to create an enterprise controlled by a small number of persons. The financiers did all they could to make the former number as large as possible and the latter number as small as possible. The former was achieved by stock splitting, issuing securities of low par value, and by high-pressure security salesmanship. The latter was achieved by plural-voting stock, nonvoting stock, pyramiding of holding companies, election of directors by cooptation, and similar techniques. The result of this was that larger and larger aggregates of wealth fell into the control of smaller and smaller groups of men.

The Money Power Used Monopoly Capitalism to

Increase Wealth and Power

While financial capitalism was thus weaving the intricate pattern of modern corporation law and practice on one side, it was establishing monopolies and cartels on the other. Both helped to dig the grave of financial capitalism and pass the reins of economic control on to the newer monopoly capitalism. On one side, the financiers freed the controllers of business from the owners of business, hut, on the other side, this concentration gave rise to monopoly conditions which freed the controllers from the banks.

The date at which any country shifted to financial capitalism and later shifted to monopoly capitalism depended on the supply of capital available to business. These dates could be hastened or retarded by government action. In the United States the onset of monopoly capitalism was retarded by the government's antimonopoly legislation, while in Germany it was hastened by the cartel laws. The real key to the shift rested on the control of money flows, especially of investment funds. These controls, which were held by investment bankers in 1900, were eclipsed by other sources of funds and capital, such as insurance, retirement and investment funds, and, above all, by those flows resulting from the fiscal policies of governments. Efforts by the older private investment bankers to control these new channels of funds had varying degrees of success, but, in general, financial capitalism was destroyed by two events: (1) the ability of industry to finance its own capital needs because of the increased profits arising from the decreased competition established by financial capitalism, and (2) the economic crisis engendered by the deflationary policies resulting from financial capitalism's obsession with the gold standard.

Chapter 21—The Period of Deflation, 1927- 1936

The period of stabilization cannot be clearly distinguished from the period of deflation. In most countries, the period of deflation began in 1921 and, after about four or five years, became more rapid in its development, reaching after 1929 a degree which