

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, but, 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

could be called acute. In the first part of this period (1921-1925), the dangerous economic implications of deflation were concealed by a structure of self-deception which pretended that a great period of economic progress would be inaugurated as soon as the task of stabilization had been accomplished. This psychological optimism was completely unwarranted by the economic facts, even in the United States where these economic facts were (for the short term, at least) more promising than anywhere else. After 1925, when the deflation became more deep-rooted and economic conditions worsened, the danger from these conditions was concealed by a continuation of unwarranted optimism. The chief symptom of the unsoundness of the underlying economic reality—the steady fall in prices—was concealed in the later period (1925-1929) by a steady rise in security prices (which was erroneously regarded as a good sign) and by the excessive lending abroad of the United States (which amounted to almost ten billion dollars in the period 1920-1931, bringing our total foreign investment to almost 27 billion dollars by the end of 1930). This foreign lending of the United States was the chief reason why the maladjusted economic conditions could be kept concealed for so many years. Before the World War, the United States had been a debtor nation and, to pay these debts, had developed an exporting economy. The combination of debtor and exporter is a feasible one. The war made the United States a creditor nation and also made her a greater exporter than ever by building up her acreage of cotton and wheat and her capacity to produce ships, steel, textiles, and so on. The resulting combination of creditor and exporter was not feasible. The United States refused to accept either necessary alternative—to reduce debts owed to her or to increase her imports. Instead, she raised tariffs against imports and temporarily filled the gap with huge foreign loans. But this was hopeless as a permanent solution. As a temporary solution, it permitted the United States to be both creditor and exporter; it permitted Germany to pay reparations with neither a budgetary surplus nor a favorable balance of trade; it permitted dozens of minor countries to adopt a gold standard they could not hold; it permitted France, Britain, Italy, and others to pay war debts to the United States without sending goods. In a word, it permitted the world to live in a fairyland of self-delusions remote from economic realities.

### Economic Realities

These realities were characterized by (a) fundamental maladjustments, both economic and financial, which made it impossible for the financial system to function as it had in 1914, and (b) the steady deflation.

The fundamental maladjustments were both economic and financial. The economic maladjustments were those which we have already indicated: the industrialization of colonial areas; the overproduction of raw materials and food as a result of wartime high prices, the overexpansion of heavy industry as a result of wartime needs, the obsolescence of much of heavy industry in Europe and in Britain which made it impossible to compete with newer equipment or to cope with the shifts in consumer demand, and the steadily increasing disadvantage of producers of raw materials and food in contrast with producers of industrial goods. To these old factors were added new ones such as the great increase in productive efficiency in Germany and the United States, the return of Russia and Germany to the European economy about 1924, and the return of

Europe-to the world economy in the period 1925-1927. Many countries sought to resist these factors, both old and new, by adopting political interference with economic life in the form of tariffs, import quotas, export subsidies, and so on.

The financial maladjustments served to create an insufficiency of gold and a mal-distribution of gold. The inadequacy of the supply of gold arose from several causes. It has been estimated that the world's stock of gold money needed to increase by 3.1 percent per year in the 1920's to support the world's economic development with stable prices on the gold standard. The production of new gold after 1920 was below this rate.

Moreover, as a result of the activities of the League of Nations and financial advisers like Professor E. W. Kemmerer of Princeton University, every country was encouraged to get on the gold standard. This led to a "gold rush" as each country tried to obtain a supply of gold large enough to provide adequate reserves. Because there were more countries on gold in 1928 than in 1914 and because prices in general were higher, more gold was needed in reserves.

The efforts to get around this by using a gold exchange standard rather than a gold standard were helpful in dealing with the problem of inadequate supplies of gold but increased the difficulty of the problem of mal-distribution of gold, since the gold exchange standard did not respond to the flow of gold as readily and thus did not serve so well to stem such flows of gold. The need for gold was made greater by the existence of large floating balances of political or panic funds which might well move from one market to another independent of economic conditions. The need was increased by the fact that in 1920 there were three major financial centers which had to make payments by shipments of gold in contrast to the single financial center of 1914 where payments could be made by bookkeeping transactions. To rectify this problem to some degree, the Bank for International Settlements was created in 1929.... Finally, the need for gold was increased by the enormous growth in foreign indebtedness, much of it of a political nature such as the war debts and reparations.

### The Financial System of 1914 Had Broken Down

On top of this insufficiency of gold was superimposed a drastic mal-distribution of gold. This was conclusive proof that the financial system of 1914 had broken down, for the old system would have operated automatically to distribute gold evenly. This mal-distribution resulted from the fact that when gold flowed into certain countries the automatic results of such a flow (such as rising prices or falling interest rates) which would have restored equilibrium in 1914 were prevented from acting in 1928. In this period, about four-fifths of the world's gold supply was in five countries, and over half was in two, the United States and France. The gold had been brought to these two for quite different reasons—to the United States because it was the world's greatest creditor and to France because of its devaluation of the franc. Britain, on the other hand, had floating balances of about £800 million, and handled each year £20,000 million in transactions with a gold reserve of only £150 million. Such a situation made it possible for France to use gold as a political weapon against Britain.

## Wholesale Prices

As a result of these conditions and the deflationary economic conditions described in Chapter 11, prices began to fall, at first slowly and then with increasing rapidity. The turning point in most countries was in 1925-1926, with Great Britain one of the earliest (January 1925). In the first half of 1929, this slow drift downward began to change to a rapid drop. The following table will show the changes in wholesale prices for five principal countries:

### Wholesale Price Indices (1913 = 100)

	United	Britain	France	Italy	Germany
1924	141	166	489	554	137
1925	148	159	550	646	142
1926	143	148	695	654	134
1927	137	142	642	527	138
1928	139	137	645	491	140
1929	137	120	627	481	137
1930	124	104	554	430	125
1931	105	102	520	376	111
1932	93	90	427	351	97
1933	95	90	398	320	93
1934	108	92	376	313	98
1935	115	93	339	344	102
1936	116	99	411	385	104
1937	124	114	581	449	106

### The Facade of Prosperity

The economic effects of these soft prices after 1925 were adverse, but these effects were concealed for a considerable period because of various influences, especially the

liberal credit policies of the United States (both foreign and domestic) and the optimism engendered by the stock-market boom. The facade of prosperity over unsound economic conditions was practically worldwide. Only in France and the United States was it a boom in real wealth, but in the latter it was by no means as great as one might think from a glance at stock prices. In Britain, the boom appeared in the form of the flotation of new stocks of unsound and fraudulent companies and a minor stock-market boom (about one-third as fast a rise in security prices as in the United States). In Germany and in much of Latin America, the boom was based upon foreign borrowing (chiefly from the United States) the proceeds of which were largely put into nonproductive construction. In Italy, held down by the over-evaluation of the lira in 1927, the boom was of short duration.

### The Crash of 1929

The history of the slump begins about 1927 when France stabilized the franc de facto at a level at which it was devalued and undervalued. This led to a great demand for francs. The Bank of France sold francs in return for foreign exchange. The francs were created as credit in France, thus giving an inflationary effect which can be seen in the behavior of French prices in 1926-1928. The foreign exchange which France received for its francs was largely left in that form without being converted into gold. By 1928 the Bank of France found that it held foreign exchange to the value of 32 billion francs (about \$1.2 billion). At this point the Bank of France began to transfer its exchange holdings into gold, buying the metal chiefly in London and New York. Because of the inadequate gold reserves in London, a meeting of central bankers in New York decided that the gold purchases of France and Germany should be diverted from London to New York in the future (July 1927). To prevent the resulting outflow of gold from having a deflationary effect which might injure business, the New York Federal Reserve Bank dropped its discount rate from 4 percent to 3 ½ percent. When the French gold purchases became noticeable in 1928, the Federal Reserve Bank adopted open market operations to counterbalance them, buying securities to a value equal to the French purchases of gold.

As a result there was no reduction in money in the United States. This money, however, was going increasingly into stock-market speculation rather than into production of real wealth. This can be seen from the following table of indices of average stock prices for both England and the United States in the years indicated:

### Industrial Shares Prices

(1924 = 100)

Year	United Kingdom	United States
1924	100	100
1925	109	126
1926	115	143

1927	124	169
1928	139	220
1929	139	270
1930	112	200
1931	87	124
1932	84	66
1933	103	95
1934	125	116

The stock-market boom in the United States was really much more drastic than is indicated by these index numbers, because these are yearly averages, and include sluggish stocks as well as market leaders. The boom began as far back as 1924, as can be seen, and reached its peak in the fall of 1929. By the spring of 1929 it had become a frenzy and was having profound effects on business activity, on domestic and international finance, on the domestic affairs of foreign countries, and on the psychology and modes of life of Americans.

#### Credit Was Diverted from Production to Speculation

Among the financial results of the stock-market boom were the following: In the United States credit was diverted from production to speculation, and increasing amounts of funds were being drained from the economic system into the stock market, where they circulated around and around, building up the prices of securities. In Germany it became increasingly difficult to borrow from the United States, and the foreign loans, which kept the German financial system and the whole system of reparations and war debts functioning, were shifted from long-term loans to precarious short-term credits. The results of this have been examined in the chapter on reparations. In other countries, funds tended to flow to the United States where they could expect to roll up extraordinary earnings in capital gains in a relatively short time. This was especially true of funds from Britain where the stock-market boom ceased after the end of 1928. By that time the fundamentally unsound economic conditions were beginning to break through the facade. The decline in foreign loans by both London and New York began to be noticeable by the last half of 1928 and made it evident that the chief support of the facade was vanishing. But the continued rise of security prices in New York continued to draw money from the rest of the world and from the productive and consumptive systems of the United States itself.

#### A Financial Disaster of Unparalleled Magnitude

Early in 1929, the board of governors of the Federal Reserve System became alarmed at the stock-market speculation, especially at its draining credit from industrial production. To curtail this, in April 1929, the Federal Reserve authorities called upon the member banks to reduce their loans on stock-exchange collateral. At the same time, it engaged in open-market operations which reduced its holdings of bankers' acceptances from about \$300 million to about \$150 million. The sterilization of gold was made more drastic. It was hoped in this way to reduce the amount of credit available for speculation. Instead, the available credit went more and more to speculation and decreasingly to productive business. Call money rates in New York which had reached 7 percent at the end of 1928 were at 13 percent by June 1929. In that month, the election of a Labour government in England so alarmed British capital that large amounts flowed to the United States and contributed further to the speculative frenzy. In August, the Federal Reserve discount rate was raised to 6 percent. By this time it was becoming evident that the prices of stocks were far above any value based on earning power and that this earning power was beginning to decline because of the weakening of industrial activity. At this critical moment, on September 26, 1929, a minor financial panic in London (the Hatry Case) caused the Bank of England to raise its bank rate from 4 ½ percent to 6 ½ percent. This was enough. British funds began to leave Wall Street, and the overinflated market commenced to sag. By the middle of October, the fall had become a panic. In the week of October 21st on the Stock Exchange and the Curb Exchange in New York, total stocks sold averaged over 9 million a day, and on Thursday, October 24th, almost 19 1/4 million shares changed hands. The shrinkage in values was measured by several billion dollars a day. Some stocks fell by 100 or even 140 points in a day. Auburn fell 210 points, General Electric 76 points, and U.S. Steel 26 points in 4 ½ days. By November 6th these three stocks had fallen respectively 55, 78, and 28 points more. It was a financial disaster of unparalleled magnitude.

### The Stock Market Crash Reduces Real Wealth

The stock-market crash reduced the volume of foreign lending from the United States to Europe, and these two events together tore away the facade which until then had concealed the fundamental maladjustments between production and consumption, between debts and ability to pay, between creditors and willingness to receive goods, between the theories of 1914 and the practices of 1928. Not only were these maladjustments revealed but they began to be readjusted with a severity of degree and speed made all the worse by the fact that the adjustments had been so long delayed. Production began to fall to the level of consumption, creating idle men, idle factories, idle money, and idle resources. Debtors were called to account and found deficient. Creditors who had refused repayment now sought it, but in vain. All values of real wealth shrank drastically.

### The Crisis of 1931

It was this shrinkage of values which carried the economic crisis into the stage of financial and banking crisis and beyond these to the stage of political crisis. As values

declined, production fell rapidly; banks found it increasingly difficult to meet the demands upon their reserves; these demands increased with the decline in confidence; governments found that their tax receipts fell so rapidly that budgets became unbalanced in spite of every effort to prevent it.

The financial and banking crisis began in central Europe early in 1931, reached London by the end of that year, spread to the United States and France in 1932, bringing the United States to the acute stage in 1933, and France in 1934.

### The Largest Bank in Austria Collapses

The acute stage began early in 1931 in central Europe where the deflationary crisis was producing drastic results. Unable to balance its budget or obtain adequate foreign loans, Germany was unable to meet her reparation obligations. At this critical moment, as we have seen, the largest bank in Austria collapsed because of its inability to liquidate its assets at sufficiently high prices and with enough speed to meet the claims being presented to it. The Austrian debacle soon spread the banking panic to Germany. The Hoover Moratorium on reparations relieved the pressure on Germany in the middle of 1931, but not enough to permit any real financial recovery. Millions of short-term credits lent from London were tied up in frozen accounts in Germany. As a result, in the summer of 1931, the uneasiness spread to London.

### The Wealthy Were Causing the Panic

The pound sterling was very vulnerable. There were five principal reasons: (1) the pound was overvalued; (2) costs of production in Britain were much more rigid than prices; (3) gold reserves were precariously small; (4) the burden of public debt was too great in a deflationary atmosphere; (5) there were greater liabilities than assets in short-term international holdings in London (about £407 million to £153 million). This last fact was revealed by the publication of the Macmillan Report in June 1931, right at the middle of the crisis in central Europe where most of the short-term assets were frozen. The bank rate was raised from 2 ½ percent to 4 ½ percent to encourage capital to stay in Britain. £130 million in credits was obtained from France and the United States in July and August to fight the depreciation of the pound by throwing more dollars and francs into the market. To restore confidence among the wealthy (who were causing the panic) an effort was made to balance the budget by cutting public expenditures drastically. This, by reducing purchasing power, had injurious effects on business activity and increased unrest among the masses of the people. Mutiny broke out in the British fleet in protest against pay cuts. Various physical and extralegal restrictions were placed on export of gold (such as issuing gold bars of a low purity unacceptable to the Bank of France). The outflow of gold could not be stopped. It amounted to £200 million in two months. On September 18th New York and Paris refused further credits to the British Treasury, and three days later the gold standard was suspended. The bank rate still stood at 4 ½ percent. To many experts the most significant aspect of the event was not that Britain went off gold, but that she did so with the bank rate at 4 ½ percent. It had always been said in Britain that a 10 percent bank rate would pull gold out of the earth. By 1931, the



authorities in Britain saw clearly the futility of trying to stay on gold by raising the bank rate. This indicates how conditions had changed. It was realized that the movement of gold was subject to factors which the authorities could not control more than it was under the influence of factors they could control. It also shows—a hopeful sign—that the authorities after twelve years were beginning to realize that conditions had changed. For the first time, people began to realize that the two problems—domestic prosperity and stable exchanges—were quite separate problems and that the old orthodox practice of sacrificing the former to the latter must end. From this point on, one country after another began to seek domestic prosperity by managed prices and stable exchanges by exchange control. That is, the link between the two (the gold standard) was broken, and one problem was made into two.

### The British Suspension of Gold

The British suspension of gold was by necessity, not by choice. It was regarded as an evil, but it was really a blessing. As a result of this mistake, many of the benefits which could have been derived from it were lost by trying to counterbalance the inflationary results of the suspension by other deflationary actions. The discount rate was raised to 6 percent; valiant efforts to balance the budget continued; a protective tariff was established and a program of fairly stiff taxes installed. As a result, prices did not rise enough to give that spur to production which would have been necessary to increase prosperity and reduce unemployment. No system of exchange control was set up. As a result, the depreciation of sterling in respect to gold-standard currencies could not be prevented, and amounted to 30 percent by December 1931. Such a depreciation was regarded by the authorities as an evil—chiefly because of orthodox economic theories which considered parity of exchanges as an end in itself and partly because of the need to pay the £130 million in Franco-American credits—a burden which increased as sterling depreciated in respect to dollars and francs.

### The Central Core of the World's Financial System Was Disputed

As a result of the British abandonment of the gold standard the central core of the world's financial system was disrupted. This core, which in 1914 was exclusively in London, in 1931 was divided among London, New York, and Paris. London's share depended on financial skill and old habits; New York's share depended on her position as the world's great creditor; Paris's share depended on a combination of a creditor position with an undervalued currency which attracted gold. From 1927 to 1931, these three had controlled the world's financial system with payments flowing in to the three, credits flowing out, and stable exchanges between them. The events of September 1931 broke up this triangle. Stable exchanges continued for dollar-franc, leaving dollar-pound and pound-franc to fluctuate. This did not permit an adjustment of the maladjusted exchange rates of 1928-1931. Concretely, the undervaluation of the franc in 1928 and the overvaluation of the pound in 1925 could not be remedied by the events of 1931. A sterling-franc rate which would have eliminated the undervaluation of the franc would have resulted in a sterling-dollar rate which would have overcorrected the overvaluation of sterling. On the other hand, the depreciation of the pound put great pressure on both

the dollar and the franc. At the same time, Britain sought to exploit as much as possible her economic relations with her home market, the empire, and that group of other countries known as the "sterling bloc." The home market was set aside by the establishment of customs duties on imports into the United Kingdom (special customs duties November 1931, and a general tariff in February 1932). The empire was brought into closer economic ties by a group of eleven "Imperial Preference" treaties made at Ottawa in August 1932. The sterling bloc was reinforced and enlarged by a series of bilateral trade agreements with various countries, beginning with Norway, Sweden, Denmark, and Argentina.

### The World Divided into Two Financial Groups

Thus the world tended to divide into two financial groups—the sterling bloc organized about Britain and the gold bloc organized about the United States, France, Belgium, the Netherlands, and Switzerland.

The depreciation of sterling in relation to gold made the currencies of the gold bloc overvalued, and relieved Britain of that burdensome status for the first time since 1925. As a result, Britain found it easier to export and more difficult to import, and obtained a favorable balance of trade for the first time in almost seven years. On the other hand, the gold countries found their depressions intensified.

### Britain Frees Herself from Bondage to France

As a third result of the British abandonment of the gold standard Britain freed herself from her financial subjection to France. This subjection had resulted from the vulnerable position of the British gold reserves in contrast to the bulging appearance of the French reserves. After 1931 the financial positions of the two countries were reversed. When Britain was able to add a financial superiority after 1931 to the political superiority she had possessed since 1924, it became possible for Britain to force France to accept the policy of appeasement. Moreover, the financial crisis of 1931 was to bring to power in Britain the national government which was to carry out the policy of appeasement.

### Trade Barriers Arise

As a fourth result, the countries still on gold began to adopt new trade barriers, such as tariffs and quotas, to prevent Britain from using the advantage of depreciated currency to increase her exports to them. The countries already off gold began to see the value in currency depreciation, and the possibility of races in depreciation began to form in the minds of some.

As a fifth result of the abandonment of gold, it became possible to rearm without the resulting unbalancing of the budget leading to financial jeopardy as under a gold standard. Little advantage was taken of this, because pacificism on the Left and appeasement on the Right were regarded as substitutes for arms.

Because of the deflationary policy which accompanied the abandonment of gold in Great Britain, recovery from depression did not result except to a very slight degree. Neither prices nor employment rose until 1933, and, from that year on, the improvement was slow. The depreciation of sterling did result in an improvement in the foreign trade balance, exports rising very slightly and imports falling 12 percent in 1932 in comparison with 1931. This led to a revival of confidence in sterling and a simultaneous decline in confidence in the gold-standard currencies. Foreign funds began to flow to London.

#### Control of Credit in Britain Left to the Bank of England

The flow of capital into Britain early in 1932 resulted in an appreciation of sterling in respect to the gold currencies. This was unwelcome to the British government since it would destroy her newly acquired trade advantage. The pound sterling appreciated in respect to the dollar from 3.27 on December 1, 1931, to 3.80 on March 31, 1932. To control this, the government, in May 1932, set up the Exchange Equalization Account with capital of £175 million. This fund was to be used to stabilize the exchange rates by buying and selling foreign exchange against the trend of the market. In this way, the old automatic regulation by the market of the internal credit structure through the international flow of funds was broken. Control of the credit structure was left to the Bank of England, while control of the exchanges went to the Exchange Equalization Fund. This made it possible for Britain to adopt a policy of easy and plentiful credit within the country without being deterred by a flight of capital from the country. Since the Exchange Equalization Fund was not a system of exchange control but merely a government management of the regular exchange market, it was not in a position to handle any very considerable emigration of capital. The easy credit policies of Britain (designed to encourage business activity) had thus to be combined with deflationary prices (designed to prevent any powerful flight of capital). The bank rate was dropped to 2 percent by July 1932, and an embargo was placed on new foreign capital issues to keep this easy money at home. The chief exceptions to this embargo arose from loans to be used in the general policy of binding the sterling bloc to Britain, and the proceeds of these had to be used in Britain.

On this basis, although sterling fell to 3.14 by the end of November 1932, a mild economic revival was built up. Cheap credit permitted a shift of economic activity from the old lines (like coal, steel, textiles) to new lines (like chemicals, motors, electrical products). The tariff permitted a rapid growth of cartels and monopolies whose process of creation provided at least a temporary revival of economic activity. The continued low food prices permitted the income from this increase in activity to be diverted to necessities of a different kind, especially dwelling construction. The budget was balanced, and early in 1934 showed a surplus of £30 million.

The improvement in Britain was not shared by the countries still on gold. As a result of the competition of depreciated sterling, they found their balances of trade pushed toward the unfavorable side and their deflation in prices increased. Tariffs had to be raised, quotas and exchange controls set up. The United States could hardly do the first of

these (her tariff of 1930 was already the highest in history), and rejected the others in principle.

### The Crisis in the United States, 1933

As a result of the British crisis, the gold countries of Europe sought to modify their financial basis from the gold exchange standard to the gold bullion standard. When Britain abandoned gold in September 1931, France was caught with over £60 million in sterling exchange. This was equal to about 30 percent of her foreign-exchange holdings (7,775 million francs out of 25,194 million). The loss exceeded the total capital and surplus of the Bank of France. To avoid any similar experience in the future, France began to transfer her holdings of exchange into gold, much of it called from the United States. As confidence in the pound rose, that in the dollar fell. It became necessary to raise the New York discount rate from 1 ½ percent to 3 ½ percent (October 1932) and to engage in extensive open-market buying of securities to counteract the deflationary effects of this. However, the gold exports and gold hoarding continued, made worse by the fact that the United States was the only gold standard country with gold coins still circulating.

### The American Banking System Began to Collapse

As a result of the decline of confidence and the demand for liquidity, the American banking system began to collapse. The Reconstruction Finance Corporation was set up early in 1932 with \$3 ½ billion in government money to advance to banks and other large corporations. By the end of the year, it had lent over \$1 ½ billion. When the details of these loans were published (in January 1933), runs on the banks were intensified. A bank holiday was declared in Nevada in October 1932, in Iowa in January 1933, in six states during February, and in sixteen states in the first three days of March. From February 1st to March 4th the Federal Reserve Bank in New York lost \$756 million in gold; it called in \$709 million from the other Federal Reserve Banks, which were also subject to runs.

### Banks in the U.S. Were Closed

The banks of the whole United States were closed by executive order on March 4 to be reopened after March 12th if their condition was satisfactory. Export of gold was subjected to license, convertibility of notes into gold was ended, and private holding of gold was made illegal. These orders, completed on April 20, 1933, took the United States off the gold standard. This was done in order that the government could pursue a policy of price inflation in its domestic program. It was not made necessary by the American international financial position, as this continued very favorable. This was quite different from the situation in Britain in 1931. London had left gold unwillingly and had followed an orthodox financial program afterward; Washington left gold in 1933 voluntarily in order to follow an unorthodox financial program of inflation.

### The Central Exchange Triangle Was Disrupted

As a result of the abandonment of the gold standard by the United States, the central-exchange triangle between London, Paris, and New York was further disrupted. All three exchange rates were able to fluctuate, although the Exchange Equalization Account kept two of them relatively steady. To the worldwide problem of economic distress was now added the problem of exchange stabilization. A dispute ensued among Britain, France, and the United States over which of these two problems should be given priority. France insisted that no economic recovery was possible until exchanges were stabilized. It surely was true that as long as the franc remained on gold at the same valuation, France would suffer from the depreciation of the pound and the dollar. The United States insisted that economic recovery must have priority over stabilization, since the latter would hamper the process of price deflation which the administration considered essential to recovery. Britain, which had supported the priority of recovery over stabilization as long as the pound was the only one of the three currencies which was depreciated, insisted on the importance of stabilization as soon as the advantages of depreciation began to be shared by the dollar. This depreciation of both the dollar and the pound put great strain on the franc. To keep France from being forced off the gold standard, Britain, on April 28, 1933, lent her £30 million to be repaid out of the sterling exchange with which France had been caught in September 1931. Until the middle of 1933, the Exchange Equalization Account was used by Britain to prevent any appreciation of the pound. This was countered in the United States by the inflationary Thomas Amendment to the Agricultural Adjustment Act (May 12, 1933). This Amendment gave the president the power to devalue the dollar up to 50 percent, to issue up to \$3 billion in fiat money, and to engage on an extensive program of public spending.

#### The World Economic Conference, 1933

This dispute over the priority of stabilization or recovery reached its peak in the World Monetary and Economic Conference held in London from June 12 to July 27, 1933. A Preparatory Commission of Experts drew up a series of preliminary agreements for countries on gold or off, with exchange controls or without, but no agreement could be obtained at the conference itself. Britain and France tried to get the dollar to join them in a temporary de facto stabilization in preparation for a real agreement. The franc and pound had already been pegged to each other at 84 francs per pound, which gave a London gold price of 122 shillings. The United States refused to join in any temporary stabilization because of the success of the administration's domestic recovery program. The general price index in the United States rose by 8.7 percent from February to June 1933, and farm products rose by 30.1 percent. The mere hint of a stabilization agreement was sufficient to cause a sharp break in the rise of security and commodity prices (June 14, 1933), so Roosevelt broke off all negotiations toward stabilization (July 3, 1933).

#### Four Great Negatives

The World Economic Conference, as Professor William Adams Brown wrote, broke up on four great negatives: the countries which had adopted trade restrictions refused to abandon them without currency stabilization; the countries on the gold standard refused to accept price increases as a road to recovery because of fear of inflation; Great Britain

wanted price increases but refused to permit an unbalanced budget or a public works program; and the United States, which was seeking recovery through inflation and public works, refused to hamper the program by currency stabilization.

### The Countries of the World Divide into Three Groups

As a result of the failure of the Economic Conference, the countries of the world tended to divide into three groups: a sterling bloc, a gold bloc, and a dollar bloc. The gold and sterling blocs were formally organized, the former on July 3rd and the later on July 8th. A struggle ensued among these three in an effort to shift the economic burdens of past mistakes from one to another.

### The Failure of the World Economic Conference

A great deal has been written since 1933 in an effort to apportion the blame for the failure of the World Economic Conference. It is a futile task. From the point of view of narrow self-interest in the short run, all countries were correct in their actions. From the wider point of view of the world as a whole or of the long-run results, all countries were worthy of blame. By 1933, the day in which any country could follow a policy of short-run self-interest and remain under liberal capitalism was past. For technological and institutional reasons, the economies of the different countries were so intertwined with one another that any policy of self-interest on the part of one would be sure to injure others in the short run and the country itself in the long run. Briefly, the international and the domestic economic systems had developed [by the Money Power] to a point where the customary methods of thought and procedure in regard to them were [considered] obsolete [by the Money Power].

### The Whole Banking System in America Is Insolvent

The reason why a policy of short-run self-interest on the part of one country was in such sharp conflict with any similar policy pursued by another country does not rest on the fact that the interests of one country were adverse to those of another. That would have been a problem to be treated by simple compromise. The conflicts between economic nationalisms were based on the fact that, viewed superficially, the crisis took entirely different forms in the chief countries of the world. In the United States, the most obvious manifestation of the crisis was low prices, which by 1933 made the whole banking system insolvent. High prices became, thus, for the United States, the chief goal of debtors and creditors alike. In Britain, the most obvious manifestation of the crisis was the outflow of gold which jeopardized the gold standard. A rectification of the international balance of payments rather than a rise in prices thus became the chief immediate aim of British policy. In France, the crisis appeared chiefly as an unbalanced internal budget. The French gold supply was more than adequate, and prices, as a result of the substantial devaluation of 1928, were considered extremely high. But the unbalanced budget created a great problem. If the deficit were filled by borrowing the result would be inflationary and injurious to the creditor classes who had suffered so greatly in the 1920's. If the deficit were filled by taxation, this would lead to deflation

(with its decline in business activity) and a flight of capital out of the country. To the French government the only way out of this dilemma was to be found in an increase in business activity, which would increase the tax yield without any rise in rates. It could see no value in the American concern with higher prices or the British concern with trade balances as short-run objectives.

This contrast between the various kinds of impact which the economic and financial crisis made on the various countries could be extended to lesser countries. In Switzerland (where gold reserves were well over 100 percent) the chief problem was "hot money." In Germany, the chief problem was foreign debts, but this soon developed into a combination of all the ailments which were afflicting other countries (low prices, unfavorable balance of trade, unbalanced budget, panicky short-term loans, and so on). In the Netherlands and in the countries of eastern Europe, the chief problem was "segmentation of prices" (that is, that prices of food and raw materials, which they sold, fell faster than prices of manufactured goods which they bought).

### Nations Begin to Pursue Policies of Economic Nationalism

As a result of the crisis, regardless of the nature of its primary impact, all countries began to pursue policies of economic nationalism. This took the form of tariff increases, licensing of imports, import quotas, sumptuary laws restricting imports, laws placing national origin, trade-mark, health, or quarantine restrictions on imports, foreign-exchange controls, competitive depreciation of currencies, export subsidies, dumping of exports, and so on. These were first established on an extensive scale in , and spread rapidly as a result of imitation and retaliation.

### World Trade System Breaks into Segregated Markets

As a result of such economic nationalism, it soon appeared that the disappearance of the old multilateral system of world finance centering in London would be followed by the breaking of the multilateral system of world trade (also centering in Britain) into a number of partially segregated markets operating on a bilateral basis. International trade declined greatly as the following figures indicate:

#### Value of Trade in Millions of Dollars

	1928	1932	1935	1933	
Europe's Trade	58,082	24,426	20,762	24,065	
World's Trade	114,429	45,469	40,302	46,865	

### The Crisis in the Gold Bloc, 1934—1936

After the breakup of the World Economic Conference, the United States continued its policy of domestic inflation. As the dollar depreciated, the pressure on the franc

increased, while the pound, through the use of the Exchange Equalization Account, tried to follow a middle ground in a depreciated, but stable, relationship to the franc. In this way, by purely artificial means, the pound was kept at about 85 francs. In the late summer of 1933 (September 8th) the United States Treasury began to depreciate the dollar by buying gold at constantly increasing prices (about \$30 an ounce, compared to the old stabilization rate of \$20.67). This put pressure on the franc as well as on the pound. Deflation became increasingly severe in France, and, in October 1933, a budget deficit of over 40 billion francs gave rise to a Cabinet crisis. By the end of 1933, the gold price in New York reached \$34, and the dollar, which had been at 4.40 in relation to the pound in August, fell to 5.50. On February 1, 1934, the United States went back on the gold standard at a considerable devaluation under the old price. The gold content was cut to 59.06 percent of the 1932 amount. At the same time, the Treasury set up a standing offer to buy gold at \$35 an ounce. This served to remove much of the uncertainty about the dollar, but stabilized it in regard to the franc at a level which put great pressure on the franc. At this price for gold, the metal flowed to the United States, France losing about 3 billion francs' worth in February 1934.

## France

Thus the world depression and the financial crisis which France had escaped for over three years were extended to her. France had been able to escape because of her drastic devaluation in the 1920's, her well balanced economy, and her ability to keep down unemployment by placing restrictions on the entrance of seasonal labor from Spain, Italy, and Poland. The crisis of the pound in September 1931 had begun to spread the crisis to France, and the crisis of the dollar in 1933 had made the situation worse. The American actions of 1934, which gave the world a 59-cent dollar and \$35 gold, made the position of the gold bloc untenable. They had to suffer a severe deflation, or abandon gold, or devalue. Most of them (because they feared inflation or because they had foreign debts which would increase in weight if their currency was to depreciate) permitted deflation with all its suffering. Italy even ordered deflation by decree in April 1934, in order to maintain business activity by forcing costs down as much as prices. Eventually, all members of the gold bloc had to abandon gold to some extent because of the pressure from the dollar.

## Belgium

Belgium was the first member of the gold bloc to yield, setting up exchange controls on March 18, 1935, and devaluating the belga to about 72 percent of its former gold content on March 30th. The final blow which forced the change was the British tariff on iron and steel established on March 26, 1935. As a result of this quick and decisive devaluation, Belgium experienced a considerable amount of economic recovery. Almost at once, production and prices rose, while unemployment fell.

## France Defends the Franc



The other members of the gold bloc did not profit by the example of Belgium, but determined to defend the gold content of their currencies to the limit. France was the leader in this movement, and by her policy was able to influence the other members of the bloc to resist with the same vigor. This determination of France to defend the franc is to be explained by the fact that the great mass of Frenchmen were creditors in some way or other, and having lost four-fifths of their savings in the inflation of 1914-1926 did not view with any pleasure another dose of the same medicine. In this effort to defend the franc, France was aided greatly by the activity of the British Exchange Equalization Account which bought francs in enormous quantities whenever the currency became very weak. By 1935, the resources of the Account capable of being devoted to this purpose were largely expended, and the franc fell below the gold export point for long periods. The Bank of France raised its discount rate from 2 ½ percent to 6 percent (May 23-28, 1935) with depressing economic results. Laval in July obtained emergency powers from the Assembly, and adopted a policy of deflation by decree, cutting ordinary public expenditures for the year from 40 billion to 11 billion francs, cutting all public salaries by 10 percent, and also reducing all rents, the cost of public utilities, and the price of bread.

### Gold Begins to Leave France

In this way, the strain on the gold reserves (which fell to 16 billion francs during 1935) was relieved at the cost of increased depression. By September, the franc was still overvalued (as far as cost of living was concerned) by about 34 percent as compared to the pound and by about 54 percent as compared to the dollar. The deflation necessary to bring French prices down to parity with the prices in the depreciated-currency countries could not be obtained. By the end of 1935, the government had abandoned the effort, and by borrowing to meet budgetary deficits had turned France toward inflation. Gold began to leave the country again, and this exit became a flood after a government of the Left led by Blum came to power in June 1936.

The Blum "Popular Front" government tried to follow an impossible program: "inflation on gold." It sought inflation to relieve depression and unemployment and sought to remain on gold because this was insisted on by both the Communist and bourgeois supporters of the government. In an effort to restore confidence and slow the "flight from the franc," it became necessary for Blum formally to disavow any intention of installing a Socialist program. The Right thus discovered that it could veto any actions of the Left government merely by exporting capital from France. The flight of such capital continued through the summer of 1936, while Blum negotiated with Britain and the United States regarding devaluation of the franc. On September 24, 1936, the bank rate was raised from 3 percent to 5 percent, and, on the following day, a Three-Power Currency Declaration announced that the franc would be "adjusted," exchange stability would be maintained thereafter (through the stabilization funds), and trade restrictions would be relaxed.

### The French Devaluation of 1936

The French devaluation (law of October 2, 1936) provided that the gold content of the franc would be reduced to an amount from 25.2 percent to 34.4 percent of the old figure of 65 ½ milligrams. From the profits obtained by thus revaluing French gold reserves, an exchange stabilization fund of 10 billion francs was set up.

### France Is Blackmailed by the Wealthy

Although the French devaluation of September 1936 shattered the gold bloc and forced the other members of the bloc to follow suit, it did not end the period of deflation. The reasons for this were chiefly to be found in the complete mismanagement of the French devaluation. This decisive event was delayed too long—at least a year after it should have been done—a year during which gold steadily flowed from France. Moreover, when the devaluation came, it was insufficient and left the franc still overvalued in relation to price levels in the other Great Powers. Furthermore, the devaluation was shrouded with uncertainty, since the law permitted the government to devalue to any gold content between 43 and 49 milligrams. By stabilizing at about 46 milligrams, the government prevented any revival of confidence because of the danger of a further devaluation to 43 milligrams. By the time the government realized that a further devaluation was necessary, the situation had deteriorated so far that a devaluation to 43 milligrams was worthless. Finally, in the devaluation law the government took punitive measures against gold hoarders and speculators, seeking to prevent them from reaping the profits they would obtain by converting their gold back into francs at the new value. As a result, the exported and hoarded gold did not return but stayed in hiding. Thus the financial, budgetary, and economic difficulties in France continued. By the middle of 1937, they had become so bad that the only possible solutions were exchange control or a drastic devaluation. The former was rejected because of the pressure from Britain and the United States based on the Tripartite Agreement of 1936 and the support which their stabilization funds afforded the franc; the latter was rejected by all politicians likely to obtain power in France. As a result, the franc passed through a series of depreciations and partial devaluations which benefitted no one except the speculators and left France for years torn by industrial unrest and class struggles. Unable to arm or give foreign affairs the attention they needed, the government was subjected to systematic blackmail by the well-to-do of the country because of the ability of these persons to prevent social reform, public spending, arming, or any policy of decision by selling francs. Only in May 1938 was a decisive step made. At that time the franc was drastically depreciated to 179 in the pound, and pegged at that figure. Its gold content (by a law of November 12, 1938) was fixed at about 27.5 milligrams nine-tenths fine. By that time France had suffered years of economic chaos and governmental weakness. These conditions had encouraged German aggression, and, when a decisive financial action was made in 1938, it was, because of the rising international crisis, too late to reap any important economic benefits.

### The Gold Bloc Was Destroyed

We have said that the gold bloc was destroyed by the French devaluation of September 1936. This was accomplished almost immediately. Switzerland, the Netherlands, and Czechoslovakia devalued their currencies by about 30 percent and Italy

by about 40 percent before the end of October. In each case, like Belgium rather than France, the devaluation was large enough in amount and abrupt enough in time to contribute to a noticeable reflation and improvement in business activity. Each country of the former gold bloc set up a stabilization fund to control exchange rates, and joined the Tripartite currency agreement of September 1936.

## The Banker-Engendered Deflationary Crisis Became a Chief Cause of World War II

The historical importance of the banker-engendered deflationary crisis of 1927-1940 can hardly be overestimated. It gave a blow to democracy and to the parliamentary system which the later triumphs of these in World War II and the postwar world were unable to repair fully. It gave an impetus to aggression by those nations where parliamentary government collapsed, and thus became a chief cause of World War II. It so hampered the Powers which remained democratic by its orthodox economic theories that these were unable to rearm for defense, with the consequence that World War II was unduly prolonged by the early defeats of the democratic states. It gave rise to a conflict between the theorists of orthodox and unorthodox financial methods.... And, finally, it impelled the whole economic development of the West along the road from financial capitalism to monopoly capitalism and, shortly thereafter, toward the pluralist economy.

## The Banker's Formula for Treating a Depression

The controversy between the bankers and the theorists of unorthodox finance arose over the proper way to deal with an economic depression. We shall analyze this problem later, but here we should say that the bankers' formula for treating a depression was by clinging to the gold standard, by raising interest rates and seeking deflation, and by insisting on a reduction of public spending, a fiscal surplus, or at least a balanced budget. These ideas were rejected totally, on a point-by-point basis, by the unorthodox economists (somewhat mistakenly called "Keynesian"). The bankers' formula sought to encourage economic recovery by "restoring confidence in the value of money," that is, their own confidence in what was the primary concern of bankers. This formula had worked in the past only when it had, more or less incidentally, reduced costs (especially wages) faster than wholesale prices so that businessmen regained confidence, not in the value of money but in the possibility of profits. The unorthodox theorists sought to achieve this latter more quickly and more directly by restoring purchasing power, and thus prices, by increasing, instead of reducing, the money supply and by placing it in the hands of potential consumers rather in the banks or in the hands of investors....

## Ivar Kreuger Sells Worthless and Fraudulent Securities

The end of financial capitalism may well be dated at the collapse of the gold standard in Britain in September 1931, but, on the personal side, it might be dated at the suicide of its most spectacular individual, the "Match King," Ivar Kreuger, in Paris in April 1932.

Ivar Kreuger (1880-1932), after several years' experience as an engineer in America and South Africa, set up in Stockholm in 1911 the contracting firm of Kreuger & Toll. By 1918 this firm was a financial company with a capital of 12 million kronor, and chiefly interested in the Swedish Match Company, a holding company organized by Kreuger. Within a decade, Kreuger had control of over 150 match companies in 43 countries. The securities of these firms were controlled through a Delaware corporation (called International Match Company). This holding company sold millions of dollars of securities with no voting rights, while control was exercised through a small bloc of voting stock held by Kreuger & Toll. By granting loans to the governments of various countries, Kreuger obtained match monopolies which brought in substantial sums. In all, £330 million was lent to governments in this way, including \$75 million to France and \$125 million to Germany. In return Kreuger obtained control of 80 percent of the world's match industry, most of Europe's paper and wood-pulp production, fourteen telephone and telegraph companies in six countries, a considerable part of the farm-mortgage systems of Sweden, France, and Germany, eight iron-ore mines, and numerous other enterprises, including a considerable group of banks and newspapers in various countries. The whole system was financed in a sumptuous fashion by selling worthless and fraudulent securities to investors through the most prominent investment bankers of the world. In all, about \$750 million in such securities was sold, about one-third in the United States. The respected Lee, Higginson, and Company of Boston sold \$150 million of these securities to 600 banks and brokers without making any investigation into their value or honesty and received about \$6 million in fees for doing so. The money thus raised by Kreuger was used to advance loans to various countries, to pay interest and dividends on securities issued previously, and to finance the further exploits of Mr. Kreuger. As examples of these exploits, we might mention that Kreuger & Toll paid dividends of 25 percent from 1919 to 1928 and 30 percent after 1929, mostly from capital; Swedish Match Company usually paid 15 per cent dividends. This was done in order to persuade the investing public to buy more of Kreuger's securities and thus keep the system going. In order to encourage this public, prospectuses were falsified, letters were forged, and the stock market was manipulated at heavy cost. Bonds were issued against the same security several times over. Most brazen of all, bonds were issued against the receipts of the match monopolies of Italy and Spain. Although Kreuger possessed neither of these, he carried them on his books for \$80 million and had bonds forged by himself to substantiate the claim. The long-drawn out depression of 1929-1933 made it impossible to keep the system afloat, although Kreuger avoided no degree of corruption and deceit in his efforts to do so. In March 1932 a note for \$11 million from International Telephone and Telegraph fell due, and Kreuger, unable to meet it, killed himself. He left claims against his estate of \$700 million, while his personal debts were \$179 million with assets of \$18 million.

#### Large Combinations and Cartels Formed

The death of Kreuger is merely a symbol of the end of European financial capitalism. For about fifty years before this event, the centralized control made possible by the financial system had been used to develop monopolistic tendencies in industry. These had been furthered by the growth of large combinations, by the formation of cartels and trade

associations between units of enterprise, and by the increase of those less tangible restrictions on competition known as imperfect and monopolistic competition. As a result, competition had been declining, control of the market had been increasing, and self-financing by industrial units had been growing. This last development made it possible for industry once more to free itself from financial control as it had been in the owner-management period which preceded financial capitalism. But, unlike this earlier stage, control did not revert from financiers back to the owners of enterprise but instead tended to shift into the hands of a new class of bureaucratic managers whose powers of control were out of all relationship to the extent of their ownership of the enterprises concerned. In France, the bankers, although in retreat when war came in 1939, had been so strengthened by the unorthodox financial policies of the 1920's that they were able to prevent any important victory for monopoly capitalism in the 1930's, with the result that the shift from financial to monopoly capitalism did not appear in France until the 1940's. In the United States, also, the transition was not complete when war came in 1939, with the result that the United States, like France, but unlike any other important country, had not shaken off the world depression even as late as 1940.

#### Chapter 22—Reflation and Inflation, 1933-1947

The period of reflation began in some countries (like Great Britain and the United States) long before the period of deflation had ended elsewhere (as in France). In most countries the recovery was associated with rising wholesale prices, with abandonment of the gold standard or at least devaluation, and with easy credit. It resulted everywhere in increased demand, rising production, and decreasing unemployment. By the middle of 1932, recovery was discernible among the members of the sterling bloc; by the middle of 1933 it was general except for the members of the gold bloc. This recovery was halting and uncertain. Insofar as it was caused by government actions, these actions were aimed at treatment of the symptoms rather than the causes of the depression, and these actions, by running contrary to orthodox economic ideas, served to slow up recovery by reducing confidence. Insofar as the recovery was caused by the normal working out of the business cycle, the recovery was slowed up by the continuation of emergency measures—such as controls over commerce and finance and by the fact that the economic dis-equilibriums which the depression had made were frequently intensified by the first feeble movements toward recovery. Finally, the recovery was slowed up by the drastic increase in political insecurity as a result of the aggressions of Japan, of Italy, and of Germany.

Except for Germany and Russia (both of which had isolated their economies from world fluctuations) the recovery continued for no more than three or four years. In most countries the latter half of 1937 and the early part of 1938 experienced a sharp "recession." In no important country had prices reached the 1929 level at the beginning of the recession (although within 10 percent of it), nor had the percentage of persons unemployed fallen to the 1929 level. In many countries (but not the United States or the gold bloc), industrial production had reached 1929 levels.

#### The Recession of 1937