PRINCETON STUDIES IN INTERNATIONAL FINANCE
No. 48, September 1981

Sterling and the Tariff, 1929-32

Barry J. Eichengreen

INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS
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PETER B. KENEN, *Director*
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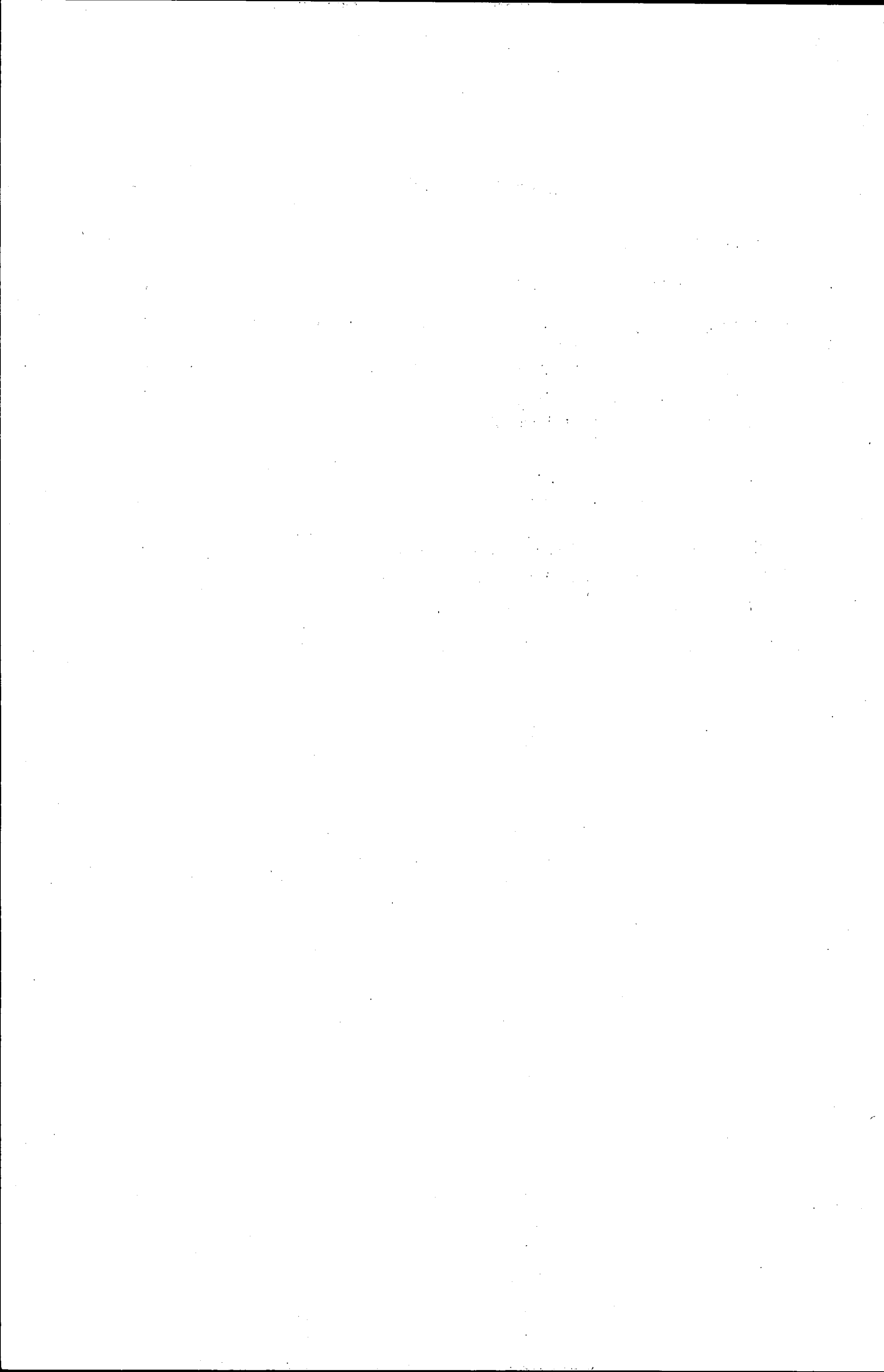

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1 INTRODUCTION

In February of 1932, less than six months after leaving the gold standard, Great Britain adopted a 10 per cent *ad valorem* tariff on imports from foreign countries.[1] For nearly two years, a number of politicians and economists had argued that Britain should abandon her traditional commitment to free trade and impose a general tariff, initially as a means of reducing unemployment and raising prices without driving herself off the gold standard, and later as a way of balancing her external accounts in order to defend the gold standard directly. Yet it was only *after* Britain was forced off the gold standard in September of 1931 by a combination of domestic and foreign events, and a floating exchange rate was adopted, that a general tariff was finally imposed.

With the demise of the gold standard, a tariff would seem to have retained no special advantage over increased public spending, a reduction in Bank rate, or other remedies for domestic unemployment. Furthermore, with the adoption of a floating exchange rate, there was a sense in which there no longer remained a balance-of-payments "problem."[2] Thus, the decision to impose a tariff in 1932 has remained an unsolved mystery in the history of British economic policy.

Some historians have argued that this decision was ill-conceived and counterproductive. For example, Drummond (1974, pp. 178-179) writes:

> As Professor Mundell has shown, when a country has a floating exchange rate a new tariff is likely to be contractionary—that is, it will

[1] The standard nominal rate of protection was quickly raised to 20 per cent. Effective rates varied widely (see Capie, 1978). It has been estimated that between 1930 and 1932 the percentage of British imports entering duty-free declined from 83 to 25 (see Pollard, 1969, p. 197). Duty-free imports under the Import Duties Act of 1932 included most Empire exports and raw materials.

[2] Even with a floating exchange rate, however, Britain continued to intervene in the foreign-exchange market in the 1930s. While sporadic at first, this intervention became systematic once the establishment of the Exchange Equalisation Account relieved the Bank of England of the obligation to buy and sell foreign exchange on its own account. The EEA, endowed initially with £175 billion, held a portfolio composed of gold, foreign exchange, and British Treasury bills. These assets were controlled by the Treasury, but day-to-day operations were undertaken by the Bank of England on the Treasury's behalf (see Sayers, 1976, and Howson, 1980a, 1980b). For purposes of the present argument, however, the important fact is that the exchange rate did float.

increase the number of unemployed, reducing national output and income, other things being equal. . . . The National Government itself believed that it was following an anti-unemployment policy. With respect to its own goals, therefore, we must find its measures inconsistent.[3]

According to this view, at the very time when their concern with unemployment reached its peak, British policy-makers adopted the one policy guaranteed to make unemployment even worse. Their decision is seen as an undiscerning action—an example of the British tendency, when two courses have long been urged, to adopt both (see Skidelsky, 1967).[4]

This Study tells the story of the circumstances leading to the imposition of the General Tariff of 1932 and offers a new explanation for its adoption.

It is argued here that the General Tariff was not imposed as an anti-unemployment policy but rather as an attempt to strengthen the trade balance and prevent the exchange rate from depreciating excessively. Policy-makers were not convinced that Britain's departure from the gold standard had solved the balance-of-payments problem. They had little faith in the curative power of flexible exchange rates. Specifically, they feared that exchange-rate depreciation would set off a "vicious spiral" of inflation, wage increases, and further depreciation, with no improvement in the external accounts. The General Tariff was designed to accomplish what exchange-rate depreciation would not: the restoration of external balance.

Uneasiness about the stability and corrective power of a floating exchange rate was not the only influence behind the decision to impose the General Tariff in 1932. Special interest groups also affected the outcome, and objectives such as the promotion of imperial preference and "rationalisation" in key industries shaped the tariff's structure. (On these questions, see Capie, 1979, and Drummond, 1974.) Party, ideology, and personality determined how politicians responded to the pressures that were applied, and other authors have emphasized factors such as these (see e.g. Drummond, 1972, 1974; Abel, 1945; Lowe, 1942; and Tiwari, 1942). This Study emphasizes instead the role of the exchange-rate regime in the debate over tariff protection as macroeconomic policy. In contrast to most

[3] For an analysis of the generality of Mundell's result, see Eichengreen (forthcoming).

[4] Drummond's assessment is cited in Howson and Winch (1977, p. 97).

previous studies, which conclude that the British authorities' adoption of the tariff was a misguided employment policy, the evidence presented here suggests that the authorities' distrust of the effects of a floating exchange rate formed the basis for their decision to impose the General Tariff in 1932.

2 COMMERCIAL POLICY AND THE GOLD STANDARD, 1929-31

By 1929 Britain had endured nearly a decade of sustained unemployment at levels unprecedented in the twentieth century. In every year between 1921 and 1929, the number of workers recorded as unemployed exceeded one million, a level that had been reached only three times in the first twenty years of the century. While figures for the unemployment rate are not directly comparable across decades, the probability of being unemployed in the 1920s appears to have been at least twice as high as it was during the preceding twenty years. The persistence of unemployment can be traced, at least in part, to the decision to return to the gold standard in 1925, which saddled the economy with high interest rates and falling prices, and to the reduced flexibility of wages that characterized the British economy in the 1920s.[1]

Proposals for reducing the level of unemployment by expansionary monetary policy and large-scale public works programs were advanced outside the Government but were rejected by the authorities. In 1923, when the Conservatives advocated the imposition of a tariff as a response to the unemployment problem, the party suffered such a decisive electoral defeat that it compaigned thereafter on the basis of a pledge not to impose new duties.[2]

When the second Labour Government took office under Prime Minister Ramsay MacDonald in June of 1929, the British economy finally appeared to have embarked on the road to recovery. The percentage of insured persons registered as unemployed had fallen from 12.2 to 9.6 since the beginning of the year. The value of total imports and exports was rising, while the level of retail prices and

[1] Statistics are drawn from London and Cambridge Economic Service (n.d., pp. 8, 20). On the debate over the causes of interwar unemployment, see Keynes, "The Economic Consequences of Mr. Churchill" (1925), reprinted in Keynes (1963, pp. 244-270), and Sayers (1970, pp. 85-98). For a recent contribution that argues that the dole played an important part in interwar unemployment, see Benjamin and Kochin (1979).

[2] On a number of occasions, Keynes advocated public works or expansionary monetary policy (see Keynes, 1924, Chap. IV, and Keynes and Henderson, 1929). The Bank of England's view is expressed by Governor Norman in his 1930 Macmillan Committee evidence, reprinted in Einzig (1932, pp. 179-255). Recent analyses include Moggridge (1972); Howson (1975); and Sayers (1976). On the Treasury view of public works, see Hawtrey (1925). Academic opinion is analyzed by Hancock (1960; 1962). For details on the 1923 General Election, see Middlemas and Barnes (1969).

the Bank of England's gold and foreign-exchange reserves appeared to be holding steady.

Initially, the members of the Labour Cabinet were united in their opposition to a tariff. They considered protection to be a regressive method of indirect taxation that would impoverish the working class. Free trade symbolized the Labour movement's commitment to internationalism and was justified by the principles of classical political economy. The most committed freetrader was Philip Snowden, who based his views on moral, intellectual, and political precepts. The Government's initial attitude toward the tariff question was signaled by the appointment of Snowden as Chancellor of the Exchequer, and of Snowden's disciple Willie Graham as President of the Board of Trade. The Government announced that it would not consider applications for protection, nor would it renew the safeguarding duties, which had been imposed in 1921 to shelter a limited number of key industries against foreign competition. Instead, the Government put its faith in a campaign for an international tariff truce. Graham submitted to the League of Nations a proposal for a two-year moratorium on commercial initiatives, to be followed by a round of multilateral tariff reductions. The final version of this plan that emerged from Geneva, however, was highly diluted, and by the time the Cabinet at last agreed upon ratification, rapidly deteriorating economic conditions had destroyed foreign support for the truce.[3]

The subsequent development of Labour attitudes toward protection was influenced by a variety of individuals, among the most prominent of whom was John Maynard Keynes. While one must take care not to exaggerate the impact of Keynes's views, since in some quarters they were received with considerable skepticism, Keynes frequently dominated the deliberations of the Government's economic advisors, and he had the ear of the Prime Minister. Furthermore, the way in which his views on the tariff question evolved is representative of the response of other influential economists to changing economic conditions.

For much of the Labour Government's term in office, Keynes was

[3] See the file entitled "Tariff Truce," Public Record Office, T 172/1713, March 1930. (In succeeding references to materials in the Public Record Office in London, "Cab" denotes Cabinet papers and "T" denotes Treasury records. They are followed by the call number of the file.) See also Graham (1948); League of Nations (1942); and Janeway (1971).

the principal advocate of innovative policies for dealing with Britain's economic problems. When he first came to advise the Labour Government, he was widely perceived as a proponent of free trade, a reputation he had acquired as a result of his activities during the 1923 General Election. In an article published that year in the *Nation and Athenaeum* (Dec. 1, p. 336), Keynes distinguished between a tariff's ability to stimulate production in protected industries and its inability to influence the overall level of activity. His analysis was based upon the classical presumption that, under full employment, any reduction in import demand will be offset by a fall in export supply. In a remark that returned to haunt him in 1930, Keynes labeled the claim that a tariff can be used for employment purposes "the Protectionist fallacy in its grossest and crudest form."[4]

It was the recognition that the British economy was behaving differently in 1930 than it had in 1923 that led Keynes to modify his position on the tariff question. Keynes's first rehearsal of his new espousal of tariff protection came in his private evidence before the Macmillan Committee in February of 1930.[5] This Committee, set up to carry out Labour's electoral pledge to investigate the relations between finance and industry, heard Keynes present a variety of unconventional proposals for dealing with unemployment. These included import duties, export bounties, import boards (to be empowered to issue import licenses), tax cuts, public investment, subsidies on private investment, an embargo on foreign loans, and bold action by the Bank of England to lower interest rates. These proposals reflected the conclusions to which Keynes had been drawn while putting the finishing touches on his *Treatise on Money*.[6] To the bankers, industrialists, and labor leaders who made up the Macmillan Committee, Keynes explained that output responded to changes in the ratio of prices to costs, which in turn depended on the relationship of saving to investment. Britain's economic malaise could be traced to the high interest rates that the Bank of England maintained to

[4] For Lionel Robbins's subsequent resurrection of Keynes's 1923 views, see "Answers by Professor L. Robbins to Questionnaire Prepared by the Chairman," Cab 58/150 EAC (E.)13, Sept. 23, 1930. Keynes's own reflections on his 1923 views appear in Keynes (1936, p. 334).

[5] The report of the Committee on Finance and Industry (1931), Cmd. 3897, was almost two years in appearing. Keynes's Macmillan Committee evidence is contained in T 200/4 and T 200/6.

[6] When the *Treatise* finally appeared later in 1930, it, too, contained an admission that the author was coming around to the view that it might be advisable to use commercial policy to reduce unemployment (Keynes, 1930, Vol. II, p. 189).

defend the gold value of sterling. High interest rates encouraged saving and depressed investment. High levels of saving reduced the demand for consumer goods, while low levels of investment depressed the demand for producers' goods. The result was downward pressure on commodity prices, which, in conjunction with the limited flexibility of wages, gave rise to unemployment.[7] Each of Keynes's proposals was designed to stimulate employment by raising investment relative to saving. A tariff, for example, would increase domestic profits and improve Britain's trade balance, enabling the Bank of England to reduce Bank rate and thereby stimulate investment without undermining the stability of the exchange rate.

The limited flexibility of wages was a critical component of Keynes's analysis. In his view, the single most significant change in the structure of the British economy was in the labor market's response to price changes. While wages had been far from fully flexible in a downward direction in previous decades, it appeared that the degree of flexibility had declined over the course of the 1920s. Between 1921 and 1922, wages and prices both fell by more than 20 per cent, in part because 55 per cent of all wage reductions that took place in 1921 and 38 per cent of those occurring in 1922 were a result of sliding-scale agreements of the sort adopted during the war. Thereafter, however, indexation fell out of favor, and by 1930 Keynes recognized that the flexibility of the economy in general and the labor market in particular had somehow been reduced. Wage reductions could be achieved only "as a result of a series of struggles ensuing on business losses and unemployment."[8] This rigidity of wages was a source of unemployment that warranted governmental action. One possible response was the imposition of a tariff, which could stimulate employment by raising prices relative to wages.

Two aspects of Keynes's Macmillan Committee evidence are relevant to the tariff debate. First, his support for a tariff was extremely hesitant. Although firmly convinced that there was a case for tariff protection as short-run employment policy, Keynes described himself as "frightfully afraid of Protection as a long run policy" (T 200/4,

[7] The *Treatise* framework is analyzed in detail in Moggridge (1975) and Patinkin (1976). But see also Robinson (1975, pp. 124-125). Keynes's fullest exposition of the framework came before the Macmillan Committee on Feb. 21, 1930 (see T 200/4, especially pp. 38-46).

[8] Although much British unemployment was related to international problems, Keynes still attributed a "large residium [to] the greediness of the factor of labor" (see T 200/6, Sept. 21, 1930, p. 1).

Mar. 6, 1931, p. 2). He warned of the danger that a temporary tariff would become permanent, entrenching inefficient firms behind high protective barriers. Eventually, Keynes came to downplay his fears about a tariff's long-term effects, but many who were otherwise convinced by his arguments retained reservations on precisely these grounds.

A second, and striking, aspect of Keynes's evidence was his rejection of devaluation as a solution to the unemployment problem. Although Keynes had opposed Britain's return to the gold standard in 1925, arguing that the proper target for monetary policy was internal price stability rather than exchange-rate stability, in 1930 he was unwilling to recommend going off gold (T 200/4, Feb. 21, p. 29).[9] Keynes saw the gold standard as the linchpin of the international finance system. London's status as an international financial center and Britain's earnings from financial services rendered to foreigners depended on the gold standard's survival. Abandoning that standard would lead to a flurry of competitive devaluations abroad and panic flights of short-term capital, creating uncertainty that would further disrupt international trade. This would be particularly devastating to Britain, where unemployment was already concentrated in the export industries.

As a result of the gold standard's supposed indispensability, any measure for combatting unemployment that threatened the stability of the exchange rate could not command widespread support. Keynes, himself, placed little emphasis on his proposals' implications for exchange-rate stability. Although he realized that increased public spending or Bank of England initiatives to reduce interest rates might force the balance of payments into deficit and undermine confidence in sterling, he suggested that complementary measures by American and French authorities could neutralize the potentially damaging impact of domestic reflation on the stability of the exchange rate.[10] Nonetheless, Keynes was attracted to the idea of a

[9] See also Keynes (1924) and Moggridge (1969, pp. 9-10). As late as the summer of 1931, only a few iconoclasts such as Ernest Bevin were openly willing to entertain the prospect of devaluation. See Bullock (1960, pp. 426-441); Francis Williams (1952, pp. 167-168); Winch (1969, p. 137).

[10] Keynes and Hubert Henderson disagreed on this point. Henderson argued that the probability of international cooperation was low, so that, in the interest of exchange-rate stability, recommendations for reflation should be limited to fiscally responsible proposals. Henderson argued that public works programs should be financed "in ways which will not do more harm to industrial activity by depressing business confidence than the stimulation of capital expend-

tariff as a response to the unemployment problem precisely because a tariff was the one measure consistent with both the target of lower unemployment and the constraint of remaining on the gold standard.

The Debate in the Economic Advisory Council

The first Government agency in which the virtues of a tariff were actively debated was the Economic Advisory Council. Established by Prime Minister Ramsay MacDonald in February of 1930 to provide the Cabinet with expert economic advice, the Council was made up of a disparate collection of economists, trade-union leaders, and businessmen.[11] Soon thereafter, an EAC Committee of Economists was established to consider the causes of Britain's industrial difficulties. This committee, under Keynes's chairmanship, included among its members A. C. Pigou, Lionel Robbins, and Hubert Henderson. Precisely how influential the advice tendered by the EAC proved to be is a matter of dispute (see e.g. Winch, 1969, p. 124). However, the body's deliberations are noteworthy if only because this was the first instance in which British politicians systematically solicited the theoretical and empirical analyses of economists. Moreover, the minutes of the EAC document the evolution of opinion on the tariff question.

As early as the summer of 1930, the idea of imposing a general tariff to reduce unemployment had considerable support within the EAC. Several of its members, while still contending that protection could not affect employment under normal circumstances, admitted that a tariff might reduce unemployment insofar as present conditions resulted from the abnormal rigidity of wages. The idea that wage rigidities impeded adjustment in the labor market was still unfamiliar in 1930, as is evident in the work of William Beveridge, the reigning British expert on unemployment. In his earlier writings on the causes of unemployment, Beveridge (1909, pp. 197-214) had emphasized the impact of part-time employment, impediments to the exchange of information between employers and workers, and the imperfect mobility of labor. By 1930, Beveridge (1930, pp. 368-

iture will do good." Henderson's own scheme for public investment entailed an import duty on manufactured goods to provide the necessary finance and maintain balance-of-payments equilibrium. See Henderson's memo, "Unemployment Policy—Industrial Reconstruction Scheme," Cab 24/212 CP196(30), June 3, 1930.

[11] A definitive history of the EAC is provided by Howson and Winch (1977).

369) had come to stress the tendency of money wages to lag behind prices during periods of deflation.[12] This drove up production costs, providing an important part of the explanation for the unemployment of the 1920s. Beveridge thought the change in the behavior of the labor market resulted from the spread of collective bargaining and the extension of unemployment-insurance coverage. That he did not devote the same systematic attention to the question of whether money wages tended to lag behind prices during periods of inflation is understandable in light of the decade of persistent price deflation Britain had just experienced. Yet the question of whether wages were equally inflexible in the upward and downward directions was to prove central to the subsequent debate over a tariff.

As they became aware that the labor market was not functioning normally, the members of the Committee of Economists began to reassess their attitudes toward a tariff. Evidence of this reassessment appears in their responses to the series of questionnaires submitted to the Committee in 1930. In July, Prime Minister MacDonald asked for views of the causes of the slump and recommendations for Government action. Among the options mentioned were a general tariff, selective import duties, import boards, and import prohibitions. The realization that the international character of the depression limited the prospect for basing recovery on the export trade moved several respondents to consider measures for restricting imports. Together these memoranda reflected a desire to promote what Hubert Henderson described in his summary as "a new orientation in our economic life in which the export trade plays a smaller part and production for the home market a larger part." They also reflected a recognition that the traditional argument that a tariff merely diverts labor from the production of exports to the production of import substitutes "loses much of its force when a large number of workers are, not merely temporarily, but permanently unemployed."[13]

Keynes's response to the Prime Minister's queries provided a tax-

[12] The evolution of Beveridge's views is described by Harris (1977).

[13] The economists' analyses were not based on Keynes's saving and investment approach but upon the simpler proposition that, if money wages are sticky, a tariff can stimulate production by raising prices and increasing profits. The Prime Minister's questions can be found in "The State of Trade," Cab 58/10 EAC (H.)98, July 8, 1930, p. 417. See also "Revised Summary by the Staff of Replies to the Questions Circulated by the Prime Minister," Cab 58/11 EAC (H.)120, Aug. 13, 1930; "The State of Trade," Cab 58/150 EAC (E.)2, Aug. 28, 1930.

onomy of the benefits to be derived from a tariff. Keynes began by reminding MacDonald of a central implication of the *Treatise* framework: a solution to the unemployment problem could be found in any measure that succeeded in raising investment relative to saving. After dismissing as "overdone and irrecoverable" objections to tariffs on the grounds that they encourage political nationalism and are incompatible with sound financial principles, Keynes repeated the list of remedies he had presented to the Macmillan Committee in February. The weight of the argument for a tariff was increased by his admission that many of the other alternatives, such as a lower Bank rate, might prove incompatible with the maintenance of the gold-standard parity.[14] Keynes framed this argument in terms of the relatively straightforward impact of a tariff on output prices and costs, rather than basing it on the more complex transmission mechanism that ran from savings and investment to prices and production, and from there to employment. Presumably, the simpler explanation was designed to appeal to the politicians in the Labour Cabinet.

Although it was never used, a second questionnaire drawn up by the Committee of Economists' secretary, Richard Kahn, is significant because it indicates that the discussions of the Committee were beginning to move away from the full-employment framework. Particularly revealing is Kahn's emphasis on the rigidity of money wages and his assertion that a tariff "is a direct method of securing primary employment, and secondary employment follows in the same ways as when the primary employment occurs in the form of home investment."[15] At the same time, the absence of unanimity is apparent. Robbins's announcement that he was prepared to submit an alternative list of topics for discussion indicates his fundamental dissatisfaction with the direction in which the debate was moving.

A shorter questionnaire drawn up by Keynes and used in lieu of Kahn's instructed the members of the Committee to consider how "(a) British output (b) British prices (c) British wages [would] be affected by (i) an increase in investment . . . (ii) a tariff (iii) a reduc-

[14] Keynes invoked a tariff's favorable terms-of-trade effects and its contribution to balancing the government budget as further reasons for considering protection ("Memorandum by Mr. J. M. Keynes, C.B.," Cab 58/150 EAC (E.)15, Sept. 23, 1930).

[15] The quotation provides evidence that the multiplier was already part of the thinking of some of the economists by early September ("Draft Heads for Discussion," Cab 58/150 EAC (E.)7, Sept. 6, 1930).

tion of British money wages."[16] The members' responses indicate that—with the exception of Keynes, who was unambiguously in favor, and Robbins, who was unambiguously opposed—the economists supported with certain reservations a general tariff to combat unemployment. Henderson, for one, warned that protection would hinder the recovery of the export trades and emphasized that he supported a tariff only as part of a comprehensive program for economic retrenchment. Pigou lent cautious support to the concept of a tariff but suggested that, in practice, the higher retail prices created by a tariff were likely to generate increased wage demands, thereby destroying the tariff's ability to stimulate profits.[17] This was a theme that appeared again and again in the debate over the macroeconomic effects of a general tariff.

Keynes's response to this questionnaire summarized the case for a tariff as it stood in the autumn of 1930. He found the principal justification for a tariff in the rigidity of nominal wages. A tariff would succeed in stimulating employment if it raised prices relative to wages. Along with a general tariff, Keynes presented a number of alternative remedies for British unemployment. Among these were measures designed to restore flexibility to the labor market. In 1930 Keynes still believed that, in principle, money-wage reductions provided a way out of Britain's economic predicament. Raising prices rather than lowering wages might have the larger effect to the extent that saving out of profits exceeded saving out of wages, but, in theory, money-wage reductions would still increase employment. In practice, the situation was different. Price increases were preferable to wage reductions on grounds of both equity and feasibility. As Keynes put it to the Committee of Economists, the "almost complete rigidity of our wage-rates since 1929" rendered inflationary tactics such as tariff protection the expedient course.[18]

It was when Keynes referred to the "almost complete rigidity" of wage rates that he and his critics parted company. Pigou and Robbins both argued that, if wages were flexible in an upward direction, a tariff would have no effect on profits or employment. Keynes's

[16] "Questionnaire Prepared by the Chairman," Cab 58/150 EAC (E.)8, Sept. 15, 1930.

[17] "Answers by Professor A. C. Pigou, M.A., to Questionnaire Prepared by the Chairman," Cab 58/150 EAC (E.)12, Sept. 15, 1930.

[18] Keynes also mentioned the danger of offsetting wage reductions abroad as another argument against wage cuts ("The State of Trade: Answers by Mr. J. M. Keynes, C.B.," Cab 58/11 EAC (H.)106, Nov. 21, 1930, p. 5).

response to this objection came in two parts. He first suggested that a tariff was less likely than alternative measures to provoke union demands for wage increases, but he left the claim unsubstantiated. Owing perhaps to his own doubts about the validity of this argument, Keynes went on to claim that even if money wages rose along with import prices and left real wages unchanged, a tariff would still increase domestic employment. Keynes reasoned that a tariff which improved the current account of the balance of payments would give rise to increased foreign investment. This investment eventually would raise the foreign demand for British goods.[19] Beveridge and his colleagues at the London School of Economics countered this argument with the suggestion that a tariff would impoverish foreigners by depressing the British demand for their exports and reducing foreign consumption of British goods.[20]

Robbins was quick to capitalize on the weaknesses of Keynes's argument. He admitted that in some hypothetical society in which money wages remained constant, "it is theoretically possible that a tariff might reduce unemployment." Robbins judged, however, that conditions in Britain were completely different. In reality, a tariff would stimulate the import-competing sectors, where there was comparatively little excess capacity and unemployment, and impede the recovery of the export industries, where there was considerable unemployment but wages were already as low as they could be pushed. Hence wage rates had nowhere to go but up. The workers, Robbins wrote, would soon be demanding "a share of the loaves and fishes." He asserted that Keynes's arguments were merely the "hackneyed slogans of a thousand controversies elsewhere."[21]

Robbins resisted Keynes's attempts to force a unanimous conclusion upon the Committee.[22] Ultimately, he refused to sign the Committee's report, which included substantial portions of his own draft, because of objections to the section on tariffs. Miraculously, Keynes

[19] "Memorandum by Mr. J. M. Keynes, C.B.,," Cab 58/150 EAC (E.)13, Sept. 23, 1930.

[20] Beveridge's analysis appears in Beveridge (1931). Harris (1977, p. 319), reports Keynes's rejoinder. A theoretical analysis of the employment effects of a tariff under conditions of real-wage rigidity appears in Eichengreen (1979).

[21] "Answers by Professor L. Robbins to Questionnaire Prepared by Chairman," Cab 58/150 EAC (E.)13, Sept. 23, 1930. Robbins's own solution to the unemployment problem was to increase labor-market flexibility. He recommended curbing the power of the unions and reforming the system of unemployment compensation (see Robbins, 1971, pp. 151-165).

[22] Robbins to Cannan, Cannan Papers, London School of Economics, n.d., Vol. 1, 3030, f. 197.

managed to paper over the dispute. The final document endorsed measures to lower wages through such means as reforms of unemployment insurance, as well as measures to raise wages and prices through any one of a number of expansionary initiatives. Keynes, Henderson, and Sir Josiah Stamp reaffirmed their support for a general tariff. Pigou was not sympathetic to this course and attached reservations, while Robbins rejected the proposal outright.

The Debate in the Cabinet

It is difficult to assess the impact of the Committee of Economists' report on the opinions of the Cabinet Ministers. The recommendations of the economists were discussed in December of 1930 and again the following summer at the height of the financial crisis. The Ministers were disturbed by an analysis which concluded that either raising or lowering wages was preferable to leaving things as they were, and some detected what they took to be internal inconsistencies in the report.[23]

Influencing the Ministers' responses to the report were considerations of party, politics, and doctrine. Free trade continued to symbolize the Labour Government's commitment to international solutions to Britain's economic problem. Snowden, Graham, and their colleagues Lords Parmoor and Passfield, Lord President and Colonial Secretary respectively, adamantly opposed any compromise of what they considered to be a moral and intellectual principle of the first order. In their view, at stake were not only the welfare of the unemployed but also the living standards of the four-fifths of the work force still employed, to whom a tariff-induced rise in the cost of living would be a serious blow.

As the year 1930 progressed, Snowden more than ever came to symbolize the financial competence of the Labour Government. His resignation as Chancellor of the Exchequer would have seriously undermined confidence in the City of London. Snowden's opposition to a tariff was incontrovertible, and the Cabinet's receptivity to the Committee of Economists' report fluctuated along with his health.[24]

[23] Henderson's plan to combine a general tariff with a program of industrial reorganization to be financed out of tariff revenues appears to have impressed the Cabinet as much as the report of the Committee of Economists (see Marquand, 1977, p. 524). Henderson describes his scheme in "Unemployment Policy—Industrial Reconstruction Scheme," Cab 24/212 CP196(30), June 3, 1930.

[24] Snowden reaffirmed his position before the House of Commons in July 1930 and again in

On November 7, when the EAC took up the report, Snowden was fit, and his characterization of a revenue tariff as regressive taxation incapable of stimulating employment ended discussion of the matter. Next, a small Cabinet Committee on Trade Policy, chaired by Snowden, was created to consider the economists' recommendations in more detail. At its first meeting on December 1, the members agreed that the report was a disappointing document—inconsistent, impractical, and containing too many general suggestions.[25] At the second meeting, Snowden asserted that the report's analysis of commercial policy was not worthy of consideration, and no further discussion of the matter ensued. However, Snowden's ill health undermined his campaign against protection. In February of 1931, he was unable to attend meetings of the EAC, permitting Prime Minister MacDonald to express his sympathy with some of the proposals of the Committee of Economists. Soon thereafter, Snowden attempted to reassert his influence by hosting a series of luncheons for prominent freetraders.[26]

Snowden had two formidable allies in this campaign. One was the Liberal contingent in the House of Commons. Toward the end of 1930, the Government had begun to move toward closer cooperation with the official Liberal Party, obtaining support for its programs in return for promises of electoral reform and continued opposition to a tariff. A second source of support was a group of economists affiliated with the London School of Economics. This group, which included Lionel Robbins and Frederic Benham, agreed in October of 1930 to produce a book under the editorship of William Beveridge. Their volume, entitled *Tariffs: The Case Examined*, presented a detailed, if not always transparent, restatement of the classical analysis of trade policy.[27] Beveridge's chapter on the employment effects of a tariff emphasized the belief that any fall in import demand would induce a decline in foreign demand for Britain's exports. Beveridge admitted that the net employment effect of stimulating the import-

a speech delivered at Free Trade Hall in Manchester in October. See also Cross (1966, p. 254); Skidelsky (1967, pp. 68-69); Snowden (1934, Chap. 68; 1930a; 1930b).

[25] "Minutes of the First Meeting of the Cabinet Committee on Trade Policy," Cab 27/435 T.P.C.(30), Dec. 1, 1930, p. 1.

[26] Even in his absence, Snowden's lieutenants at Treasury were preparing ammunition for use upon the Chancellor's return (see Forber to Fergusson, Mar. 26, 1931, and "Some Notes on Revenue Tariffs," T 175/52(5), Mar. 26, 1931).

[27] As it happened, the book appeared only after Britain's departure from gold (see Chap. 3 below).

competing sectors and depressing the export-oriented sectors was uncertain in theory. But the existence of substantial excess capacity in Britain's export industries along with relatively little slack in the import-competing sectors led Beveridge to conclude that the overall employment effects were likely to be unfavorable. In addition, he argued that because of the tendency of wages to rise with the cost of living, a tariff should not be expected to raise profits and thereby stimulate investment. Beveridge stated bluntly the argument Robbins had put to the Committee of Economists: the utility of a tariff as employment policy depends on the assumption that money wages will continue to be rigid in both an upward and a downward direction. If money wage rates are flexible downward, a tariff is unnecessary; if they are flexible upward, it is useless.

While Snowden made use of these sources of support in his Cabinet-level campaign to defend free trade, his position was under attack from several directions. His campaign was undermined when the Prime Minister expressed willingness to support a 10 per cent tariff under certain conditions, as he did in January and again in July of 1930 (Marquand, 1977, pp. 554-555). MacDonald was above all a pragmatist, willing to consider whatever economic policy circumstances might warrant. His new views on the tariff question were sympathetically received by J. H. Thomas, initially Lord Privy Seal with special responsibilities for dealing with unemployment, and by Noel Buxton, the Minister of Agriculture. In part, MacDonald may have adopted this new stance out of concern about the Conservative Party's increasingly protectionist position. Neville Chamberlain, Conservative son of Joseph Chamberlain and heir to the tariff reform tradition, did much to promote protectionist sentiment while the Conservatives were in opposition. In the interest of party unity and in response to the campaign for Empire free trade led by the press lords Beaverbrook and Rothermere, Stanley Baldwin, leader of the Conservatives, moved toward the protectionist wing of his Party.

Chamberlain had encouraged the protectionists within his Party by helping to establish a research department and a shadow-cabinet subcommittee to prepare a plan for adopting an across-the-board tariff. He advocated protection on many grounds but found it particularly useful to suggest that a tariff might be used to promote industrial "rationalisation." "Rationalisation" was the code word for national industrial policy, which entailed consolidating existing operations

and installing new plant and equipment. Chamberlain suggested that protection could be used to promote investment in industries requiring rationalization, and he argued that it was necessary to impose import duties in order to protect sectors undergoing rehabilitation from the predatory tactics of foreign competitors.[28]

However, the single factor that did most to strengthen the case for a tariff was the deteriorating state of the economy. Over the course of 1930, unemployment rose from 12 to 20 per cent of the insured labor force. Deflation accelerated, led by the collapse of primary commodity prices. Even more disturbingly, Britain's balance-of-trade deficit grew; the sterling value of imports fell by approximately 14 per cent, but export value fell by nearly 50 per cent. The only reassuring development was the stability of the Bank of England's gold and foreign-exchange reserves.[29]

The worsening state of the economy led a number of prominent figures previously identified with the Labour Government's approach to trade policy to announce their defection. In May of 1930, with the unemployment rate for insured persons at 15 per cent, Oswald Mosley, an outspoken member of the Cabinet unemployment task force, resigned from the Government following its rejection of his proposal for an ambitious program of home development supported by a comprehensive set of import controls. In June, the General Council of the Trades Union Congress, an organization traditionally opposed to import duties, adopted a rather ambiguous position on protection. Another blow came in March of 1931, when Keynes announced publicly his support for a 10 per cent tariff.[30]

Soon thereafter, in July of 1931, the Macmillan Committee's report finally appeared. The report effectively publicized the case for imposing a general tariff as a way of reducing domestic unemployment. A variety of measures designed to increase international liquidity and raise the domestic price level were discussed, but devaluation was ruled out because Britain's "international trade, commerce and finance are based on confidence" (Committee on Finance and

[28] Chamberlain's moves are discussed in Howson and Winch (1977, p. 96).

[29] Monthly statistics on unemployment, prices, and the trade balance appear in Tinbergen (1934, pp. 114-124). Information on the Bank of England's position appears in Moggridge (1972, pp. 148-149).

[30] Skidelsky (1975, pp. 177-220); TUC Economic Committee, *Minutes*, June 18, 1930; Bullock (1960, pp. 442-443). Trade-union attitudes are discussed in detail by Sidney Pollard, "Trade Union Reactions to the Economic Crisis," in Pollard, ed. (1970, pp. 146-161); *New Statesman and Nation*, Mar. 7, 1930, pp. 53-54; Marquand (1977, pp. 590-591).

Industry, 1931, par. 256, pp. 110-111). The body of the report contained no suggestion that recommendations for deflation and for defense of the gold standard might prove incompatible. However, awareness of this problem led Keynes and other Committee members to attach an addendum to the report. In it they revived Keynes's argument that wage reductions could not be relied upon to solve the unemployment problem because money wages had proven themselves "less elastic" of late. With devaluation ruled out, a scheme for uniform import tariffs and matching export bounties was presented as a way to raise the price level without undermining confidence in the currency. The signatories to the addendum argued that employment was likely to rise more in the import-competing sectors than it would fall in the export-producing industries. Keynes's contention that a tariff, unlike a devaluation, could be used to raise prices without eliciting increased wage demands made another appearance. Only Ernest Bevin and Sir Thomas Allen, who represented organized labor, did not share their colleagues' fears of devaluation. In a reservation to the addendum, they stated their preference for devaluation instead of a tariff, but their decision to sign the addendum may be an indication that they realized the impracticability of their position (Addendum I and reservation to Addendum I, pp. 190-210).

The Impact of the 1931 Financial Crisis

Under different circumstances, the Macmillan Committee's report might have swayed Cabinet-level opinion toward advocacy of a tariff as a way of combatting unemployment, but the problem of unemployment and the report itself were soon overshadowed by other events. The rapid deterioration of Britain's external position in the summer of 1931 forced policy-makers to turn their attention to the balance-of-payments problem. In 1931, Britain's current-account balance moved into deficit for the first time in five years. This deficit was due not so much to the excess of commodity imports over commodity exports, which was little worse in the early months of 1931 than in earlier years, as to the insufficiency of invisible earnings. The depression cut into Britain's invisible balance, because declining international trade reduced incomes from shipping and financial services and falling interest rates lowered the return on foreign investments. Superimposed on the deteriorating current account were the

effects of Continental liquidity crises. The collapse of the Austrian and German banking systems and French procrastination regarding Hoover's proposed debt moratorium created a scramble for liquidity. As foreigners liquidated their deposits in London, Britain's capital-account position worsened.

The publication of the May Committee's report on July 31 (Committee on National Expenditure, 1931) provided many with their first inkling that the budget was seriously out of balance. The May Committee, set up in March to consider the Government's budgetary position, predicted in its report that the budget deficit for the year 1932-33 would approach £120 million. While the accuracy of this figure was disputed, the basic premise was correct. The depression had aggravated the budgetary problem both by reducing revenues and by increasing expenditure, especially on the dole.[31] From the French experience in the 1920s, the public had learned that there was a correspondence between government budget deficits and balance-of-payments deficits. Thus the May report, which revealed the magnitude of Britain's budget deficit, severely undermined confidence in sterling. From the beginning of August, the Bank of England began to lose gold at a rate that could be sustained for perhaps a month, and the Cabinet became totally preoccupied with the defense of the exchange rate.

The financial community believed that sterling's strength could be restored only by balancing the budget, and the Cabinet-level debate centered upon what combination of higher taxes and lower expenditure should be adopted. Most Conservatives demanded reduced spending on unemployment relief and public services. Since Labour backbenchers opposed any proposal that would reduce support or raise the cost of living for the unemployed, the Government found it difficult to agree on a measure designed to balance the budget either by reducing spending or by increasing taxes. As Bank of England gold losses continued to mount, however, it became vital to do something to restore confidence. One option was to reduce unemployment benefits by 10 per cent. Another was to impose a 10 per cent revenue tariff. A tariff was seen as the most desirable way to balance the budget because, besides raising tax revenues, it would discourage consumption of imports and thus directly strengthen the

[31] The 1931 financial crisis is considered by Davis (1975); Moggridge (1970); David Williams (1963a, 1963b).

trade balance. Under normal circumstances, a tariff would not have been acceptable to the Trades Union Congress or to Labour Members of Parliament. But the specter of substantial reductions in unemployment payments created a considerable change of opinion in trade-union circles on the question of tariffs.[32]

Thus, by midsummer of 1931 a tariff was no longer being advocated as a means of reducing unemployment but, rather, as the least objectionable method of balancing the budget and restoring confidence in sterling. The question of whether a tariff should be used to defend the exchange rate came to a vote before the Cabinet on August 19. Five Ministers apparently blocked adoption of the measure. Four days later, the Cabinet split again, with nine Ministers opposing the alternative of a 10 per cent reduction in unemployment benefits. Incapable of marshaling support for a response to the flight from sterling, the Labour Government was dissolved the following morning.

The new National Government, formed on August 24, quickly broke the impasse over macroeconomic policy. The four Labour, four Conservative, and two Liberal Ministers who served under MacDonald agreed to austerity measures. These included lowering the salaries of public employees, cutting the standard rate of unemployment benefits, reducing public borrowing and support for local-authority expenditure, raising unemployment-insurance contributions, and adding new taxes. These measures were introduced in the House of Commons on September 10.

While some, such as Snowden, argued that these economies completely destroyed the case for a tariff, others remained unconvinced that the Government's actions had in fact solved the confidence problem. Keynes, for one, predicted that the new budget would have little immediate impact on the balance of trade and would only worsen unemployment. He argued that, for both reasons, the imposition of a tariff was still in order. Henderson, in his September 18 evaluation of the balance-of-payments position, came to the same conclusion.[33] Even some members of the General Council of the

[32] Although the General Council of the Trades Union Congress (TUC) reached no final decision, support for a tariff increased considerably during the second and third weeks of August (TUC Economic Committee, *Report on Fiscal Policy*, 1932, pp. 3-4; see also *Times*, Aug. 19, 1931, p. 10, Aug. 20, 1931, p. 10; Bassett, 1958, p. 75).

[33] Keynes, "Mitigation by Tariff," in Keynes (1963, p. 234); "The Balance of Payments," T 172/1746(6), Sept. 18, 1931.

Trades Union Congress continued to press the National Government to adopt a general tariff as a way to defend the exchange rate (*Times*, Sept. 4, 1931, p. 10).

The more vocal advocates of protection were not deterred by the announcement of the new budget. The Board of Directors of the Manchester Chamber of Commerce adopted a resolution of support for a tariff, and the President of the Federation of British Industries (F.B.I.), the leading employers' group, recommended imposing a tariff for balance-of-trade purposes (F.B.I./C/32 Box 75). The imperial preference lobby continued to press its case for a tariff. While applauding the Government's budgetary economies, the editors of the *Times* suggested that a balanced budget and a tariff were but two indispensable components of a comprehensive scheme to restore economic stability and stated that "there is an enormous preponderance of opinion in the country behind [a tariff] already" (*Times*, Sept. 16, 1931, p. 16).

The events of the following week were to prove correct those who had warned that budgetary measures would not stem the run on sterling. On September 18 and 19, the Bank of England's gold and foreign-exchange losses reached crisis proportions, and the Government was forced to suspend convertibility on September 21. Almost immediately the pound fell toward $4.00. On September 24, the Bank of England intervened with sales of sterling to push the pound down still further to what it estimated was the equilibrium level. By the end of September, sterling had reached $3.75. This drop was followed by a brief recovery and a period of stability lasting through the end of October. Then sterling fell again, and once more the Bank of England did little to slow the adjustment. The pound fell to $3.24 at the beginning of December but began to recover soon thereafter. It reached $3.40 by the end of 1931, and Treasury officials eventually decided that this was not an undesirable neighborhood in which the exchange rate might float.[34]

[34] Sayers (1976, p. 419); Howson (1980, pp. 5-6). For bilateral exchange rates against the major currencies, see Einzig (1937, pp. 470-471).

3 COMMERCIAL POLICY AND THE FLOATING POUND STERLING, 1931-32

The fall of the exchange rate and the continued weakness of the trade balance reinforced the impression that the crisis was not yet over. Thus it proved unrealistic to anticipate an early dissolution of the National Government. Perceiving the disarray in which the opposition had been left by the collapse of the Labour Government, the leaders of the Conservative Party pressed for an early election. They hoped that the new Government's mandate to balance the budget and defend the exchange rate could be extended to encompass protectionist measures. Parliament was dissolved on October 7, 1931, and MacDonald went forth to campaign for a "doctor's mandate" to apply any necessary remedy to Britain's economic ills. Each party issued its own election manifesto. The Labour manifesto stated that "in the circumstances produced by our departure from the gold standard, [tariffs] have no relevance to economic need" (*Times*, Oct. 10, 1931, p. 7). The Conservative manifesto, as enunciated by Stanley Baldwin, advocated the imposition of a tariff as a way to strengthen the trade balance and stabilize the exchange rate:

> At home, the paramount question is that of the adverse balance of trade, the redress of which is essential to secure our financial stability. This can be accomplished only by reducing imports, by increasing exports, or by a combination of both. I am prepared to examine any method which can effect what is required. I recognize that the situation is altered by the devaluation of the pound, but in my view the effect of that devaluation can be no valid substitute for a tariff. . . . We must shrink from no step to prove the stability of our country and to save our people from the disasters attached to a currency fluctuating and falling through a lack of confidence at home and abroad (Royal Institute, 1932, pp. 20-21).

The election resulted in a resounding victory for the National Government and a substantial increase in Conservative influence in the Cabinet and the House of Commons. Prime Minister MacDonald transferred Snowden to the post of Lord Privy Seal and replaced him with Neville Chamberlain, who came to dominate the formulation of economic policy in this Cabinet much as Snowden had dominated it under the Labour Government (Feiling, 1946, p. 201; Walker-Smith, 1939, pp. 173-174). Resistance to a tariff within the National Cabinet of twenty came only from Snowden and three free-

trade Liberals: Sir Herbet Samuel, Sir Archibald Sinclair, and Sir Donald Maclean. The issue of overriding importance for the new National Government, succinctly stated in the King's speech on November 10 (*Hansard*, Nov. 10, 1931, p. 46), was to establish confidence in Britain's financial stability by ensuring a favorable balance of trade. Whether a general tariff was needed to accomplish this goal became a question for heated debate.

By November it was generally recognized that the suspension of the gold standard was permanent. Even those who desired a return to the traditional parity recognized that the Bank of England lacked the resources to bring it off. Most politicians and economists were aware that the advent of a floating rate had altered the policy environment, although whether for the better was subject to considerable disagreement. Some, like Lionel Robbins and Frederic Benham, argued that exchange-rate flexibility provided a complete solution to Britain's problem of external balance. In their view, the current-account deficit no longer represented an economic problem, for exchange-rate adjustments would lead automatically to balance-of-payments equilibrium. The misguided individuals who continued to call for a tariff to balance the external accounts simply did not realize that circumstances had changed.

Yet others, like Hubert Henderson and Henry Clay, had less faith in the corrective power of a floating exchange rate. They worried that depreciation would be incapable of restoring balance to the external accounts or that, even if it could, the social costs of the required depreciation would be prohibitively high. To some, this meant that external balance could be restored only if Britain imposed a tariff. To others, it implied that, while exchange-rate adjustments were capable of balancing the external accounts, a tariff could do so at a lower social cost.

Some of the participants in the debate altered their views on the desirability of a tariff once Britain left the gold standard, but two of Britain's political parties remained unswayed. For the Liberals free trade and for the Conservatives protection constituted the central issue uniting party members. Indeed, by 1931 defense of free trade had become the primary rationale for the Liberal Party's survival. The Conservative Party, which had suffered the effects of several years of internal dissension, united behind Baldwin's protectionist election manifesto. The 1922 Club of Conservative backbenchers de-

clared unanimously that "the suspension of the gold standard had in no way modified the need for immediate imposition of an emergency tariff" (*Times*, Oct. 10, 1931, p. 7). The position of the Labour Party was more difficult. Although the Party opposed protection throughout the 1931 electoral campaign, the credibility of its position was undermined by the public's knowledge that in August a majority of the Labour Cabinet had been willing to support a general tariff as an alternative to spending reductions.

Employers and employees were on opposite sides of the tariff question. The Trades Union Congress was convinced that the adoption of a floating exchange rate had destroyed the force of the argument for a tariff. Tariffs, its Economic Committee stated, were of "no relevance to economic need" (*Times*, Sept. 22, 1931, p. 12; TUC Economic Committee *Report*, p. 4). Ernest Bevin, the most prominent of Britain's labor leaders, had argued for months that depreciation was sufficient to resolve the balance-of-payments problem, and he had said as much in his own addendum to the Macmillan Committee report. In October and November, Bevin admitted of no doubts that depreciation was having its anticipated effect. The Federation of British Industries expressed the opposite opinion. On September 25, its Economic Emergency Committee was told that "the mere departure from the gold standard could not of itself correct our adverse trade balance; the imposition of a tariff—advocated for a long time past by the F.B.I.—was also necessary" (F.B.I./C/32 Box 75). A declaration to this effect (F.B.I./C/32 Box 74) was submitted to the Board of Trade, which passed it on to Treasury officials.[1]

Editorial opinion could be predicted on the basis of past performance. Publications catering to the export trade boldly stated the case for a floating exchange rate. In the words of the *Manchester Guardian Commercial*, "Losing the gold standard we gain an opportunity. There is now no need to devote our attention to our adverse trade balance, for this will be quickly adjusted by the exchanges" (Oct. 15, 1931, p. 339). The *Manchester Guardian* labeled demands for a tariff "parrot cries" and suggested on September 28 (p. 8) that there was no reason to doubt that the trade balance had already righted itself. On October 19 (p. 9) it published an article by Frederic Benham and Lionel Robbins restating the case for floating exchange rates.

[1] "Statement of Policy of the Federation of British Industries," T 172/1768, Jan. 15, 1932.

The *Economist* made the same point some four months after Britain's departure from the gold standard: "For it cannot be too often repeated," its editors wrote, "that, with the pound no longer tied to gold, the balance of payments cannot do otherwise than adjust itself automatically" (Feb. 6, 1932, p. 283). The *Times* continued to argue that a floating exchange rate alone would not restore external balance and that a tariff was needed to bring imports and exports into line (Sept. 24, 1931, p. 13; Nov. 5, 1931, p. 13).

Neither the Treasury nor the Bank of England played a major role in the public debate. Montagu Norman, Governor of the Bank of England, described the desirability of a tariff as a purely political question and refused to make public his opinion. The Treasury view of protection, naturally, fluctuated with the inclination of the Chancellor of the Exchequer. When Chamberlain replaced Snowden as Chancellor, Treasury analyses of the protectionist case became increasingly sympathetic. Even so, there were some in the Treasury, such as R. G. Hawtrey, willing to disagree with Chamberlain on this issue.

Elasticity Pessimism and the Case for a Tariff

Within the National Government, it was widely feared that the depreciation that would ultimately be required to balance the external accounts would be unacceptably large. Henry Clay had warned the Ministers that Britain's price elasticity of demand for imports was low because it imported more than half its foodstuffs and a large part of its raw materials. This pessimism about the size of demand elasticities implied that residents would economize on their consumption of imported goods only if import prices rose considerably. The elasticity pessimists drew on evidence from Britain's experience with floating rates in 1919, when a 20 per cent depreciation had been followed by a negligible improvement in the trade balance. Hubert Henderson argued that the French experience with a floating exchange rate between 1923 and 1926 had shown that a sizable depreciation was necessary to effect an improvement in the trade balance.[2] Keynes counseled that the Government should not attempt to stabilize the exchange rate at more than 75 per cent of its gold-standard parity, and Hawtrey, writing the week following devalua-

[2] "Comment on Mr. Hawtrey's Memorandum by H. D. Henderson," T 188/29, October 1931.

tion, recommended aiming for an exchange rate of approximately \$3.40.[3]

The National Government's Cabinet Committee on the Financial Situation, with its familiar cast of characters (Keynes, Henderson, and Lord Macmillan among them), considered this question as early as September 24. Chamberlain attempted to exploit the fears of the elasticity pessimists; on those occasions when he admitted that there existed a value of the pound at which the trade-balance deficit would be eliminated, he selected an alarming figure like \$2.[4]

Fear about the extent of the depreciation that would be required to restore balance to the external accounts was reinforced by expectations of competitive devaluations abroad. The assumption that any depreciation of sterling would be accompanied by similar movements of other currencies was correct. To some extent, of course, devaluation abroad was encouraged by the British themselves. In the Economic Advisory Council, it was recognized that depreciation would stimulate production only insofar as output prices rose relative to costs. In light of Britain's dependence on imported raw materials, officials hoped that sterling would depreciate relative to the currencies of Britain's industrial competitors, but they encouraged the principal raw-material suppliers to link their currencies to the pound at the traditional parity.[5] A total of twenty-five countries followed Britain off the gold standard. Foremost among these were the British Commonwealth nations, all of which, except for Canada, tied their currencies to sterling. Other countries to which the British export market was important, such as Portugal, immediately devalued in order to maintain their exchange rates against the pound. Still others, such as Argentina, whose currencies had already depreciated took the opportunity to establish a peg against the pound. All the countries of Scandinavia and much of Eastern Europe eventually joined in the decision to devalue.

Robbins, Benham, and others were quick to point out that under

[3] Marquand (1977, p. 610); "Pegging the Pound I," T 175/56, Sept. 28, 1931, pp. 64-66.

[4] "Capital Items in the International Balance of Payments," T 172/1768, Dec. 15, 1931. Note that the Economic Advisory Council Subcommittee on Financial Questions was constituted as the Prime Minister's Advisory Committee on Financial Questions. See "Minutes," Cab 58/169 EAC (S.1.(31)), and "Report on Sterling Policy," Cab 58/169 EAC (H.)147, Dec. 15, 1931.

[5] This strategy is discussed in "Note by the President of the Board of Trade prepared for the Committee on the Balance of Trade," T 172/1768, n.d. (apparently December 1931); see also Clay (1957, pp. 410-411).

floating exchange rates there was no reason to worry about the effects on the trade balance of foreign devaluation. Competitive devaluation would be offset automatically by further depreciation of the pound, bringing Britain's external accounts back into balance. "Our balance of trade must balance," they stated bluntly and simplistically, given the importance to Britain of invisibles and capital transactions (Benham and Robbins, 1931). Yet the public and a dominant contingent within the National Government were unwilling to entertain the prospect of a large depreciation. Depreciation would lower the real value of British foreign investments denominated in sterling. Moreover, it would reduce the real value of the earnings on fixed-interest sterling securities. Not only would depreciation reduce the real value of British wealth, but it would contribute to deterioration of the invisible component of the current account. The Treasury, in particular, was concerned that excessive depreciation would increase the cost of repaying that portion of Britain's external debt denominated in U.S. dollars relative to the income from British foreign investments denominated in sterling. Britain's war debt to the United States was an obvious example of a liability denominated in dollars, while interallied debts owed the United Kingdom were denominated largely in sterling. When both public and private assets were considered, perhaps half of Britain's foreign-investment income was denominated in sterling. On Sept. 24, the Cabinet Committee on the Financial Situation took note of this fact.[6]

The concern that a large depreciation would lead to a costly reduction in the value of Britain's external assets provided a rationale for the imposition of a tariff. Although both exchange-rate depreciation and the imposition of a tariff would reduce real wealth by raising the price level, some felt that a tariff was preferable because it would not raise the cost of repaying the American debt relative to the interest income accruing on Britain's sterling-denominated loans to foreigners.

A second reason why many politicians were unwilling to countenance a large depreciation was that higher import prices would impoverish the working class. If the cost of living rose by 25 or 50 per cent, living standards would decline as long as wages lagged behind prices. The *Times* (Nov. 5, 1931, p. 13) warned that a depreciation

[6] "A Crisis of the £," *Times*, Oct. 17, 1931, p. 13; "Minutes," Cab 58/169 EAC (H.)147, Sept. 24, 1931.

resulting in a calamitous rise in the cost of living would intensify class conflict. While concern for workers' living standards provided an argument against excessive depreciation, it did not provide a rationale for an across-the-board tariff, since both import taxes and lower exchange rates would raise the cost of living. Indeed, the effect of a tariff on the cost of living was the basis of Snowden's opposition to commercial restrictions. However, there was considerable dispute about the realism of the assumption that wages would continue to lag behind higher import prices.

The Exchange Rate and the Vicious Spiral

It seems curious that policy-makers were preoccupied by fears of uncontrollable inflation during a period of pronounced price deflation. By the reckoning of the Board of Trade, wholesale prices fell by 34 per cent between 1925, when Britain returned to the gold standard, and 1931. They fell by 23 per cent between 1929 and 1931 alone, and the cost of living fell by 8 per cent over the same two-year period (Methorst, 1938, pp. 200-214). Yet the gold-standard system was seen as the only restraint on the government's innate tendency to spend more than it took in. Once Britain abandoned the gold standard and allowed the exchange rate to float, policy-makers considered the way opened for runaway inflation. Thus Henry Clay advised the National Government in August 1931:

> Above all, the abandonment of the gold standard would remove the chief obstacle to inflation. The Government could incur expenditure without thought of covering it by taxation and expand the floating debt to cover the deficit. This would cause a fall of sterling on the exchanges and a rapid rise in prices at home. This is advocated as the simplest way of cutting real wages and other charges. But it might stimulate demands for wage increases which would lead to further inflation and further sterling depreciation. In other words, the process of inflation is a vicious circle. . . . This was the experience of England during the war and of most Continental countries since the war.[7]

Not only the policy-makers but also the public were haunted by memories of the Central European inflations of the 1920s. In particular, the fear that exchange-rate depreciation would lead to uncontrollable inflation was rooted in recollection of the German hyper-

[7] "The Pound and the Gold Standard" (A Note Prepared by Henry Clay for the Guidance of the National Government, Lothian Papers, Box 219), quoted in Skidelsky (1967, pp. 414-415).

inflation of 1923. The fear of inflation with which this episode imbued a generation of policy-makers is a recurrent theme in the history of British economic policy in the interwar years. But even before 1923, similar concerns had been foremost in the minds of members of the Cunliffe Committee. When recommending in 1919 that Britain return to the gold standard at pre-war parity, the Committee cited the danger of inflation, and this phobia was reinforced by the post-war inflation that accompanied the unpegging of sterling (Winch, 1969, p. 89). The German hyperinflation was fresh in the public mind in 1925, when Britain's return to the gold standard met with widespread support. Winston Churchill referred to the danger of runaway inflation under floating exchange rates in the debate over the return to gold. Snowden voiced similar fears in 1927 and again whenever the gold standard came under attack during his reign as Chancellor of the Exchequer (Howson, 1975, p. 76).

In announcing that Britain was being forced off the gold standard, the Government referred obliquely to previous episodes by mentioning reassuringly the enormous financial resources of the nation. This did not prevent members of the government from using fears of hyperinflation to their advantage. In a famous incident of the election campaign, MacDonald brandished a handful of German currency from the 1920s and warned of what the combination of a floating exchange rate and irresponsible financial management could entail.[8]

In part, fears of hyperinflation were based upon a simple "confidence" argument. Any large depreciation would convince the public that sterling was no longer a stable store of value, and further depreciation would ensue as individuals lost faith in the currency. To a considerable extent, however, the fear of hyperinflation was based upon the unions' presumed response to a rise in the cost of living. Officials within a number of Government ministries anticipated that a sizable depreciation that led to an unmistakable rise in the cost of living would stimulate increased wage demands. Costs would rise along with prices, so that depreciation would not stimulate output and employment. More to the point, depreciation would not restore balance-of-payments equilibrium. If domestic costs rose, the price of home goods would not fall relative to the price of imports. There

[8] *Manchester Guardian*, Sept. 21, 1931, p. 9; *News Chronicle*, Sept. 29, 1931, p. 1.

would be no incentive for consumers to redirect their spending from imports toward domestic goods, so that no reduction in the size of the trade-balance deficit would take place. Since Britain was running a trade deficit at the time of devaluation, the sterling value of that deficit would be increased, assuming little or no change in the volume of trade. Further depreciation would result, followed by another round of wage increases and ever-accelerating depreciation. This was the "vicious circle of inflation" of which Clay warned (Skidelsky, 1967, pp. 414-415).

Concern with this problem was voiced at the Treasury and the Board of Trade. "Depreciation will only work if prices rise relative to wages," read an internal Treasury communiqué.[9] Arthur Loveday, the British economist in charge of the League of Nations Economic Intelligence Service, warned Sir Arthur Salter of the Treasury, who had served previously as Britain's representative to the League of Nations Economic Commission, of the danger that substantial depreciation would lead to escalating wage demands. Henderson issued a blunt warning that wage demands would offset any large depreciation, and Chamberlain alluded to the "insoluble problems" that would be created by a very great rise in the cost of living.[10] Not everyone agreed that wages would rise in step with import prices. Hawtrey, for example, argued that in the past wages had always lagged behind prices. Even if the unions had since acquired increased market power, he saw no reason to anticipate that they would exert it during the present crisis.[11]

The British had learned from the German experience that inflation is fueled by the government's printing presses. Therefore, the discussion of inflation focused on two issues: the effect of exchange-rate depreciation on the Government budget and the authorities' response to the growth of the deficit. Depreciation would force up Government expenditure by adding to the cost of the goods purchased by Government agencies and raising the wages paid in the public sector. So long as there was no decline in the unemployment

[9] "Comments on Mr. Hawtrey's Memorandum by H. D. Henderson," T 188/29, Oct. 6, 1931. Sentiment within the Board of Trade is reported by the *Times*, Oct. 14, 1931, p. 7.

[10] Loveday to Salter, T 175/56, Sept. 26, 1931, pp. 102-105; Henderson to Hawtrey, T 175/56, Oct. 16, 1931; "Capital Items in the Balance of International Payments," Cab 27/467 BT(31)8, Dec. 15, 1931.

[11] "Pegging the Pound II," T 188/29, Oct. 16, 1931.

rate, expenditure on the dole would not be relieved. With some sources of revenue fixed in nominal terms, Government receipts would lag behind outlays. Together, these factors meant that depreciation would add to the burden of deficit finance. If the Government financed the deficit by expanding the floating debt, higher wages would be accommodated and no ceiling would be placed on the wage-price spiral.

Advocates of a tariff suggested that the Government could abort the wage-price spiral by relying on commercial policy rather than exchange-rate depreciation to restore external balance. If a tariff were added to depreciation, the import-tax revenues accruing to the Government could be used to balance the budget. The authorities would not be forced to expand the floating debt, wage increases would not be accommodated, and the vicious spiral would be halted. If workers continued to demand higher wages, the unemployment problem might be exacerbated but hyperinflation would not ensue.

The protectionists had additional arguments. They suggested that offers of protection could be used to promote investment and modernization. Industries characterized by scale economies would be able to produce at lower cost if provided with tariff protection. In addition, they argued that only through the imposition of a tariff could Britain force foreign countries to reduce their own trade barriers.[12] However, the vicious-spiral argument was the essence of their case for a tariff.

While doubts about the ability of a freely floating exchange rate to bring the external accounts into balance were pervasive in official circles, they were treated skeptically by the academic community. Keynes submitted a letter to the *Times* a week after the departure

[12] Oddly, the question of possible foreign retaliation did not play a major role in the debate over a tariff, perhaps because many foreign countries had already imposed trade barriers of their own. The Subcommittee on Financial Questions did point out that foreign authorities would perceive the imposition of a tariff so soon after exchange-rate depreciation as a heavy economic blow and a violation of the code of international comity. However, Cabinet Ministers disagreed about whether it would be more effective to impose a tariff first and then bargain for foreign concessions or merely to threaten imposition unless foreign restrictions were lifted. Samuel felt that, by merely threatening to use the powers of retaliation, Britain could obtain immediate concessions from Germany and the Scandinavian countries. Once imposed, he suggested, a tariff would be useless for bargaining purposes. Chamberlain argued the opposite, asserting that the British threat would be made credible only by the passage of a tariff bill and that foreign concessions could be extracted only following the actual imposition of trade restrictions.

from gold in which he argued that the case for a tariff had ceased to be urgent. Salter suggested that there remained a case for a tariff under a regime of floating exchange rates only if foreign countries pursued a policy of competitive depreciation. He was confident that Britain would escape the vicious spiral simply because the authorities were unwilling to see the value of the nation's external assets reduced to naught. Beveridge argued that since Britain had gone off the gold standard, the case for a tariff had been "killed entirely."[13] The 1932 edition of *Tariffs: The Case Examined*, also edited by Beveridge, contained a new chapter in which Benham analyzed the virtues of a tariff in light of Britain's departure from gold. A floating exchange rate, he wrote, "is a solution, and a complete solution, of the problem of restoring external equilibrium. . . . The case for a tariff on these grounds is dead" (p. 253). Benham could detect no evidence that there remained an adverse trade balance, no tendency of wages and other costs to rise in step with import prices, and no indication that sterling would depreciate at an ever-accelerating rate.

Most economists were aware that the imposition of a tariff was likely to exacerbate the unemployment problem. Henderson reminded Treasury officials in October that any tariff-induced appreciation of sterling would offset the favorable effects of depreciation on domestic economic activity. Robbins composed for Beveridge an elaborate memorandum in which he argued, "If, when the exchanges are free, we impose a tariff, not only do we do what is unnecessary, we also do what is immediately harmful." Loveday made the same point in a letter to his friend Sir Richard Hopkins at Treasury.[14]

Yet the employment effects of a tariff were a concern of only secondary importance in the Government. Many Ministers were not convinced that the depressing effects of the price deflation induced by exchange-rate appreciation were as important as the reduction of uncertainty that would result from the restoration of balance to the external accounts and the stabilization of the exchange rate at a new equilibrium level. They saw the alternative to protection as persistent current-account and budget deficits, with wages and prices spiraling ever upward and the exchange rate depreciating without end.

[13] *Times*, Sept. 29, 1931, p. 15, Oct. 2, 1931, p. 14, Oct. 17, 1931, p. 13.

[14] Henderson to Hawtrey, T 175/56, Oct. 16, 1931; "How to Balance the Balance of Trade" by Lionel Robbins, Beveridge Papers (London School of Economics), BP/II/B, n.d.; Loveday to Hopkins, T 175/56, Oct. 26, 1931.

The Decision to Impose a Tariff

The continuing concern with the international accounts and skepticism that a floating exchange rate alone was sufficient to restore external balance were reflected in Parliamentary debate. While traditional free-trade and protectionist sentiment and the special problems of certain industries made their inevitable appearance, several Members of the House of Commons focused upon the role of a tariff in correcting the adverse balance. On November 11, Mr. Mander presented the view that, under a floating exchange rate, the balance of trade must balance. This Mr. Entwistle labeled the "most arrant nonsense" (*Hansard,* Nov. 11, 1931, pp. 202-203, 221-222). Entwistle's objections were based on the vicious-spiral argument. Entwistle's view was echoed the following month by a number of Conservative Members, who argued that a tariff was the only weapon capable of correcting the adverse trade balance and preventing the pound sterling from falling further (*Hansard,* Dec. 9, 1931, pp. 1976-1982).

As this debate progressed, it became obvious that importers were increasing their inventories in anticipation of possible future import levies. To deter anticipatory importing, the Abnormal Importations Act was introduced in the House of Commons on November 17 while the desirability of permanent measures was still under consideration. This Act conferred on the Board of Trade temporary power to impose duties of up to 100 per cent *ad valorem* on imports judged to be entering the country in abnormal quantities. Three orders were quickly issued, imposing duties of 50 per cent *ad valorem* on a variety of products.[15]

At this point the debate reached the Cabinet. The Cabinet Committee on the Balance of Trade, constituted on December 11, 1931, provided the arena within which the final battle over the General Tariff was fought. With the Abnormal Importations Act already in effect, Liberal members of the Cabinet hoped that the new Committee would undertake a comprehensive analysis of permanent measures. In this they were disappointed. The Committee met only five times, under the chairmanship of Chamberlain, who resisted

[15] In addition, a Horticultural Products (Emergency Provisions) Act was introduced to provide the Minister of Agriculture with temporary power to impose specific duties on products that were difficult to value and tax on an *ad valorem* basis. For details, see Findlay (1934, p. 15).

proposals to call upon outside experts. Snowden no longer attempted to influence the course of the proceedings, satisfying himself with a harshly worded memo of dissent from the Committee's report. Samuel, the Home Secretary, was the principal spokesman for the anti-tariff view, but Chamberlain neutralized his efforts by giving ground on minor points and ruling Samuel's major objections out of order.

When the Committee first met on December 17, it possessed a considerable amount of information on the economic situation. In September, the Economic Advisory Council Committee on Economic Information had been forced to admit the difficulty of making "even an approximate estimate" of how the balance of trade responded to exchange-rate changes. Now the Cabinet Ministers possessed preliminary estimates of trade in November. Between September and October, the sterling value of both imports and exports had risen, but the increase in the value of imports had been four times as great. In November, the increase in the value of imports had been substantially smaller, but export value had actually fallen relative to the preceding month. December would show the first signs of improvement, with imports falling and exports rising in value. The cost of living had begun to climb slowly, but wage rates were holding firm for the time being.

Chamberlain set the tone of the meeting on January 2, 1932, by turning first to his own memorandum on the external position. The Chancellor argued that the trade balance was the critical component of the external accounts; the stability of the pound could still be undermined by capital outflows, and the announcement of further deficits in merchandise trade might be sufficient to undermine foreign confidence. He argued that relying on exchange-rate adjustments to eliminate the trade-balance deficit would entail an unacceptably large depreciation. The members of the Committee generally agreed with Chamberlain on the dangers of depending on exchange-rate depreciation to solve the problem of external balance. But when Chamberlain invoked Keynes as an authority who favored tariff protection, Samuel did not let this slip by. He pointed out that Keynes no longer favored a tariff now that Britain had left the gold standard.[16]

[16] Samuel to Chamberlain, Chamberlain to Samuel, T 172/1768, Dec. 17, 1931. See also "The Balance of Trade: Memorandum by the Chancellor of the Exchequer," Cab 27/467 BT(31)8, Jan. 12, 1932.

The third meeting of the Committee, on January 12, was notable for the presentation of Chamberlain's own proposal for a general tariff. This plan entailed a 10 per cent duty on all imports plus selective surtaxes on luxury items. When Samuel pointed out that the imposition of taxes on imported raw materials would constitute a burden for the export industries, Chamberlain yielded on this issue. The Committee reconvened the following day, and the Chairman expressed his willingness to meet Samuel's objections by drawing up a plan for a 10 per cent tariff that excluded raw materials. Chamberlain then summarized the case for a general tariff. Along with its effects on the external accounts, Chamberlain emphasized a tariff's contribution toward balancing the Government budget. Again, the only discordant note was sounded by Samuel, who reported that Keynes was no longer concerned about Britain's balance of payments and retained complete confidence in what the other members of the Committee derisively referred to as the "automatic equilibrium theory."[17]

The Report of the Cabinet Committee on the Balance of Trade, issued on January 19, predicted continued weakness in Britain's trade balance.[18] A 10 per cent general tariff was proposed as a means of reducing imports by 25 per cent and balancing the budget. Memoranda of dissent by Snowden and Samuel were attached. Snowden's expressed its author's undiminished faith in the power of a floating exchange rate to rectify any imbalance in Britain's external accounts. Samuel's contained a blanket rejection of the majority's views.

Snowden and Samuel, along with Sinclair, the Secretary of State for Scotland, proved equally intractable in the debates that took place at the Cabinet level. On January 21, Sir E. Hilton Young, the Minister of Health, put forth the vicious-spiral argument on behalf of the majority.[19]

> Previous experience showed that in a large country with a highly developed economic organisation what was likely to happen with such an adverse balance as ours was not that the £. would balance exports and

[17] Samuel also reported Keynes's mysterious remark that a tariff might be appropriate in the future for political or social reasons. "Conclusions of the Third Meeting of the Cabinet Committee on the Balance of Trade," Cab 27/467 BT(31), Jan. 12, 1932, pp. 39-48. See also Howson and Winch (1977, p. 98); Harrod (1951, p. 431). Keynes (1933) developed these views in an article first delivered as the Findlay Lecture at University College, Dublin, Apr. 19, 1933.

[18] Cab 27/467 CP25(32), Jan. 19, 1932, pp. 3-18.

[19] "Conclusions of a Cabinet Meeting," Cab 23/70 Cabinet 5(32), Jan. 21, 1932, p. 111.

imports by slow movements, but that there would be a gradual fall to a danger point, at which there would be a catastrophic fall, with far more serious consequences to the cost of living than those attending a tariff.

Prime Minister MacDonald responded that he had been forced to reconsider his position on a policy that he believed to be unsound under normal international conditions. He agreed that the Government must find some means of protecting the pound. He was prepared to contemplate a tariff under "these exceptional circumstances."[20] Sinclair raised the question of tariff retaliation abroad and expressed his belief that it would be impossible to dispense with the tariff once circumstances had returned to normal.

Without the cooperation of the dissenting members, the Government was faced with the alternatives of abandoning plans for a tariff or restructuring the Cabinet. The Conservative majority was unwilling to adopt the first course, but the second would have destroyed MacDonald's pretensions of leading a government of national unity. In fact, a third alternative was invented: the celebrated agreement to differ, whereby the free-trade members of the Cabinet could continue to serve in the Government while speaking out against its tariff proposal (Beer, 1965, pp. 287-292).[21] Thus Snowden, Samuel, Sinclair, and Maclean, the Education Minister, dissociated themselves from the decision to approve the Report of the Cabinet Committee on the Balance of Trade.

These members of the Cabinet also dissociated themselves from the Import Duties Bill, which was introduced in Commons on February 4, 1932. This bill provided for three types of duties: a general 10 per cent import levy, additional duties and exemptions for special commodities, and retaliatory duties. Imports from the Empire were exempted, pending negotiations with the Empire at the Ottawa Conference. Imports of many raw materials were excluded, among them wheat and maize, meat and animals, iron and tin ores, scrap steel, zinc, lead, rubber, pulp and newsprint, cotton, wool, flax, and hides and skins. An Import Duties Advisory Council was created to receive applications for modifications of existing duties and to frame recommendations for new and modified duties for presentation to Parliament.

[20] *Ibid.*, pp. 114-115.
[21] See also *ibid.*, Jan. 22, 1932, pp. 2-5.

The introduction of the Import Duties Bill was widely perceived as the culmination of a series of momentous events in the evolution of British commercial policy. The *Times* (Feb. 5, 1932, p. 12) noted the festive and attentive appearance of the House of Commons and remarked that it reflected the fact that "the business at hand marked a turning point in British policy." The unusually moving character of Neville Chamberlain's speech of introduction was widely commented upon. Its substance was that a tariff was needed to improve Britain's adverse trade balance and "to effect an insurance against a rise in the cost of living which might easily follow upon an unchecked depreciation of our currency." Chamberlain concluded that "really the essential point is the value of sterling" (Royal Institute, 1932, pp. 25-26).

4 CONCLUSION

No single factor was responsible for the British decision to adopt the General Tariff in 1932. The familiar shibboleths of protection and free trade continued to dominate the opinions of many politicians, although Britain's immediate economic problems forced some to reconsider their views. Recently, it has been suggested that the policy-makers' dominant concern was unemployment, and that, because they waited to impose a tariff until Britain had adopted a floating exchange rate, their actions magnified the dimensions of this problem. The evidence presented here supports another interpretation. The politicians' outlook was conditioned by the European inflations of the 1920s, and few had faith that a floating exchange rate represented a solution to the problem of external balance. They supported the imposition of the General Tariff in order to guard against the dangers of hyperinflation and unbounded exchange-rate depreciation, and they made this choice knowing that the tariff might exacerbate the problem of domestic unemployment. This possibility, however, was the price to be paid for exchange-rate and price stability.

In retrospect, it is difficult to assess the realism of the politicians' fears. Whether, in the absence of a tariff, the British economy would have been launched into a vicious spiral of inflation and depreciation is a matter for conjecture. To many, this possibility now seems unlikely. But, justified or not, the authorities' fears and their distrust of the effects of a floating exchange rate formed the basis for their decision to impose the General Tariff.

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