14. An Explanation of the 1929 Depression

We return to the original questions: what produced the world depression of 1929, why was it so widespread, so deep, so long? Was it caused by real or monetary factors? Did it originate in the United States, in Europe, in the primary-producing countries of the periphery, in the relations among them? Was the fatal weakness the nature of the international capitalist system, or the way it was operated, i.e. the policies pursued by governments? Were such policies, to the extent they were important, the consequence of ignorance, short-sightedness or ill-will? Were the depth and length of the depression a reflection of the strength of the shock to a relatively stable system, or a measure of the system's instability in the presence of a blow or series of blows of normal force (however measured)? Or to bring the issue back to the difference between Milton Friedman and Paul Samuelson, was the 1929 depression the consequence of United States monetary policy or a series of historical accidents? Inevitably in drawing the threads together there will be a considerable amount of confirmation of preconceptions. We are open to the accusation of having selected statistics, facts and incidents from the history of the decade which support a position chosen *a priori*. But we would claim that we have not knowingly suppressed any facts that do not fit the explanation which follows, nor ignored other explanations such as United States monetary policy (Friedman); misuse of the gold standard (Robbins); mistaken deflation (Keynes); secular stagnation (Hansen); structural disequilibrium (Svennilson); and the like. The chapter is entitled 'An Explanation' not 'The Explanation'.

The explanation of this book is that the 1929 depression was so

wide, so deep and so long because the international economic system was rendered unstable by British inability and United States unwillingness to assume responsibility for stabilizing it in three particulars: (a) maintaining a relatively open market for distress goods; (b) providing counter-cyclical long-term lending; and (c) discounting in crisis. The shocks to the system from the overproduction of certain primary products such as wheat; from the 1927 reduction of interest rates in the United States (if it was one); from the halt of lending to Germany in 1928; or from the stock-market crash of 1929 were not so great. Shocks of similar magnitude had been handled in the stock-market break in the spring of 1920 and the 1927 recession in the United States. The world economic system was unstable unless some country stabilized it, as Britain had done in the nineteenth century and up to 1913. In 1929, the British couldn't and the United States wouldn't. When every country turned to protect its national private interest, the world public interest went down the drain, and with it the private interests of all.

Asymmetry

If the world economy behaved symmetrically, there could be no world depression. A decline in the price of wheat might produce losses for farmers; it would, however, lead to gains in real purchasing power for consumers (shifts in real income from groups with different marginal rates of saving are ignored). Gold losses for one country would be deflationary, but gains for the recipient country would yield offsetting expansion. Contractive exchange appreciation would be matched by stimulating depreciation. The stock market could not absorb funds, since for every buyer that gives up money, there is a seller that gains it.

But symmetry is not the way of the world in all times and places, and not for the reason of interference by men with, say, the rules of the gold-standard game, or that New York as an international financial centre was inexperienced. It happened that in Britain, from 1873 to 1913, foreign lending and domestic investment were maintained in continuous counterpoint. Domestic recession stimulated foreign lending; boom at home cut it down. But the

boom at home expanded imports which provided an export stimulus abroad in place of domestic investment with borrowed funds. Counter-cyclical lending stabilized the system.

In the 1920s, United States foreign lending was positively correlated with domestic investment, not counterpoised. The boom of the 1920s was accompanied by foreign lending; the depression of the 1930s saw the capital flow reversed. In his *The United States and the World Economy*, written in 1943, Hal Lary recorded the fundamental fact that the United States cut down on imports and lending at the same time. The cut in lending actually preceded the stock-market crash as investors were diverted from the boom in foreign bonds which followed the Dawes loan to the boom in domestic stocks dating from the spring of 1928. The deflationary pressure on Germany may be debated;[1] the pressure on the less developed countries at the periphery is clear cut.[2] As Table 1 (p. 56) shows, moreover, Britain joined the United States in reducing its lending in 1929 over 1928.

Maintaining a market for distress goods can be regarded as another form of financing. Free trade has two dimensions: (a) to adapt domestic resources to changes in productive capacities abroad, and (b) to maintain the import market open in periods of stress. The first is more readily done by a rapidly growing country which needs to transfer resources out of less productive occupations and is willing to embrace the competition of imports. By holding firm to free trade during depression at some short-run cost to resources in import-competing lines, the second provides a market for surpluses accumulated abroad. Britain clung to free trade from 1846 (or some year thereafter, such as 1860, when all tariffs but those for revenue had been dismantled) until 1916.

1. See Heywood W. Fleisig, 'Long-Term Capital Flows and the Great Depression: The Role of the United States, 1927–1933', unpublished dissertation, Yale University, 1968, *passim*, and Peter Temin, 'The Beginning of the Depression in Germany', *Economic History Review*, vol. XXIV, No. 2 (May 1971), pp. 240–48. Fleisig and Temin argue over the size of the shock to the system. If the system is basically unstable, this issue is downgraded in importance.

2. Heywood Fleisig, 'The United States and the World Periphery during the Early Years of the Great Depression', forthcoming in Herman van der Wee, ed., *The Great Depression Revisited*, Nyhoff, The Hague, 1972.

After 1873, she was not growing rapidly, but continued to adhere to free trade since her declining industries were exporters rather than import-competers. Her tenacity in adhering to free trade in depression may have been born of cultural lag and the free-trade tradition of Adam Smith, rather than of conscious service to the world economy.

The contrast is with the Smoot-Hawley Tariff Act of 1930. At the first hint of trouble in agriculture, Hoover reached for the Republican household remedy, as Schumpeter characterized it, in the face of a recommendation of the World Economic Conference of 1927 that nations of the world should adopt a tariff truce. The action was important less for its impact on the United States balance of payments, or as conduct unbecoming a creditor nation, than for its irresponsibility. The congressional rabble enlarged protection from agriculture to primary products and manufactures of all kinds, and Hoover, despite more than thirty formal protests from other countries and the advice of 1,000 economists, signed the Bill into law. This gave rise to (or at least did nothing to stop) a headlong stampede to protection and restrictions on imports, each country trying to ward off deflationary pressure of imports, and all together ensuring such pressure through mutual restriction of exports. As with exchange depreciation to raise domestic prices, the gain from one country was a loss for all. With tariff retaliation and competitive depreciation, mutual losses were certain. The formula of tariff truce and exchange stabilization proposed for the World Economic Conference of 1933 offered no positive means of raising prices or expanding employment. It would none the less have been significant as a means of slowing further decline. With no major country providing a market for distress goods, or willing to tolerate appreciation, much less furnish long-term capital or discounting facilities to countries suffering from payments difficulties, the fallacy of composition with the whole less than the sum of its parts ensured that deflation would roll on.

Initial conditions

The lack of leadership in providing discount facilities, anti-cyclical lending or an open market for goods rendered the system unstable. So did the heritage of war, and especially the combination of reparations, war debts, overvaluation of the pound and undervaluation of the French franc. One should perhaps add the German inflation of 1923, which made that country paranoid in its subsequent attachment to deflation. The structural dislocations of war in excess production of wheat, sugar and wool, plus ships, cotton textiles and coal, were of less consequence and could have been cared for fairly readily by the price system if macroeconomic stability could have been preserved. The financial distortions made such stability difficult if not impossible to sustain. A far-seeing leadership on the part of the United States might have been willing to waive war debts, but it would have been difficult to persuade the American voter of the merit of the course, especially when Britain and France were receiving reparations. Britain was willing to forego reparations, to the extent that war debts were written off – an attitude of limited self-denial – but the suggestion that the French could write off reparations, after having paid them in 1871 and 1819, and after four years of cruel war, is to ask too much from history.

The failure to achieve a system of equilibrium exchange rates must be set down, like budget-balancing in government accounts, at the door of economic ignorance. In the British case, the urge was to restore the *status quo ante*; it was aided by destabilizing speculation. The selection of an exchange rate for the French franc was addressed much more clinically – as it could be, since restoration of the old par was out of the question – but too little account was taken of the earlier export of capital and the need for an import surplus to transfer it inward as it returned to France. This can be regarded as economic ignorance of a second order. In combination with war debts and reparations, the disequilibrium rates made the underlying position weak. It is interesting, though perhaps idle, to contemplate whether the depression could still have been avoided, or mitigated by some substantial fraction such

as two thirds, if the United States had managed to keep open its market, maintain long-term capital flowing and provide lending of last resort through discounting in crisis. One great difficulty was that while the market for goods might be kept open by vetoing congressional tariff proposals, and discounting undertaken through government or central-bank action, there was no way in which governments of the day could sustain international lending. Foreign loans were made by the market, or largely not at all. Lending could be stopped by government fiat, as the Capital Issues Committee did from time to time in London; it was impossible for government to get the private market to start after it had stopped. And to substitute government loans for the market on anything but an emergency-discounting basis called for machinery which was virtually non-existent. The Bank of France would direct President Luther of the Reichsbank to talk loans with private bankers. The Department of State could suggest that foreign governments talk to J. P. Morgan & Company. They could not produce loans. Leverage was weak.

British leadership

Not until 1931 was it clear that Britain could not provide the leadership. In the early 1920s, there were League of Nations programmes for the stabilization of the currencies of Austria and Hungary. These were to a considerable extent British in spirit, with help of experts from Scandinavia, the Low Countries and the Dominions, such as staffed the League of Nations Economic and Financial Section. Later the Dawes and Young Plans to settle German reparations were dominated by British experts, with Americans serving as front men to foster the British hope of tying reparations to war debts. By 1931, British capacity for leadership had gone. In small part it had been dissipated in puerile central-bank quarrels between Norman and Moreau, although much of the competition for domination over the smaller central banks of Europe was the product of Moreau's imagination. (Benjamin Strong tried hard to arbitrate these quarrels, and his death in 1928 was a loss for the stability of the system.) More significant was the burden of French sterling balances, which

inhibited Britain as a lender of last resort. In the June 1931 crises, the climax of weakness was reached on the second Austrian loan for the *Kreditanstalt* when Norman offered 50 million schillings or $7 million as a loan for one week. At the World Economic Conference in 1933, it was clear that Britain had turned away from a leading world role, cultivating the Commonwealth and freedom to manage sterling, and largely leaving it to the United States to devise a world programme.

Lack of United States leadership

Revisionist historians, such as William A. Williams, insist that the United States undertook a leading world role under Charles E. Hughes as early as the Disarmament Conference of 1922.[3] It is difficult or impossible to find support for this position in the field of international economics, which supports the conventional wisdom of such historians as E. H. Carr, that 'in 1918, world leadership was offered, by almost universal consent, to the United States . . . [and] was declined'.[4] There was interest in the affairs of Europe in New York, in the Federal Reserve Bank of New York under Strong and Harrison, in the financial community represented by such people as Dwight Morrow, Thomas Lamont and Norman Davis. A few non-New Yorkers, such as Charles G. Dawes and Andrew Mellon, were brought into international finance and diplomacy. On the whole, however, the isolationism expressed by Henry Cabot Lodge in leading the rejection of the Versailles

3. See, for example, William Appleman Williams, *The Tragedy of American Diplomacy*, World Publishing Co., Cleveland, Ohio, 1959, *passim*, but esp. Chapter IV, 'The Legend of Isolationism'. Mr Williams, a Marxist revisionist historian, states (p. 123): 'Hoover did not grasp the fact that the depression was a sign of stagnation in a corporate economy which was born during the civil war and came to maturity in the decade from 1895 to 1905'; and (p. 128): '. . . from the fall of 1932 Roosevelt and Hull stressed the importance of foreign trade for domestic revival and expansion and for world wide relief of conditions which caused war and revolution'. It is difficult to see how a historian could ignore such evidence as the First Inaugural Address, cited earlier, to be able to make such a statement about Roosevelt.

4. Edward Hallett Carr, *The Twenty Years' Crisis, 1919–1939: An Introduction to the Study of International Relations*, Macmillan, London, 1939; 2nd edition, 1946, p. 234.

Treaty and United States adherence to the League of Nations typified the dominant sentiment. The United States was uncertain in its international role. It felt that the British were shrewder, more sophisticated, more devious in their negotiating tactics, so that the United States came out of international conferences losers. Stimson would have been willing to undertake a major discounting operation to rescue the Reichsmark in July 1931. Hoover, Mellon and (though from New York) Mills were opposed to sending good money after bad, as discounting calls for. In 1933, James Warburg, Moley and, presumably, Woodin and Roosevelt still resisted sending good money after bad. Proposals for embryonic international monetary funds were legion; and even Britain presented one officially. They were uniformly turned down with a lecture on how much the United States had already lost in unpaid war debts and the Standstill Agreement.[5] It was not until 1942 that Harry D. White began preparing a world plan for discussion at Bretton Woods – together with the plan of Lord Keynes – a world plan for limited discounting.

Cooperation

Clarke's conclusion that central-bank cooperation was maintained up to mid 1928 but failed thereafter has already been dealt with in some detail. In summary, such cooperation on matters such as hegemony over small central banks or the choice of an equilibrium exchange rate was inadequate before 1926, and the Bank of France supported the pound loyally (and expensively) in the late summer of 1931. A deeper question is whether cooperation as such would have been sufficient. In *America's Role in the*

5. Jørgen Pedersen blames the liquidity crisis of 1931 on the United States for its failure to support the German mark, and, when that had been forced to suspend gold payments, for its failure to underwrite sterling. See 'Some Notes on the Economic Policy of the United States during the Period 1919–1932', in Hugo Hegeland, ed., *Money, Growth and Methodology*, In Honor of Johan Åkerman, Lund Social Science Studies, Lund, 1961, pp. 490–91. This would be agreed today, and Professor Pedersen put it forward himself, as noted earlier, in 1933. As he himself points out, however (p. 494), the United States was acting with 'the normal prejudices of the period'.

World Economy,[6] Alvin Hansen prescribed for the United States policies of maintenance of full employment at home and co-operation with international efforts at freer trade, restoring capital movements, improvement of the world monetary system and so on. With the advantage of hindsight, it appears that more than cooperation was provided, viz. leadership, and that mere cooperation would not have built the institutions and policies of the Organization for Economic Cooperation and Development, Group of Ten, Bank for International Settlements, International Monetary Fund, International Bank, General Agreement on Tariffs and Trade, etc. As an acquaintance on the International Monetary Fund staff put it (admittedly to an American), if the United States does not take the leadership, nothing happens. Leadership may lack followership, and foolish or even sensible proposals may be defeated through lack of support. But the most sensible proposals emanating from small countries are valueless if they lack the capacity to carry them out and fail to enlist the countries that do. The World Economic Conference of 1933 did not lack ideas, as that of 1927 seems to have done. The one country capable of leadership was bemused by domestic concerns and stood aside.

One special form of cooperation would have been joint Anglo-American leadership in the economic affairs of the world. Economists usually agree that such arrangements, whether duopoly or bilateral monopoly, are unstable, and so do political scientists. Carr states explicitly that the hope for Pax Anglo-Saxonica was romantic and that Pax Americana 'would be an easier contingency'.[7] Vansittart, referring to the Standstill agreements and the German occupation of the Rhineland, wrote *à propos* of the World Economic Conference: 'When action was required two years earlier, the two governments [British and American] sheltered behind each other like the British and French governments three years later.'[8] With a duumvirate, a troika, or slightly

6. Alvin Hansen, *America's Role in the World Economy*, W. W. Norton, New York: Allen & Unwin, London, 1945.

7. Carr, *The Twenty Years' Crisis, 1919–39*, pp. 233–4.

8. Lord Vansittart, *The Mist Procession, the Autobiography of Lord Vansittart*, Hutchinson, London, 1958, p. 466.

wider forms of collective responsibility, the buck has no place to stop.

Changing leaders

Friedman and Schwartz make a great deal of the role in the great depression of the shift of monetary leadership in the United States from New York to Washington.[9] They suggest that this sounds far-fetched, since it is a 'sound general principle that great events have great origins', but note that small events at times have large consequences through chain reactions and cumulative force. The universality of the asserted principle seems dubious to this observer;[10] the observation that shifts of the locus of leadership give rise to instability does not. Had they not focused so exclusively on monetary conditions in the United States, Friedman and Schwartz might have noted the accentuation of the depression which came with the transfer of the presidency from Hoover to Roosevelt (occurring after the money supply had been greatly enlarged); and the still more significant (in my judgement) transfer of leadership in the world economy from Whitehall to the White House.

This notion of the instability of a financial system with two centres, or of one where leadership is in process of being dropped by one and picked up by another, is cited by Edward Nevin as crucial to the collapse of the gold standard in 1931. He quotes Sir Ernest Harvey's testimony before the Macmillan Committee: 'such leadership as we possess has been affected by the position which America has gained'; making a change in the ancient system as set out in the Macmillan Report, under which bank rate regulated the reserve position of the United Kingdom, and other countries adjusted their positions to that of Britain. He then went

9. Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867–1960*, Princeton University Press, Princeton, 1963, p. 419.

10. cf. Benjamin Franklin, *Maxims Prefixed to Poor Richard's Almanac*, Philadelphia, 1757, 'Little strokes fell great oaks', and 'A little neglect may breed mischief: for want of a nail the shoe was lost; for want of a shoe the horse was lost; for want of a horse the rider was lost'. The exception for cumulative feedback embraces the second quotation, but not the first.

on to say, 'Better that a motor car should be in charge of a poor driver than of two quite excellent drivers who are perpetually fighting to gain control of the vehicle.'[11] The analogy of two excellent drivers fighting for control of the wheel may be more graphic than apposite. The instability seems rather to have come from the growing weakness of one driver, and the lack of sufficient interest in the other. William Adams Brown, Jr, describes the gold standard of the period as 'without a focal point', meaning that it had two, but the conclusions of his monumental work do not dwell on this critical aspect of the world economy.[12]

Role of the small countries and France

One passenger in the vehicle which did not lack interest was France. And one group which lacked responsibility – to discontinue the metaphor, or perhaps they should be regarded as passengers in the back seat – consisted of the smaller countries: Belgium, the Netherlands, Switzerland and Scandinavia. The smaller countries can be disposed of first. They are sometimes blamed, as in Born's analysis, for having acted irresponsibly in, say, converting sterling into gold in the summer of 1931, or raising tariffs with alacrity after 1930. There is, however, no universally accepted standard of behaviour for small countries. On one showing, they lack power to affect the outcome of great events and are therefore privileged to look after the private national interest rather than concern themselves with the public good of stability in the world economy as a whole. On a somewhat higher ethical level, the small countries may be held Kantian Categorical Imperative, which enjoins them to act only in ways which can be generalized.

11. Edward Nevin, *The Mechanism of Cheap Money: A Study of British Monetary Policy, 1931–1939*, University of Wales Press, Cardiff, 1955, pp. 9n., 12 and 14.

12. William Adams Brown, Jr, *The International Gold Standard Reinterpreted, 1914–34*, National Bureau of Economic Research, New York, 1940, vol. II, p. 781: 'The essential difference between the international gold standard of 1928–29 and that of 1914 was that when the world returned to gold after the war it built its international financial system around a nucleus of London and New York, and not a single center.' The title of his Chapter 20 is 'The Experiment of a Gold Exchange Standard without a Focal Point'.

In such circumstances, of course, they would not have withdrawn credits from Austria in the spring of 1931, nor from Germany and Britain in the summer, nor from the United States in the autumn. The economist chooses between these standards perhaps on the basis of comparative cost. If the Netherlands had known the cost of leaving its sterling unconverted into gold, it seems unlikely that it would have done so, even at the risk of accelerating the collapse of the pound and deepening of the world depression. It may be that such countries as Sweden, Canada and New Zealand that set high standards of international conduct - in foreign aid, contributions to United Nations peacekeeping missions, etc. - do so solely from ethical reasons; or they may choose among occasions to take largely the opportunities which are relatively cheap. One may thus note that the small countries contributed substantially to the deflation by the speed with which they cut imports, depreciated, or converted sterling and dollars into gold, but find it hard to blame them for it.[13]

There is another aspect to the role of small countries: they could offer programmes for recovery because they knew that the major cost of programmes adopted would fall on other countries. Proposals for an embryonic international monetary fund in the Washington discussions preceding the World Economic Conference of 1933 were put forward by Poland, Turkey, Belgium, the I.L.O., and one was made by Britain, though this latter was quickly withdrawn when the United States frowned upon it. Lacking resources to make these schemes effective, small countries were reduced to advisory roles without conviction, even when the proposals were sound. An essential ingredient of followership is to convince the leader that he is the author of the ideas which require the use of his resources.

The case of France is different. France sought power in its

13. For an interesting political model of countries which are free-riders behind the leadership of others, see Norman Froelich and Joe A. Oppenheimer, 'I Get Along with a Little Help from My Friends', *World Politics*, vol. XXIII, No. 1 (October 1970), pp. 104–20. But note, p. 119, that leadership is rewarded in this model rather than made to pay for the privilege, as implied where the responsibilities of leadership are maintaining an open market for goods, a counter-cyclical export of capital and a mechanism for rediscounting in crisis.

national interest, without adequately taking into account the repercussions of its positions on world economic or political stability. Its intransigence in the matter of reparations or the attempt to attach political conditions to the second Austrian credit of June 1931 or the contemplated German loan of July of that year illustrate the position. Hurt in the depreciation of sterling in September, the Bank of France, under strong political pressure at home, converted its dollars into gold in the private national interest during 1931–2, all the while protesting its cooperation and concern for the interest of the United States. The rivalry between the Bank of France and the Bank of England over which should take over the leadership in restoring independence to central banks and stabilization of currencies in Eastern Europe would be pathetic, had it not run risks of instability for the system as a whole when the French threatened to withdraw balances from London.

Not quite big enough to have responsibility forced on it, nor small enough to afford the luxury of irresponsibility, the French position in the inter-war period was unenviable. It had the power to act as a destabilizer, but was insufficiently powerful to stabilize. 'Great Britain and the United States together were the active nucleus that replaced the single centre of pre-war days, but the position and policy of France actively affected their mutual as well as their joint relations to the outlying countries.'[14] In these circumstances France could be (and was) blamed for upsetting the system when she had no capacity to take it over and run it in the presence of two larger powers, one feeble, the other irresponsible.

Public v. private interest

Cynicism suggests that leadership is fully rewarded for its pains in prestige, and that no matter how much it protests its commitment to the public welfare, its fundamental concern is private. Bismarck insisted that free trade was the weapon of the dominant economy anxious to prevent others from following in its path. 'The white

14. Brown, *The International Gold Standard Reinterpreted, 1914–1934*, p. 785.

man's burden' is an expression used today only in mockery. A country like France deliberately setting out to achieve prestige suggests that those with a concern for problem-solving are either perfidious or self-deceiving. None the less there is a difference between accepting and declining responsibility for the way the system is run. The British accepted responsibility, although, as the 50 million schilling loan emphasizes, they were unable to discharge it. The French and the United States were unwilling to underwrite stability. Under Coolidge and Hoover, the United States refused to commit itself to any programme of foreign reconstruction or currency stabilization, leaving these questions to the Federal Reserve System.[15] There was hardly any improvement in Roosevelt's commitment to the world economy until timidly in 1936, at the time of the Tripartite Monetary Pact, and ultimately during the Second World War. Inside France, as between France and the other leading powers, 'all groups thought their opponents more united and dedicated than they were, and a concern for the general interest was virtually absent'.[16]

Unable to cope with the public good, the British more and more turned their energy to the private. Keynes's advocacy of a tariff and the refusal to contemplate stabilization after 1931 are examples. One may find a hint or two in the documents that the initiative came from the Dominions rather than Britain.[17] For a time, until well after the war, the British economics profession and public almost drew the lesson that each country should take care of itself without regard to external effects.

The point is illustrated in the memorandum written by Hubert Henderson at the British Treasury in 1943, entitled 'International

15. Lester V. Chandler, *Benjamin Strong, Central Banker*, The Brookings Institution, Washington, D.C., 1958, p. 255.

16. Alfred Sauvy, *Histoire économique de la France entre les deux guerres*, I: *1918–1931*, Fayard, Paris, 1965, p. 73.

17. See *Documents diplomatiques français, 1932–39*, 1er série (1932–1935), Tome III, Imprimerie Nationale, Paris, 1967, #470, Bonnet to Paul-Boncour, 9 July 1933, p. 871: 'One fact is evident: it is that Britain is not free. Its dominions and in particular Canada whose Prime Minister Bennett is a man of extraordinary violence have a predominant influence on her, to the point of modifying totally her opinion in the space of a few seconds.' This is doubtless hyperbole.

Economic History of the Interwar Period'.[18] This summarizes the crude view of the depression as resulting from nationalism and tariffs, the collapse of world trade, bilateralism and preferences and disregard of the advice of the League of Nations, leading to the conclusion that after the war there is need for the world to be more resolute in avoiding economic nationalism, and attempting to construct a freely working economic system with international credits, the reduction of trade barriers and the outlawry of qualitative regulation.[19] Henderson states that the history of the inter-war period provides no support for this view. He opposes exchange depreciation: '... there can be little doubt that the depreciation of the pound was in part responsible for the sharper fall in gold prices, and disillusionment is general in the United Kingdom and still more in the United States on the power of exchange depreciation to promote national recovery'.[20]

But the conventional view is false in all essential respects. The old international order has broken down for good. Nothing but futility and frustration can come from the attempt to set it up again. Individual countries must be free to regulate their external economies effectively, using control of capital movements, quantitative regulation, preferences, autonomous credit policies, etc.[21]

This foot-dragging, which Keynes shared during the 1930s and until late in the war, is understandable. It misses the main lesson of the inter-war years, however: that for the world economy to be stabilized, there has to be a stabilizer, one stabilizer.

Counter-cyclical capital movements

Assume that the United States had not led the way to destroying the trade mechanism through the Smoot-Hawley Tariff of 1930, and that a discounting mechanism had been available to cope

18. See Hubert D. Henderson, *The Inter-war Years and Other Papers*, Clarendon Press, Oxford, 1955, pp. 236–95.

19. ibid., pp. 236 and 290.

20. ibid., pp. 260 and 262; see also p. 291: 'Of the various expedients which different governments employed in the 1930s, none produced more unfortunate results than deliberate exchange depreciation. It was the least helpful to the countries which tried it, and the most harmful to other countries.'

21. ibid., p. 293.

with 1931. There would still have been a serious depression, if perhaps not so prolonged, owing to the failure of counter-cyclical lending, and the absence of machinery such as the World Bank or foreign aid coordinated through the Development Assistance Committee (D.A.C.) of the Organization of Economic Cooperation and Development (O.E.C.D.), to replace the private market with public funds. It remains puzzling that the foreign capital market in New York (and to a much lesser degree in London) started to come back in the spring of 1930, after the stock-market crash, and then relapsed. There was no panic, and no alarm, but 'people felt the ground giving way under their feet'.[22] Arthur Lewis's explanation of the relapse in terms of the decline of prices is perhaps not wholly satisfactory, nor is the 'inexperience' of the New York capital market in international lending. They are all that is available. Even with anti-cyclical capital movements, there would have been a depression. With a flow of international capital positively correlated with business conditions in the lending country, the depression was inevitably severe. Add to this position, which was perhaps beyond the power of policy to correct in the existing state of knowledge, beggar-thy-neighbour tactics in trade and exchange depreciation, plus the unwillingness of the United States to serve as a lender of last resort in 1931, and the length and depth of the depression are explained.

There is one respect in which United States 'inexperience' in lending might be said to be relevant to the pattern of lending. A new lender is likely to behave differently from an old lender because of the wider array of investment opportunities available to it. Consider a country which has been long engaged in international investment. Its foreign loans are likely to follow what may be called a 'demand model', in which a given flow of savings is allocated between domestic and foreign uses depending upon the relative demands from them. A domestic boom diverts foreign loans to the home market. Depression at home and expansion abroad stimulates foreign lending. The result is a counter-cyclical pattern.

22. Joseph A. Schumpeter, *Business Cycles, A Theoretical, Historical and Statistical Analysis of the Capitalistic Process*, vol. II, McGraw-Hill, New York and London, 1939, p. 911.

When a country begins lending abroad for the first time, however, there are likely to be a host of unfilled opportunities for foreign loans. As savings become available, they are invested at home and abroad, simultaneously. The more profits at home in boom, the more foreign investment. This is a 'supply model', in which foreign lending depends on the availability of savings. Alteration between demand and supply models is evident in direct foreign investment. That it may apply to lending through foreign bonds is only a hypothesis. It would, however, explain why United States lending at the beginning of its career as a creditor was positively correlated with the domestic business cycle, whereas in Britain, the experienced lender, the pattern had been otherwise.

Relevance to the 1970s

Leadership is a word with negative connotations in the 1970s when participation in decision-making is regarded as more aesthetic. Much of the overtones of *der Führer* and *il Duce* remain. But if leadership is thought of as the provision of the public good of responsibility, rather than exploitation of followers or the private good of prestige, it remains a positive idea. It may one day be possible to pool sovereignties to limit the capacity of separate countries to work against the general interest; such pooling is virtually attained today in some of the functions needed to stabilize the world economic system, such as the Basle arrangements for swaps and short-term credits which, pending a world central bank, serve as a world rediscounting mechanism in crisis. In this area, and in the world agencies for maintaining freer trade and a liberal flow of capital and aid, however, leadership is necessary in the absence of delegated authority. That of the United States is beginning to slip. It is not yet clear that the rising strength of Europe in an enlarged European Economic Community will be accompanied by an assertion of leadership in providing a market for distress or aggressive goods, in stabilizing the international flow of capital or in providing a discount mechanism for crisis. Presumably the Basle arrangements for the last will endure. There are indications that the European market for goods

will remain ample, except in agriculture, which is an important exception from a world viewpoint. There is still some distance to go to stabilize the flow of capital counter-cyclically.

As the United States economic leadership in the world economy falters, and Europe gathers strength, three outcomes are politically stable; three unstable. Among the stable outcomes are continued or revived United States leadership, after the exchange controls of 1963 to 1968 and the 1970–71 wave of protectionism have been reversed; an assertion of leadership and assumption of responsibility for the stability of the world system by Europe; or an effective cession of economic sovereignty to international institutions: a world central bank, a world capital market, and an effective General Agreement on Tariffs and Trade. The last is the most attractive, but perhaps, because difficult, the least likely. As between the first two alternatives, the responsible citizen should be content with either, flipping a coin to decide, if the third alternative proves unavailable, simply to avoid the undesirable alternatives.

The three outcomes to be avoided because of their instability are: (a) the United States and the E.E.C. vying for leadership of the world economy; (b) one unable to lead and the other unwilling, as in 1929 to 1933; and (c) each retaining a veto over programmes of stability or strengthening of the system without seeking to secure positive programmes of its own. The articles of agreement of the International Monetary Fund (I.M.F.) were set up to provide the United States with a veto over action which it opposed. In the 1969 reform which legislated the addition of Special Drawing Rights (S.D.R.s) to the monetary system, quotas of I.M.F. were adjusted to provide a veto to the E.E.C. as well. This leaves open the possibility of stalemate, as in the United Nations Security Council, when two major powers are unable to agree. In the circumstances of the Security Council there is a danger of regressive spiral into war; the analogue in the economic field is stalemate, and depression.

In these circumstances, the third positive alternative of international institutions with real authority and sovereignty is pressing.