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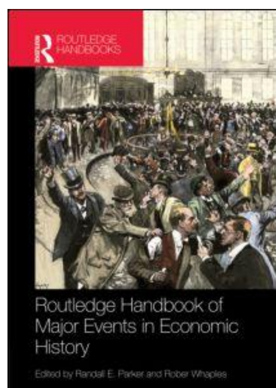

Routledge Handbook of Major Events in Economic History

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Publication details
https://www.routledgehandbooks.com/doi/10.4324/9780203067871.ch12
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Published online on: 28 Jan 2013

How to cite :- Michael Kitson. 28 Jan 2013, *Britain's withdrawal from the gold standard from:* Routledge Handbook of Major Events in Economic History Routledge
Accessed on: 02 Dec 2023
https://www.routledgehandbooks.com/doi/10.4324/9780203067871.ch12

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12

BRITAIN'S WITHDRAWAL FROM THE GOLD STANDARD

The end of an epoch

Michael Kitson

> It is safe to predict that Monday, September 21, 1931, will become an historic date; the suspension of the gold standard in Great Britain on that day, after the six years of painful effort which followed this country's return to gold in 1925, marks the definite end of an epoch in the world's financial and economic development.
>
> (*Economist* 1931: 547)

Introduction

Britain's withdrawal from the interwar gold exchange standard (henceforth "the gold standard", not to be confused with "the classical gold standard" of an earlier period – on which, see Chapter 9) in September 1931 was the end of an epoch and the start of a new one. The gold standard was a fixed exchange rate regime which provided the framework for the global monetary system during much of the interwar period. When Britain withdrew, the whole system was undermined and began to fall apart. By the mid-1930s the system had been replaced by a world order where countries adopted independent and uncoordinated policies. But this lack of coordination and collaboration was preferable to the previous system, as the gold standard was a flawed construction which led to slow growth of the world economy and provided little flexibility for individual nations to deal with economic problems and international economic disturbances. This rigidity became particularly manifest in the Great Depression during the late 1920s and early 1930s where the gold standard led to countries adopting deflationary policies when they should have being doing the opposite. Following the end of the First World War, Britain decided to join the United States, Germany and other nations and returned to the gold standard in May 1925. This decision was a mistake which led to slow growth of the British economy in the 1920s and deepened the extent of the Great Depression. When Britain left the gold standard in September 1931 it provided the flexibility needed to introduce policies that increased aggregate demand which promoted recovery and stimulated growth for much of the rest of the decade.

This chapter traces the rise and fall of the gold standard in Britain. It considers the economic case for the gold standard and why this case was flawed. Furthermore, it considers

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how the gold standard harmed the British economy and how Britain's withdrawal from the system promoted recovery.

The economics of the gold standard

To examine the impact of both the return to, and the departure from, the gold standard it is important to evaluate how it was *supposed* to work. In particular, it depended on an implicit model of the economy where the flows of gold would ensure smooth adjustment of individual economies to changing economic conditions including the eradication of balance of payments surpluses and deficits. But in practice there were two main problems – one which was fundamental, the other which was operational. First, economies did not operate in the smooth frictionless way assumed by many proponents of the gold standard – and as assumed in many economic models. Second, intervention by governments and monetary authorities tended to disrupt and distort the, albeit imperfect, adjustment mechanisms that the gold standard did retain.

So how should the system have worked? First, assume that markets (for products, labor and so on) are working efficiently – markets respond quickly and effortlessly to shifts in supply and demand, and firms and workers are price-takers (as in competitive markets) and are not price makers (as in uncompetitive or imperfect markets). Thus, the economy will fully employ all available resources. Second, assume that an increase in the money supply leads to an increased demand for all goods – not just demand for financial assets – and excess money is definitely spent, not just hoarded (under the bed or somewhere else). These two assumptions are Say's Law and the quantity theory of money – two of the pillars of monetarism in its various guises. Next introduce a gold standard where each nation's currency is in the form of gold or in the form of a currency fully convertible into gold at a fixed price (thus creating a fixed exchange rate system). This should introduce a mechanism to ensure price stability and the automatic adjustment of trade deficits and surpluses – a mechanism first developed by David Hume and known as the price–specie–flow mechanism. According to Hume (1898: 333):

> Suppose four-fifths of all the money in Great Britain to be annihilated in one night, … what would be the consequence? Must not the price of all labour and commodities sink in proportion, … What nation could then dispute with us in any foreign market … In how little time … must this bring back the money which we had lost, and raise us to the level of all the neighboring nations? Where, after we have arrived, we immediately lose the advantage of the cheapness of labour and commodities; and the farther [sic] flowing in of money is stopped by our fulness and repletion.

The role of gold was to change (or "annihilate" in Hume's language) the money supply in response to global shifts in supply and demand. Take the case of country where there is excess supply of its goods and services, that is, it is running a trade deficit – buying more goods and services than it is selling to the rest of the world. This will lead to a loss of gold reserves and a contraction of its money supply. This in turn will lead to a fall in its price level compared to the rest of the world, which will improve its competitiveness and eradicate its trade deficit. Now, take the case of country where there is excess demand for its goods and services, that is, it is running a trade surplus – selling more goods and services than it buys from the rest of the world. This surplus will lead to an accumulation of gold reserves and an increase of its money supply. This in turn will lead to an increase in its price level compared to the rest of the world, which will lead to a reduction in competitiveness which will eradicate its trade surplus.

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The economics of the gold standard were, therefore, dependent on highly restrictive assumptions about the way markets behave and also on the understanding that countries would freely permit their money supplies to be altered by the uninterrupted functioning of the price–specie–flow mechanism. If these assumptions were not correct, then the gold standard would not provide the means for economies to adjust to economic change. Instead, it would lock countries in to a fixed exchange rate system with little flexibility to accommodate the needs of individual economies.

The return to gold

The restoration of the gold standard progressed throughout the 1920s as all the major countries returned to the system. Britain returned to gold in 1925 and, as illustrated in Figure 12.1, by 1927 the vast majority of trading nations had joined the system which was, in effect, a global fixed exchange rate system (Kitson and Michie 1993). In Britain the conventional wisdom after the First World War was that a return to gold would provide stability and prosperity. The Cunliffe Committee, which was established to make recommendations for the development of the economy, reported in 1918 that "it is imperative that after the war, the conditions necessary for the maintenance of an effective gold standard should be restored without delay" (Cunliffe 1918). The commitment of the government to return to gold, combined with relatively high interest rates to facilitate the return, caused the sterling exchange rate to appreciate. In April 1925, the Chancellor of the Exchequer, Winston Churchill, restored sterling to the gold standard at its pre-war exchange rate of $4.86. According to Churchill (1925: cc. 52–8):

> A return to an effective gold standard has long been the settled and declared policy of this country. Every Expert Conference since the War – Brussels, Genoa – every expert Committee in this country, has urged the principle of a return to the gold standard. No responsible authority has advocated any other policy. No British Government – and every party has held office – no political party, no previous holder of the Office of Chancellor of the Exchequer has challenged, or so far as I am aware is now challenging, the principle of a reversion to the gold standard in international affairs at the earliest possible moment. It has always been taken as a matter of course that we should return to it, and the only questions open have been the difficult and the very delicate questions of how and when.

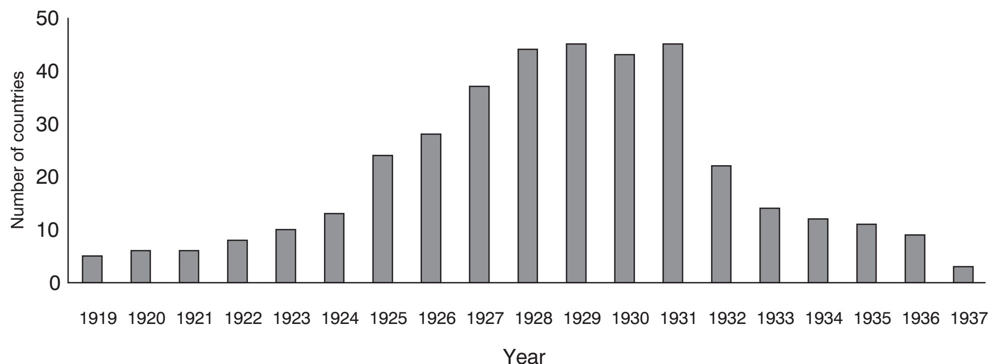

Figure 12.1 The rise and fall of the gold standard (number of countries on gold, 1919–1937)
Sources: Eichengreen (1992) and Kitson and Michie (1993)

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Churchill was, of course, exaggerating. There were alternatives but, in political discourse, the various options for economic policy are very rarely clearly debated. This is a problem today, just as much as it was in the interwar period. But in the 1920s the conventional wisdom was that a return to gold would be good for the economy, although there were dissenters (on which, see Hume 1963; and Irwin 2011, on Cassel). The most prominent dissenter was John Maynard Keynes who wrote a stringent critique of the decision to return to gold (Keynes 1925). Keynes mainly focused on the decision to return at the pre-war parity, which he thought would lead to a loss of competitiveness for domestic businesses, rather than the fundamental flaws of the exchange rate system itself. Keynes (1925: 10) was scathing about Churchill, writing:

> Why did he do such a silly thing? Partly, perhaps, because he has no instinctive judgment to prevent him from making mistakes; partly because, lacking this instinctive judgment, he was deafened by the clamorous voices of conventional finance; and, most of all, because he was gravely misled by his experts.

But those experts were not to have their wisdom contaminated by Keynes. Keynes was a member of the Cunliffe Committee but his dissension led to Cunliffe calling for his resignation and arguing that: "Mr. Keynes, in commercial circles," … is … "not considered to have any knowledge or experience in practical exchange or business problems" (quoted in Moggridge 1995: 273).

Structurally flawed: "golden fetters" in the UK

Much of the discussion of the effectiveness of the gold standard has focused on whether it was allowed to operate according to the "rules of the game." It has been contended that problems were caused by governments or monetary authorities intervening to prevent the flows of gold adding to, or reducing, their money supply (Kitson 2003). A more fundamental problem was that markets rarely if ever worked according to the model that underpinned the gold standard. From the onset the fault lines of the gold standard were apparent. It was a fixed exchange rate system which contained countries with different economic structures and with different economic problems. In a floating exchange rate system, individual countries have some power to alter their exchange rate and monetary policy in response to national-specific factors or changing economic conditions. Within a fixed exchange rate system these powers are largely lost – a problem that has become recently apparent with the turmoil in the euro area and in particular the modern "Greek Tragedy." The effectiveness of the gold standard depended on the circulation of gold having the equilibrating properties discussed above. But it did not have these properties – even if countries did not meddle with gold flows. Instead the system was highly destabilizing, creating a deflationary bias in the global monetary system which hampered world economic growth and led to rising unemployment. It was to become one of the main causes of the Great Depression and the extent to which it spread internationally.

The countries that entered the gold standard had contrasting abilities to deal with its strictures and constraints (see Kitson and Michie 1993). The resilient countries were those that could maintain both a strong trade performance with high economic growth. Such countries did not have the problem of dealing with a balance of payments deficit by deflationary means. Two of the most resilient countries in the 1920s were the United States and France. The United States had emerged as the strongest industrial nation at the end

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of the nineteenth century based on its abundant raw materials, sustained investment and the development of new industries and new forms of industrial organization. France had recovered successfully from the First World War and had entered the gold standard at an undervalue exchange rate which provided a stimulus to export-led growth.

But not all countries were as resilient as the United States and France; in particular, Germany and Britain had fragile economies at that time. Both had emerged from the aftermath of the First World War with economic problems. Britain had been in relative decline since the 1870s and had become structurally dependent on traditional industries which were declining in importance in global markets. The German economy had been wrecked by the War and was further handicapped by the conditions of the peace settlement at Paris in 1919 (on which, see Keynes 1919). The problem for the fragile economies, such as Britain and Germany, was that they found it difficult to maintain a balance of payments equilibrium and a high level of domestic economic activity at the same time.

The problem for the reconstructed gold standard was that it did not comprise of similar economies with markets that were operating in the smooth frictionless manner of textbook economics. Instead, very dissimilar economies with different structures and different problems were combined together in an exchange rate system which provided little room to maneuver. All economies suffer from shifts in supply and demand and shocks of varying degrees of magnitude and severity. The response to such changes can broadly take two forms: a market response or a policy response. A market response depends on the quick, effective and painless adjustment of relative prices in response to shocks and shifts in supply and demand. In reality, most markets rarely operate like this – they are mainly slow-moving institutions and prices tend to be "sticky." Some can move quickly – such as financial markets – but this just makes adjustment more difficult for the slower moving product and labor markets. Take a collapse in global demand. In response, nominal exchange rates may move very quickly – but exporters will take time to reduce production, change prices and reallocate physical capital. And workers who lose their jobs may take considerable time to find new employment – and many may never succeed or may fail to regain employment as productive as that prevailing before the collapse.

The limitations and inadequacies of the market response often mean that the alternative of changing economic policy results in better economic outcomes. But entering a fixed exchange rate system – such as the gold standard – means that many of the policy adjustment mechanisms cannot be used. First, and most obviously, adjustment of the nominal exchange rate is not possible. The market response would be that this could be offset by adjustment of the real exchange rate – that is, the price level adjusts to maintain "equilibrium" of the exchange rate. But this process is often slow and uncertain. For the UK, most studies showed that the decision to return to the gold standard at the prewar parity led to a significant overvaluation of the real exchange rate in the period 1925–31 (Redmond 1980 and 1984). Overall, Keynes's (1925) contemporary estimate that sterling was overvalued by 10 percent proved to be a good approximation of many more recent estimates (Kitson and Michie 1993). It should also be emphasized that the real exchange rate was also significantly overvalued in the early 1920s (Kitson 2003 and Solomou 1996). The announcement of the intention of the return to gold led to rapid appreciation of the nominal exchange rate – but domestic prices relative to the rest of the world only adjusted slowly – leading a rise in the real exchange rate. According to Keynes (1925: 209–10): "the improvement in the exchange prior to the restoration of gold was due to a speculative anticipation of this event and to a movement of capital, and not to an intrinsic improvement in sterling itself."

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The second policy mechanism that is inoperable in a fixed exchange rate system is the use of interest rates to achieve domestic economic objectives – such as economic growth, full employment, and low and stable inflation. Once a currency is locked into a fixed exchange rate system, interest rates have to be deployed to maintain the exchange rate parity. For the UK, this was a particular problem as sterling entered the gold standard, at an overvalued rate (as discussed above) which required relatively high interest rates to maintain demand for the currency. From 1923 there was a trend rise in the Bank of England's discount rate as the authorities had to tighten monetary policy to facilitate the return to gold at the pre-war parity (Kitson and Michie 1993). This contributed to the slow growth of the UK economy and persistently high unemployment during the 1920s (Kitson and Solomou 1990).

The third policy mechanism is the use of fiscal policy as a demand management tool. In a fixed exchange rate regime, the orthodox Mundell–Fleming model of open economy macroeconomics suggests that governments should use fiscal policy to manage the domestic economy (Mundell 1963 and Fleming 1962). For instance with slow growth, governments should engage in fiscal expansion which will increase output; this will put upward pressure on interest rates and the exchange rate. But as the latter is fixed, the monetary authorities will have to engage in monetary expansion to relieve the pressure, which in turn will boost aggregate demand. However, despite slow growth in the 1920s, fiscal policy was not used as a demand management tool. A more powerful orthodoxy was then dominant: the "Treasury view." The Treasury view asserted that fiscal policy has no impact on the level of economic activity and unemployment as any increase in government spending would "crowd out" an equal amount of private sector economic activity. As Winston Churchill, the Chancellor of the Exchequer, explained in 1929:

> The orthodox Treasury view … is that when the Government borrow[s] in the money market it becomes a new competitor with industry and engrosses to itself resources which would otherwise have been employed by private enterprise, and in the process raises the rent of money to all who have need of it.
>
> (Churchill 1929, cc. 53)

The Treasury View was comprehensively debunked by Keynes (1936), and the use of fiscal policy in demand management became a cornerstone of economic policy in the "Golden Age of Capitalism" in the 1950s and 1960s.

Britain was suffering from slow growth and structural problems when it joined the gold standard. And the gold standard made these conditions worse. An overvalued exchange rate led to loss of competitiveness. The exchange rate straightjacket meant that there were few if any policy options to ameliorate the problem. When the Great Depression hit, the problems deteriorated further and were to ultimately result in the UK withdrawing from gold – which was the catalyst for the collapse of the entire system.

Gold and the Great Depression

The structural flaws of the gold standard were starkly exposed by the Great Depression. The causes of the Great Depression are subject to much debate, but the depth, length and spread of the Depression can largely be explained by the operation of the gold standard (Eichengreen 1992, Temin 1989). The gold standard operated as an effective mechanism for transmitting depression around the globe. As the Depression took hold in the U.S., loans

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to other countries (capital exports) were called in. This increased gold flows to the U.S., but drained gold reserves from other countries. For the countries losing gold to maintain convertibility of their exchange rate within the gold standard, they had to increase demand for their currency by raising interest rates. Thus as the world economy was moving into depression, the gold standard forced many countries to tighten monetary policy at the very time that policy should have been loosened.

In Britain the economy went into depression in 1929, although some indicators suggest that it was already in recession by 1928 (Solomou and Weale 1993). The first phase of the Depression was primarily caused by a collapse in exports as world trade went into severe decline (Corner 1956). The second phase was primarily caused by the policy response – which was in turn caused by the twin constraints of the gold standard and the Treasury View. The gold standard constraint led to a tightening of monetary policy, particularly in 1931 when the government raised interest rates in the forlorn attempt to maintain the value of sterling. This particularly harmed interest-sensitive sectors such as construction. As the British economy slowed, unemployment rose – and this led to pressure on the Government's finances as tax revenue fell and expenditure on unemployment benefits increased. The impact of such "fiscal stabilizers" is usually to dampen the impact of recessionary forces. But in Britain, policy was constrained by the Treasury View. For instance the May Report of July 1931 urged public sector wage cuts and large cuts in public spending, particularly in benefit payments to the unemployed. The gold standard and the Treasury View constraints reinforced each other as balancing the budget was considered as necessary for confidence in sterling. But the tightening of fiscal policy during a depression counteracted the impact of fiscal stabilizers – which in turn depressed economic activity even further.

The conduct of economic policy in Britain was closely bound up with shifts in the political landscape. In May 1929, the Labour Party formed a government with support from the Liberal Party. The government was committed to the Treasury View – but this commitment was to be tested by the Great Depression. The impact of the Depression was uneven with the industrial cities and regions – primarily in the north of Britain – suffering the most in terms of unemployment and poverty. These were the areas from which the Labour Party primarily garnered its support. Thus, the burden of fiscal austerity – involving public sector wage cuts and large cuts in benefit payments – would largely fall on the working class who were, in the main, supporters of the Labour Party. The dispute over public spending cuts divided the Labour Party and the Government – which was most evident after the publication in July 1931 of the May Report. There was economic and political turmoil, and in response the Prime Minister (Ramsey MacDonald) formed a "National Government" with the Conservative and the Liberal parties in August 1931. This led to MacDonald and his supporters being expelled from the Labour Party, and a General Election was called in October 1931 which subsequently resulted in a large majority for the Conservative Party. Thus, the National Government became Conservative-dominated, although MacDonald continued as Prime Minister until 1935.

The newly elected Government brought in emergency measures in an attempt to balance the budget and restore confidence in sterling. The budget of 10 September 1931 implemented cuts in public spending and wages of public sector workers. But this did not restore confidence either at home or abroad: while some of the British Navy mutinied, international investors took flight. Despite all the attempts to prop it up, on 21 September 1931 the Government was finally forced to abandon the gold standard, and immediately the sterling exchange rate fell by 25 percent.

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The impact of the suspension of gold on the British economy: "Nobody told us we could do that"

When Britain left the gold standard one prominent Labour politician pithily observed: "Nobody told us we could do that" (quoted in Moggridge 1969: 9). This is an example of a recurring refrain in British political discourse that there are few if any options in the conduct of economic policy. In the 1980s, Prime Minister Thatcher proclaimed that "there is no alternative"; more recently, the Chancellor of the Exchequer, George Osborne stated that there can be no plan B for economic policy. But there are always alternatives or different plans that can be implemented. And when Britain withdrew from the gold standard, this ushered in a new policy regime.

There were two primary benefits of the suspension of the gold standard. First, devaluation replaced persistent deflation, the fall in both the nominal and real exchange rate increased the competitiveness of domestic products including exports and import substitutes. According to Broadberry (1986), the devaluation led to an £80 million improvement in the balance of trade which, assuming a multiplier of 1.75, would have increased GDP by approximately 3 percent (Solomou 1996). It should be noted, however, that the competitive impact of devaluation was subsequently eroded as other countries followed Britain and also withdrew from the gold standard (on the global impact of the collapse of the gold standard, see Eichengreen and Sachs 1985, 1986). Second, the suspension of gold allowed the implementation of expansionary monetary policy as interest rates were no longer used to protect the exchange rate parity. The ending of the deflationary cycle brought about by the loss of gold reserves and the introduction of "cheap money" after 1932 have been identified as important stimuli for economic growth – in particular encouraging growth in the housing sector (Richardson 1967).

The withdrawal from the gold standard was quickly followed by another emergency measure, the introduction of widespread protectionism in November 1931 (measures which were formalized in 1932). The orthodox case, often based on the notion of comparative advantage and the case for free trade, is that protectionism either harmed growth (Capie 1983) or had little impact (Richardson 1967). But there is an alternative argument that under the special conditions of the early 1930s – depressed demand and wide-scale unemployment – protectionism helped to stimulate the economy (Kitson and Solomou 1990). This more optimistic assessment of protectionism suggests that it raised demand for British goods as imports were replaced by domestic products. The usual argument that tariffs are harmful did not apply in 1930s Britain. First, it did not lead to a misallocation of resources and inefficiency as Britain imposed tariffs on manufactured imports which competed with domestic products, and it did not impose tariffs on complementary imports such as raw materials and other inputs. Furthermore, the increased demand for their products allowed firms to exploit increasing returns. Second, the potential for "beggar thy neighbor" responses by other countries was negligible. Britain was the last major country to move away from free trade – most of its major competitors had developed their economies behind tariff walls limiting their potential to introduce additional protectionist policies which would harm British exports. During the 1930s, Britain's share of world exports was stable whereas it had been declining in the 1920s (Kitson and Solomou 1990). Thus, the optimistic assessment of protectionism suggest that it did not lead to a misallocation of resources but a mobilization of resources – it led to increased employment and output.

Although the new policy regime introduced at the end of 1931 was not based on strategic long-term planning, it did turn out to provide a coherent impetus for recovery and growth. The suspension of the gold standard led directly to a devalued exchange rate, cheap money

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and indirectly to the protectionism of British manufacturing. These policies together led to increased aggregate demand which led to a rapid rise of GDP from 1932. As Keynes argued:

> It is a wonderful thing for our business men and our manufacturers and our unemployed to taste hope again. But they must not allow anyone to put them back in the gold cage, where they have been pining out their hearts all these years.
>
> (News broadcast quoted in Backhouse and Bateman 2006: 11)

According to a narrow definition, the policy-induced recovery was not Keynesian as it did not involve expansionary fiscal policy. But a wider notion of Keynesianism stresses the importance of aggregate demand – and growth in the 1930s was very much demand induced – and central to this was the withdrawal from gold.

The impact of Britain's suspension of gold on the world economy

Britain's withdrawal from the gold standard triggered the global collapse of the exchange rate system. Other countries followed Britain and left the gold standard, including most of the dominions and empire, the Scandinavian countries and Canada and Japan; and the U.S. devalued in March 1933. As shown in Figure 12.1, by 1934 there were only 12 countries left on gold compared to 45 countries in 1931. Those remaining on gold included France, Belgium and the Netherlands; these countries only left the system later in the decade.

Overall, various studies have shown that those countries that withdrew from the gold standard – in particular those that left early – had superior economic performance compared to those that remained committed to gold (Eichengreen 1992, Eichengreen and Sachs 1985, Kitson and Michie 1994). Although there were variations in economic performance between individual countries, the comparative evidence suggests that countries that withdrew from gold had more flexibility to adjust their exchange rates and had the ability to use monetary and fiscal policies to help stimulate their domestic economies. Conversely, the countries that were committed to gold were hindered by both the constraints of the gold standard and by increasing overvaluation of their exchange rates as competitor countries left the exchange rate system and devalued.

The 1930s was a period of turbulence in the international economy. The withdrawal of sterling from the gold standard led to countries pursuing independent policies to achieve domestic economic goals. In many cases, such policies had competitive "beggar thy neighbor" impacts which would have been reduced by a coordinated international response to the Great Depression. But such a coordinated response was not feasible due to a lack of international leadership and a failure to appreciate the insights of Keynesian economics. Such a response had to wait until the Bretton Woods agreement in 1944 which provided the intellectual and institutional frameworks which would underpin the "golden age of capitalism" in the 1950s and 1960s.

The 1930s was a decade where high unemployment persisted; countries competed rather than collaborated, and political and social unrest led to the rise of fascism in many countries. But the roots of these problems can be traced to the operation of gold standard which was highly deflationary for many individual countries and the world economy as a whole.

Conclusions

The conventional wisdom in Britain in the early 1920s was that returning to the gold standard at the prewar parity would provide prosperity. This was a mistake. Instead it had a

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deflationary impact on the economy leading to slow growth. Furthermore, the constraints of being in the system initially led to Britain adopting contractionary policies during the Great Depression, at the very time when expansionary policies were needed. Under pressure from global financial markets, Britain could not maintain its exchange rate parity and was forced to withdrawal from the gold standard in 1931. Although unwanted by many at the time, this withdrawal provided the impetus for recovery from depression and sustained economic growth. It led to a more competitive exchange rate, expansionary monetary policy and helped usher in the protection of domestic manufacturing. The withdrawal of sterling from the gold standard was also the catalyst for the global collapse of the system. As the *Economist* pointed out at the time, this was the end of an epoch. And thankfully so. The gold standard epoch had hampered the growth of the world economy and amplified the Great Depression. The world economy was better off without it.

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