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Sterling and the Tariff, 1929-32

Barry J. Eichengreen

INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS
PRINCETON UNIVERSITY

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PETER B. KENEN, *Director*
International Finance Section

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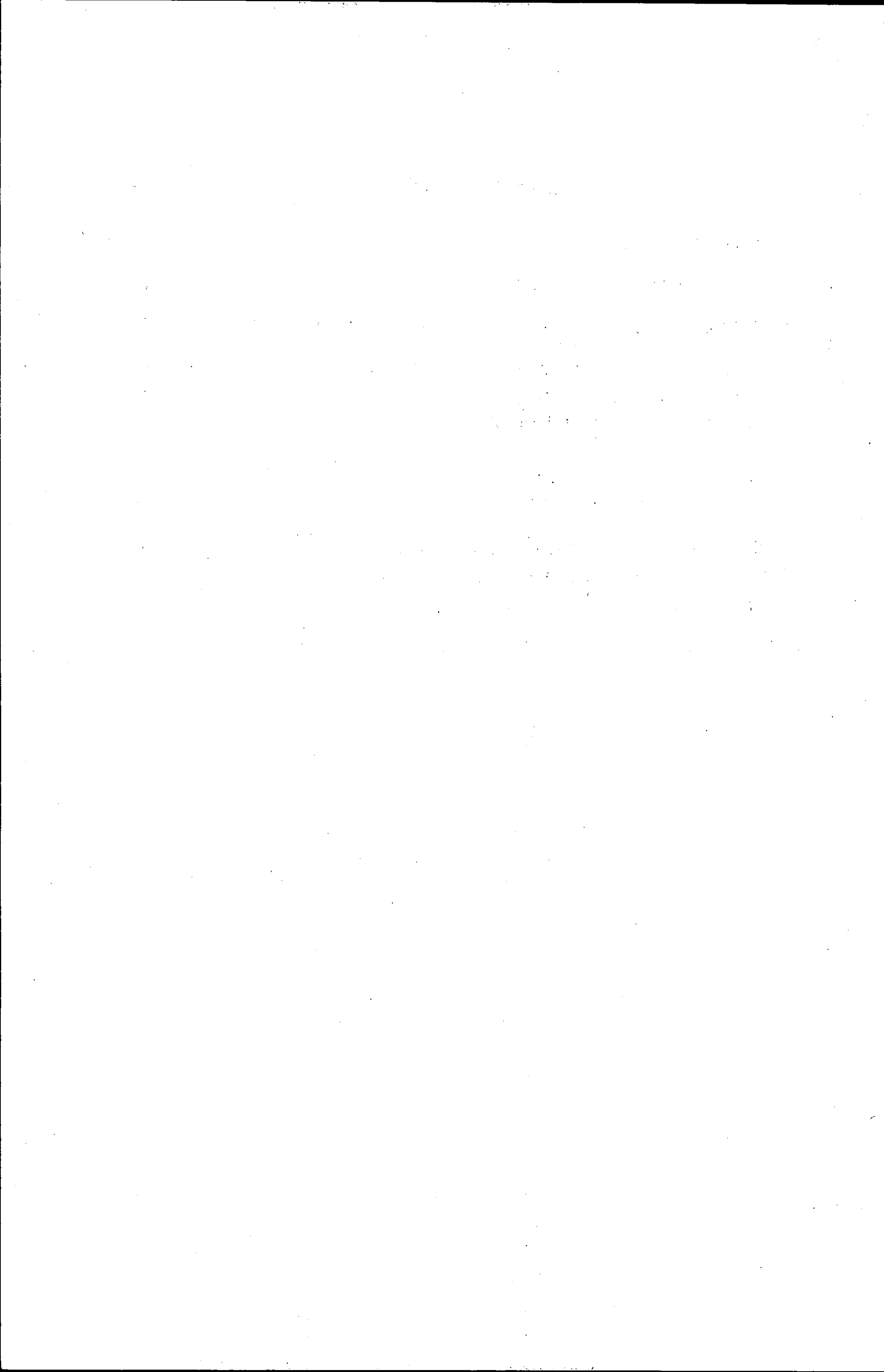

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1 INTRODUCTION

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.