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The Heyday of the Gold Standard, 1820-1930

1925 July

"The Economic Consequences of Mr. Churchill": John Maynard Keynes published a broad-ranging attack on Britain's return to the gold standard in 1925 in which he argued that Britain had returned to the gold standard at too high a parity. He suggested that committing to the pre-war parity would ultimately prove deflationary with deleterious consequences for employment and growth. In this excerpt, Keynes rejects the financial community's unanimity in favor of a return to the gold standard, a consensus of opinion that is illustrated in several of the immediately previous documents. Keynes' analysis proved prescient.

WHAT MISLED MR. CHURCHILL

The arguments of Chapter I are not arguments against the Gold Standard as such. That is a separate discussion which I shall not touch here. They are arguments against having restored gold in conditions which required a substantial readjustment of all our money values. If Mr. Churchill had restored gold by fixing the parity lower than the pre-war figure, or if he had waited until our money values were adjusted to the pre-war parity, then these particular arguments would have no force. But in doing what he did in the actual circumstances of last spring, he was just asking for trouble. For he was committing himself to force down money-wages and all money-values, without any idea how it was to be done. 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.

His experts made, I think, two serious mistakes. In the first place I suspect that they miscalculated the degree of the maladjustment of money values, which would result from restoring sterling to its pre-war gold parity, because they attended to index numbers of prices which were irrelevant or inappropriate to the matter in hand. If you want to know whether sterling values are adjusting themselves to an improvement in the exchange, it is useless to consider, for example, the price of raw cotton in Liverpool. This must adjust itself to a movement of the exchange, because, in the case of an imported raw material, the parity of international values is necessarily maintained almost hour by hour. But it is not sensible to argue from this that the money wages of dockers or of charwomen and the cost of postage or of travelling by train also adjust themselves hour by hour in accordance with the foreign exchanges. Yet this, I fancy, is what the Treasury

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did. They compared the usual wholesale index numbers here and in America, and—since these are made up to the extent of at least two-thirds from the raw materials of international commerce, the prices of which necessarily adjust themselves to the exchanges—the true disparity of internal prices was watered down to a fraction of its true value. This led them to think that the gap to be bridged was perhaps 2 or 3 per cent., instead of the true figure of 10 or 12 per cent., which was the indication given by the index numbers of the cost of living, of the level of wages, and of the prices of our manufactured exports—which indexes are a much better rough-and-ready guide for this purpose, particularly if they agree with one another, than are the index numbers of wholesale prices.

But I think that Mr. Churchill's experts also misunderstood and underrated the technical difficulty of bringing about a general reduction of internal money values. When we raise the value of sterling by 10 per cent., we transfer about £1, 000, 000, 000 into the pockets of the rentiers out of the pockets of the rest of us, and we increase the real burden of the National Debt by some £750, 000, 000 (thus wiping out the benefit of all our laborious contributions to the Sinking Fund since the war). This, which is bad enough, is inevitable. But there would be no other bad consequences, if only there was some way of bringing about a simultaneous reduction of 10 per cent, in all other money payments; when the process was complete, we should each of us have nearly the same real income as before. I think that the minds of his advisers still dwelt in the imaginary academic world, peopled by City Editors, members of Cunliffe and Currency Committees et hoc genus omne, where the necessary adjustments follow "automatically" from a "sound" policy by the Bank of England; the theory is that depression in the export industries, which are admittedly hit first, coupled if necessary with dear money and credit restriction, diffuse themselves evenly and fairly rapidly throughout the whole community. But the professors of this theory do not tell us in plain language how the diffusion takes place.

Mr. Churchill asked the Treasury Committee on the Currency to advise him on these matters. He declared in his Budget speech that their Report "contains a reasoned marshalling of the arguments which have convinced His Majesty's Government." Their arguments—if their vague and jejune meditations can be called such—are there for anyone to read. What they ought to have said, but did not say, can be expressed as follows:

"Money-wages, the cost of living, and the prices which we are asking for our exports have not adjusted themselves to. -' the improvement in the exchange, which the expectation of your restoring the Gold Standard, in accordance with your repeated declarations, has already brought about. They are about 10 per cent, too high. If, therefore, you fix the exchange at this gold parity, you must either gamble on a rise in gold prices abroad, which will induce foreigners to pay a higher gold price for our exports, or you are committing yourself to a policy of forcing down money wages and the cost of living to the necessary extent.

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"We must warn you that this latter policy is not easy. It is certain to involve unemployment and industrial disputes. If, as some people think, real wages were already too high a year ago, that is all the worse, because the amount of the necessary wage reductions in terms of money will be all the greater.

"The gamble on a rise in gold prices abroad may quite likely succeed. But it is by no means certain, and you must be prepared for the other contingency. If you think that the advantages of the Gold Standard are so significant and so urgent that you are prepared to risk great unpopularity and to take stern administrative action in order to secure them, the course of events will probably be as follows.

"To begin with, there will be great depression in the export industries. This, in itself, will be helpful, since it will produce an atmosphere favourable to the reduction of wages. The cost of living will fall somewhat. This will be helpful too, because it will give you a good argument in favour of reducing wages. Nevertheless, the cost of living will not fall sufficiently and, consequently, the export industries will not be able to reduce their prices sufficiently, until wages have fallen in the sheltered industries. Now, wages will not fall in the sheltered industries, merely because there is unemployment in the unsheltered industries. Therefore, you will have to see to it that there is unemployment in the sheltered industries also. The way to do this will be by credit restriction. By means of the restriction of credit by the Bank of England, you can deliberately intensify unemployment to any required degree, until wages do fall. When the process is complete the cost of living will have fallen too; and we shall then be, with luck, just where we were before we started.

"We ought to warn you, though perhaps this is going a little outside our proper sphere, that it will not be safe politically to admit that you are intensifying unemployment deliberately in order to reduce wages. Thus you will have to ascribe what is happening to every conceivable cause except the true one. We estimate that about two years may elapse before it will be safe for you to utter in public one single word of truth. By that time you will either be out of office, or the adjustment, somehow or other, will have been carried through."

Source: Keynes, John M. 1925. The Economic Consequences of Mr. Churchill, (London: XXX), pp. 10-13.