Monetary Regimes of the Twentieth Century

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CAMBRIDGE
UNIVERSITY PRESS

PUBLISHED BY THE PRESS SYNDICATE OF THE UNIVERSITY OF CAMBRIDGE
The Pitt Building, Trumpington Street, Cambridge CB2 1RP, United Kingdom

CAMBRIDGE UNIVERSITY PRESS
The Edinburgh Building, Cambridge, CB2 2RU, UK http://www.cup.cam.ac.uk
40 West 20th Street, New York, NY 10011-4211, USA http://www.cup.org
10 Stamford Road, Oakleigh, Melbourne 3166, Australia

First published 2001

Printed in Great Britain at the University Press, Cambridge

A catalogue record for this book is available from the British Library

ISBN 0 521 80169 9 hardback

Abstract economic theory may be timeless and potentially universal in its application, but macroeconomics has to be seen in its historical context. The nature of the policy regime, the behaviour of the economy and the beliefs of professional economists all interact, and influence each other. This short historical account of monetary regimes since 1900 shows how the role of policy has changed, and how this has related to experience of inflation and the real economy, as well as to changes in political philosophies.

The narrative concentrates on developments in America, Britain, Germany, France and Japan. It begins with the era of the classical gold standard and ends with the 'neo-liberal' regimes of today. The decades in between saw much more active policy intervention, and much less faith in the stability of markets. The 'grand narrative' of the century is a journey 'to Utopia and back'. It is argued that no school of macroeconomics is right for all time; different theoretical models may be appropriate for different periods and regimes.

ANDREW BRITTON has been a Visiting Professor at the University of Bath since 1998. He was Director of the National Institute of Economic and Social Research between 1982 and 1995, when he left to join the Churches' Enquiry into Unemployment and the Future of Work. His other books include *Macroeconomic Policy in Britain 1974–1987*, *The Goal of Full Employment* and *The Trade Cycle in Britain, 1958–1982*.

THE NATIONAL INSTITUTE OF
ECONOMIC AND SOCIAL RESEARCH
XLII

2 DEAN TRENCH STREET, SMITH SQUARE, LONDON, SW1P 3HE

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Preface

The turn of the century seems an appropriate time for reflection, interpreting the past so as to imagine the shape of the future. Often, in my career at the Treasury and at the National Institute I have tried to give an account of economic events in one country, in one year, or even in one month. But it is impossible to make sense of the detail unless one has some conception of the broader pattern to which it belongs. This book is my attempt to make that conception explicit.

Writing this book has been one of the most congenial tasks that I have set myself since I retired from the post of Institute director. I am very grateful to my successor, Martin Weale, for encouraging me to take it up, and providing assistance essential to carrying it out. I have been able to make full use of the Institute's library, including the many fascinating old books and periodicals hidden away in the basement. I am very grateful to Claire Schofield, the Institute's librarian, for her help in obtaining research material from this and other sources. One of my happiest hunting grounds was the library of the Bank of England; I would particularly like to thank Howard Picton for enabling me to make the most of that valuable collection.

Whilst working on this project, I was also, amongst other things, a visiting professor at the University of Bath. I was able to use draft chapters of the book as the basis for lectures to MBA students. I believe that they found both the historical perspective and the global context valuable to understanding economic conditions today. I am thankful for the encouragement that they gave me.

My warm thanks are also due to friends and colleagues who read my text in draft and commented on it: Martin Weale, Charles Goodhart and (especially) John Flemming. Responsibility for the finished product is, of course, my own. And, finally, I am very grateful also to Fran Robinson,

who has done an excellent job in preparing the text for publication, as she has done for the other books that I have written for the Institute over the years.

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Introduction: economics and history

This is a book about both history and economics. As a history book, it describes, in chronological order, the main monetary 'events' of the twentieth century, concentrating on the five major economies – the United States, the United Kingdom, Germany, France and Japan. The century is divided into eight periods of ten to fifteen years, and a chapter is devoted to each of them. Each chapter begins with a section that describes the behaviour of the major economies in respect of inflation, output growth, unemployment and interest rates.

A very broad overview of the century is provided by figures 1–4 at the end of this introduction (pp. 21–2).

> At the beginning of the century inflation was low everywhere. In both world wars, and immediately after them, it was high, sometimes very high indeed. Between the wars it was sometimes negative. In the latter half of the century it was persistent, but not explosive. Towards the end of the century it was again generally low.
>
> Growth rates varied greatly from year to year in the first half of the century. In the interwar period, output fell continuously for four years in America. There were recessions in the latter half of the century as well, but they were not so long, or so deep.
>
> The peak rate of unemployment in the 1930s was much higher in America (and in Germany) than it was in Britain. Full employment was maintained in Europe for a generation after the Second World War. In the last two decades of the century, however, the rate was persistently higher in Europe than in the USA.
>
> Interest rates remained low throughout the first half of the century, showing far less variation than there was in rates of inflation.

In the second half, on the other hand, they rose almost continuously for about thirty years, reaching double figures, before turning sharply down again.

These will be some of the story lines running right through this book. Whilst the meaning of the statistics does change from one period to another, it is often helpful to see the events of each decade, or regime, in the context of the longer-term trends.

The history of monetary regimes cannot properly be considered except in a broader political context. In each of the chapters, a second section will describe the evolution of economic policy in general, and of monetary policy in particular. The story is not quite the same in every country, but the broad trends are similar. There were relatively 'liberal' or 'free-market' regimes at the beginning and again at the end of the century, with relatively 'interventionist' or 'planned' regimes in between.

One cannot discuss the domestic policy regimes of nation states without considering how their external relations were conducted. The third section of each chapter is devoted, therefore, to international monetary systems. The first chapter describes the gold standard as it operated at the start of the century; the final chapter focuses on the formation of the European Monetary Union. In the intervening chapters some account is given of the turmoil between the world wars, of the Bretton Woods system from the 1940s to the 1960s, and of the subsequent experience with more or less freely floating exchange rates.

This is also a book about economics. It is about the interrelation between economic behaviour and the character of the monetary regime. There is, it will be argued, no general theory of macroeconomics which is independent of politics, social institutions and beliefs. One cannot, therefore, choose between alternative monetary regimes on the basis of 'the economic arguments' alone. A fourth section of each chapter will illustrate this interrelationship for each period and each policy regime. The remainder of this introduction will develop some related themes. It will look at the connections between economics and history from a number of different angles.

To Utopia and back

At the beginning of the twentieth century the freedom of action of central banks was constrained by the commitment to convert their currencies freely into gold. At the end of the century they were again inhibited by the need to maintain confidence in international capital markets. But in the middle decades of the century monetary regimes were of a quite different character. Monetary policy was one element in a scientifically designed strategy intended to maximise the economic well-being of an independent nation state. We have been to Utopia and back again.

In his introduction to the history of the world economy over these hundred years, Robert Skidelsky (1998) distinguishes four phases: 'liberal market (1900–13), autarkic (1914–50), managed market (1950–73) and neo-liberal (since 1973)'. In his conclusions he refers to the 'remarketization of economic life' in the closing years of the century as 'a modest movement back towards the world with which the century opened'. From a British perspective the phases are particularly easy to recognise, especially the sharp contrast between the role played by the state in the economy before and after the Second World War, and again before and after the change of government in 1979. But broadly the same grand narrative can be used to shape the history of America or western Europe, and indeed of the world as a whole. The sequence of monetary regimes, both national and international, relates to an accompanying succession of institutional and social developments.

The grand narrative tells how the nation state took increasing responsibility for the stability and prosperity of the national economy for a period of about sixty years, and then progressively abandoned that responsibility over the next forty years or so. The story can be told as a tragedy. Two generations of political leaders, public servants and applied economists overcame dark forces of ignorance and self-interest. They created, in the mixed economies of the mid-century, a system of economic management which gave the world a period of unprecedented prosperity. Then, perhaps because of some flaw in social organisation, or in human nature itself, their work was destroyed. The next two generations were unable, or unwilling, to sustain the system which gave us the 'golden age', and it fell apart.

Another way of telling the story is to condemn the attempt to manage economies as a dangerous attack on individual liberty. It was an attempt to copy the deceptive early achievements of economic planning and control in the totalitarian systems of Russia and Germany. The attempt to build the 'Great Utopia', as Hayek (1944) described it, was simply 'the Road to Serfdom'. It might be inspired by high ideals to begin with, but sooner or later 'the worst get on top'. The high road of human progress did not, on this view, lead through the regimes which were constructed in the middle years of the century. All that was just a diversion which led nowhere. It was necessary to retrace our steps.

It is not the purpose of this study to offer support to either side in this clash of ideals and historical interpretations, but it is important to recognise the strong feelings which lie just below the surface of much academic debate. Economics may seem to be a detached and scientific discipline, but it seldom is or has been. The history of economic thought can be seen as itself part of the same grand narrative. It justified successive changes of monetary, and indeed economic and political, regime. It supported – often tacitly – the values, and indeed the material interests, of some groups in society against others. The Keynesian revolution from the 1930s to the 1960s, and the counter-revolution which followed, were both expressions of changing political philosophies as well as shifts in the accepted explanatory paradigm. New evidence certainly played a part in changing the beliefs of economists, but what happened in economics cannot be fully understood in isolation from the political environment of the times.

It might seem therefore that economic history cannot be written without taking sides in the great controversies of political economy. One cannot avoid the need for a theoretical framework when describing economic behaviour and the consequences of monetary regimes. A mere catalogue of events would be superficial, and probably not in fact free from bias. Does one not therefore need at the outset to declare oneself a conservative or a radical? The contention of this study is that one can, and should, avoid making such a choice. Many different theories of behaviour may all be valid, each in the interpretation of a different regime. For example, classical economics may be appropriate to describe behaviour under a liberal regime, whilst what was called 'modern' economics may be right for a managed economy. Perhaps neither would qualify as a truly 'general' theory.

Macroeconomics and history

Clearly, there is a methodological question here of some importance, concerning the relationship of history and theory in economics. It was very familiar to students of the subject a hundred years ago and is not finally settled even now. There is an extensive discussion by J.N. Keynes (1891) (the father of the better known son). The historical school, especially in Germany, maintained that each country and each historical period had its own laws of economic behaviour, depending on its methods of production, its social structure and its institutions. The interesting questions to study concerned economic development and institutional change. The analytical school, on the other hand, in particular the British neoclassicals, sought to build economic theory on axioms of individual rationality which were supposed to be of general application. So-called 'economic man' is a model of human nature itself, not just of members of our own culture and society. It has been, in the main, the analytical approach which has prevailed. So far as what we now call 'microeconomics' is concerned, this may well be for the best, and this was what interested economists most at the start of the century, but it is a different matter when the focus is on what we now call 'macroeconomics'.

J.N. Keynes did recognise that social beliefs and interactions can influence economic behaviour, despite his general support for the axiomatic approach. Two examples that he gives are particularly relevant to this study, because they refer to two phenomena of particular concern for the design of monetary regimes, that is inflation and financial crises. The passage is worth quoting at length:

> Even in the case of a purely monetary question, such as the circumstances determining the amount of depreciation of an inconvertible currency, an important consideration may be the extent to which a people's distrust is aroused, and this in its turn may depend partly on their political sympathies, and on their knowledge and intelligence, or on the extent to which their power of moral restraint prevents them giving way to unreasoning panic. This last point is still more clearly important in connection with the phenomena that constitute a financial crisis. The theory, for example, of the recurrence of such crises at regular intervals, so far as it does not involve the operation of physical causes (as in Jevons' sun-spot theory), may require to be modified according to the stage of a nation's intellectual and moral development. (pp. 134–5)

The crucial question that faced macroeconomists in the twentieth century was the stability of the market system. Could the economy safely be left to stabilise itself? Or did the monetary authorities need to intervene, occasionally or all the time? Theory could point to mechanisms which should preserve or restore equilibrium. But how generally applicable was that theory? The evidence of the turbulent interwar years was that the system was fragile, or sluggish, or unreliable. How relevant was the experience of that period to others? If we are to gain a deeper understanding we must look at institutional change, at the framework of law and at the common beliefs which underlie the choices of individuals. This historical approach to macroeconomics may not result in many straightforward testable predictions, but it is nevertheless indispensable.

If we think of individual behaviour as rational and calculating, then it is clear enough that the nature of the monetary regime will affect behaviour. This is the favoured approach of present-day monetary theory, taking the theory of choice under uncertainty as its starting point. It follows that influencing rational expectations is the essence of monetary policy. A credible commitment to a fixed exchange rate, for example, will encourage stabilising capital flows. There will be little need for actual market intervention by government or central bank, because currency traders and speculators will anticipate such action. Similarly, a credible commitment to a money-supply target will discourage wage increases that are potentially inflationary. A credible commitment by government to maintain full employment may also encourage firms to initiate investment projects even in a time of recession. In all these cases rational individual behaviour will tend to preserve and validate the regime.

Commentators often use the more elusive concept of market 'confidence'. This is not just another word for expectations. It is a state of mind as well as a view of the future. It may be particularly significant when views of the future are most difficult to form rationally. Under great uncertainty people have to put their trust in something, even when they do not have the information on which an estimate of probabilities might be based. Confidence is not just an individual conviction; it is a shared belief, reinforced much of the time by social contact.

The ability to think rationally was seen by J.N. Keynes as a mark of moral development, the ability to keep one's head. But, if so, there has been little development since his time. Markets can still behave like herds of cattle or flocks of birds. Economists are reluctant to introduce crowd behaviour into their theories of economic behaviour, but clearly it is crucial to the understanding of events such as bank failures or stock market booms. It may also be important to the explanation of business cycles, and to the success or failure of monetary regimes. We shall keep an open mind.

A liberal regime is more likely to be viable if people believe that it is so, if people read neoclassical economists and trust central banks to observe the rules of the game. Equally a managed regime is viable, and indeed necessary, if people have been taught to rely on government intervention to keep the economy on course. It might seem, then, that whichever monetary theory is generally believed becomes, in that context, correct. This is too simple and too sweeping a conclusion. The relationship between the behaviour of the economy and the choice of monetary regime is more complex than that. It involves institutions as well as beliefs.

Clearly the behaviour of an economy must reflect its social organisation. For example, the equilibrium level of unemployment may depend on