PIGOU ON THE RETURN TO GOLD, 1918-1925

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PRELIMINARY REMARKS

This paper covers only a single incident in Pigou's long career—his analysis of the British return to the gold standard in 1925. Pigou's work is notoriously voluminous, filling thousands of pages of books and articles, both scholarly and otherwise, reports to parliamentary committees, testimony before royal commissions, and letters to *The Times* running to some fifty years. The present paper is a small piece of a book-length study of Pigou's economics. In light of these considerations, a brief account of its premises may be useful.

Policy Analysis, Not Policy Making

Pigou's economics is conventionally understood as a body of policies, chiefly "Pigouvian' taxes and subsidies designed to maximize economic welfare. Although he assessed welfare programs of his time, Pigou's policy judgments were invariably prima facie, guarded, and qualified by a detailed consideration of a formidable array of contingent variables, many of which were beyond the powers of economic calculation and prediction. Pigou was not a proponent of specific economic policies but, as he called himself, a logician of policy analysis.

Historicism

In targeting, rejecting, or discarding policies for analysis, Pigou's choices were decided chiefly by his sense of the shifting balance of interests, priorities, and power that would determine which policies were likely to be enacted and which would disappear from the public agenda. His conception of the validity of policy analysis was based on the same considerations. As a result, Pigouvian economic generalizations are empirically fragile propositions, vulnerable to shifts in the polity and the economy. As these shifts occur, it is impossible for economists,

enmeshed in history, to make scientifically reliable estimates of their scope and implications. An economic analysis is an historical artifact, constrained by the same contingencies that define all historical phenomena.

Politics and Economics

In a Pigouvian regime, economists do not make policy, which lies in the province of politics. Economists analyze effects of alternative policies, spelling out their consequences for the size, distribution, and stability of national income. The choice between these alternatives is not a legitimate question for economics, which is a purely positive science. Political leaders, not economists, make economic policy.[1]

Reading Pigou by His Own Light

Pigou has generally been read as he appears in the writings of his younger Cambridge contemporary J.M. Keynes, whom he endowed with a lectureship paid from his professorial stipend in 1908, following a precedent established by his own master Marshall. This is roughly comparable to understanding the ancient Greek sophists based on their appearance as philosophical knaves or villains in the dialogues of Plato. We read Pigou in a different light: on the grounds of what he attempted to achieve in his writings: theoretical intentions that were situated in British politics and economics when he took up a particular set of problems as well as analytical objectives that shifted with his sense of movements in the British polity and economy.

THE SETTING

Before World War I, the British currency consisted of gold coins and Bank of England notes, largely convertible to gold at a parity rate of $4.86. On entering the War, the government did not abandon the gold standard but pegged the sterling at a parity rate of $4.76, some two percent below its long held sacrosanct prewar rate. With a ban on melting gold and sovereigns that were out of circulation, the Treasury was allowed to issue as legal tender a new and primarily inconvertible paper money called currency notes. The government funded its wartime expenditures through taxes, loans, and credit from the Bank of England based on promissory notes. Credit and currency policy, however, were linked (Hawtrey 1922, 292). As the government paid workers and contractors through central bank credit, balances in commercial bank accounts swelled, leading to more loans and higher prices. The Bank Act of 1844 had authorized but strictly limited fiduciary note issues. No limit was set on currency note issue.[2] Without the so-called adjustment mechanism of the gold standard, British and world prices could not be coordinated (*HMSO* 1918, 4). Because of the threat posed by German submarines, higher prices did not result in gold exports. The peg stabilized the nominal exchange-rate. Nevertheless, it was obvious that the sterling had depreciated, although it was difficult to estimate the extent (HMSO 1918, 5).

In January 1918, the Treasury and the Ministry of Reconstruction formed the Committee on Currency and Foreign Exchanges after the War under the Chairmanship of Lord Walter Cunliffe, then governor of Bank of England. The Committee members were banking and finance executives, Treasury officials, central bank governors, and Pigou, the sole academic. The remit of the Committee included the charge to consider "the various problems which will arise in connection with currency and foreign exchanges during the period of reconstruction and report

upon the steps required to bring about the restoration of normal conditions in due course" (HMSO 1918, 2). On August 15, 1918, it released an interim report: "nothing can contribute more to a speedy recovery from the effects of the war, as to the re-establishment of the foreign exchanges, than the re-establishment of the currency upon a sound basis" (HMSO 1918, 3). In order to achieve this objective, the Committee recommended that the government begin by returning to fiscal discipline: terminating seemingly endless borrowing and credit expansion and repaying its debt, a difficult undertaking in view of the extreme pressure to fund postwar reconstruction. Fiscal responsibility depended on strict limits on the fiduciary note issue. However, these limits could not be specified with precision due to various contingencies, including uncertainty over post-war prices. In consequence, the Committee recommended that the Treasury gradually reduce the currency notes in circulation to a level consistent with £150 million in gold reserves, which was the estimate sufficient to maintain stable exchange rates on the gold standard. This level would be maintained for one year, at which time the remaining currency notes would be replaced with Bank notes (HMSO 1918, 8-10; Pigou 1919d).

In March 1919, the government ended its currency peg, which had been sustained by loans at a cost, between 1915-16 and 1918-19, of more than $2 billion (Moggridge 1969, 12). Some ten days after the currency peg was suspended, the gold standard was abandoned and the sterling floated. To prevent a gold flight, gold exports were banned until the end of 1925. These measures did not change the position of the Committee, which issued its final report on December 3, 1919. It held that an inconvertible currency spelled disaster: interminable issues of currency, inflation, and depreciation in the foreign exchange markets. Because the economy was in the final stage of demobilization, it was time to reduce the volume of currency notes in circulation. The actual volume of fiduciary notes circulated in one year became the maximum

legal limit for the following year (HMSO 1919b, 3). The Committee reiterated its view of the importance of restoring "the pre-war methods of controlling the currency and credit system of the country for the purpose of re-establishing at an early date a free market for gold in London" (HMSO 1919b, 3). There was broad consensus among Committee members and expert witnesses that a return to gold was the best policy for the country, to be achieved as expeditiously as possible. The Committee report made the tacit assumption that on the occasion of the return, the country would reestablish the prewar parity rate (hereafter, par).

The return to gold proved to be a hazardous undertaking. A period of demobilization and planning for postwar exigencies was followed by a vigorous one-year boom that peaked in April 1920. Several factors, including elimination of wartime controls and deficit financing that increased liquidity in the banking system, created high rates of inflation—10.1 percent in 1919 and 15.4 percent in 1920 (Historical UK Inflation and Price Conversion). The pound depreciated, reaching its lowest level of $3.20 in February 1920 (Dimsdale 1981, 308). Inflationary expectations and uncertainty over whether the government could continue to raise funds through short-term securities compelled the Bank of England to increase its discount rate to 7 percent in April 1920. This rate was maintained through the first year of the Great Slump—the worst the country had experienced—even though unemployment had risen by some 10 percent (Social Democracy for the 21st Century n.d.).[3] Thereafter, the rate was gradually lowered to 3 percent. Beginning in 1921, severe deflation—8.6 percent in 1921 and 14 percent in 1922—reduced British prices relative to American prices (Historical UK inflation and Price Conversion n.d.; Historical Inflation Rates: 1914-2013 n.d.). While the economy suffered from the slump, the pound gradually recovered some of its lost value. However, it seemed politically unwise to return to gold. Elevating a severely depreciated currency would require steep increases in interest rates

and further reductions in prices. Wage reductions would follow, aggravating labor strife dramatically.

In July 1923, some six months after the end of the slump, the Bank of England increased its discount rate from 3 to 4 percent, taking a serious step toward restoring the gold standard. The Federal Reserve Bank of New York complemented the move the year after by reducing its rate to 3 percent, creating a differential rate of one percent in favor of London (Dimsdale 1981, 311). This increase in the value of the sterling encouraged policy makers to believe that a return to gold was possible in the near future. Accordingly, the Treasury Minute of June 10, 1924, appointed the Committee on the Currency and Bank of England Note Issue to "consider whether the time had come to amalgamate the Treasury note issue with the Bank of England note issue, and, if so, on what terms and conditions the amalgamation should be carried out" (HMSO 1925b, 372). The Committee was composed of five members. Again, with the exception of Pigou, they represented the Treasury, banking and finance, and the Exchequer. Austen Chamberlain, Joseph Chamberlain's son, chaired the Committee until he was appointed Foreign Secretary, after which Lord John Bradbury assumed the Chairmanship. The Committee held nine meetings in June, July, and September 1924 and heard 13 witnesses, including Sir Montague Norman, the governor of the Bank of England, Reginald McKenna, Chairman of the Midland Bank, Sir Robert Horne, former Chancellor of the Exchequer, Edwin Cannan; Sir George Paish, advisor to Lloyd George; J.M. Keynes; and representatives from the clearing banks, the Association of British Chambers of Commerce, and the Federation of British Industries (HMSO 1925b, 372). As the Committee worked on a draft of its report, the Labor government, which had appointed it, was defeated in the general election of October 1924.

The Chamberlain-Bradbury Committee began its work with the Cunliffe Committee recommendation to amalgamate the Bank-Treasury paper currencies following a return to the gold standard. Thus consideration of notes amalgamation depended on determining whether and when the gold standard would be restored. Expiration of the gold exports embargo at the end of 1925 also made a decision on the return imperative. As Committee members understood their brief, they were expected to consider three options: (1) return to the gold standard at par; (2) return to gold at a new, devalued parity; or (3) recommend a currency system that was independent of gold. They declared that devaluation "was never in our opinion, a policy which the United Kingdom could have adopted" but offered no explanation for this position (HMSO 1925b, 373). However, even if the Committee had regarded devaluation as politically possible in September 1924, when the exchange rate against the dollar—the only currency the Committee apparently considered—was 10 to 12 percent below prewar parity, it had become a dead issue by January 1925, when the difference between the current rate and par was less than 2 percent. A return to par would have required minor adjustments—"inconveniences," a euphemism for deflation, unemployment, and labor unrest.[4] An alternative currency system was ruled out as impracticable at the time. Hence the conclusion of the Committee that there was no acceptable alternative to a return to prewar gold parity of the sovereign, a view that was "supported by the overwhelming majority of opinion, both financial and industrial, represented in evidence before us" (HMSO 1925b, 373).[5] Thus the only serious question concerned the mechanics and timing of the return to gold.

The report of the Committee was drafted by its secretary and revised by Pigou, following which other members strengthened its language (Moggridge 1969, 33-34). It took into account the postwar international malaise in trade, the fact that Britain could not collect war debts from

its economically weaker European allies, and the country's need to create a sinking fund to pay off its own war debt to the United States. However, the Committee was optimistic about the ability of the country to restore and maintain a free gold market at par if it made the necessary domestic price and wage adjustments and restricted its foreign investments to match its export surplus (HMSO 1925b, 373-74). In September 1924, the difference between the actual exchange rate and prewar parity was wide enough to tip the balance of cost-benefit calculations in favor of a "waiting policy in the hope that the disparity would disappear through a rise in American prices (of the probability of which there appeared to be indications)." At that time, a return to prewar parity would have required a contractionary credit policy to slash domestic prices. The Committee entertained hopes that essentially the same result could be achieved "within a very few months" by means of a policy that would maintain stable domestic prices against the anticipated rise in American prices (HMSO 1925b, in Gregory 1929, 375). In October 1924, the Committee submitted its recommendation to the governor of the Bank of England: the country should curtail foreign lending and maintain the sterling at its current value, reevaluating the situation within a year (Moggridge 1969, 34).

Brian Reddaway has speculated that if the Labor government had not been defeated in the general election of autumn 1924, the Committee would have reassessed the situation one year later, finding the pound weak and recommending further delays (1970, 16-21). Reddaway's counterfactuals were mooted by the election of a Conservative government, which encouraged the perception that a return to gold was imminent. The sterling appreciated to $4.79 at the beginning of 1925, when the Committee heard evidence from governor Norman. He reported on his discussions with the governor of the Federal Reserve Bank of New York and an American line of credit that would support the return. The economic adjustments required for prewar parity

would not be significantly different from those needed to maintain the current exchange rate of $4.79. Unsurprisingly, the Committee recommended an immediate return to gold and amalgamation of the two paper currencies in a not too remote future—they were in fact amalgamated in 1928. On April 28, 1925, Winston Churchill, the new Chancellor, announced the return in his budget speech (Reddaway 1970, 19-21).

The decision to reintroduce the gold standard has been analyzed at length and lies beyond the scope of this book (see Moggridge 1969, 1972; Dimsdale 1981; Eichengreen 1992). With a few exceptions (e.g. Moggridge 1969), the decision has been assessed from the point of view of costs of the return: deflation, labor strife, unemployment, and damage to the competitiveness of British exports (Keynes 1925; Stamp, 1925; Barkai 1993). Pigou's views have been ignored, misconceived, or otherwise misunderstood. We offer an analysis of his views, exploring his reasoning and its basis. No effort on our part to defend Pigou's position should be expected. Our objective is analysis and explanation, not apologetics.

In 1931, the Committee on Finance and Industry—popularly known as the Macmillan Committee—examined the predicament of British export industries. It maintained that the difficulties encountered in this area were, in the main, a consequence of two factors: the rigidity of domestic costs in the face of deflation that followed the 1925 return to par and the American stock market crash of 1929 (in Stamp 1931, 426). In his evidence before the Committee given on May 29, 1930, Pigou was asked to explain his position. He was "not particularly inclined" to apologize. "It seems to me," he observed, "the argument is put rather unfairly against the return to gold" (HMSO 1931, 54). Here, as in his writings prior to April 1925, Pigou conducted his analysis by weighing the costs of the return to par with the costs that would ensue if the country maintained the status quo, refusing to purse that policy. In what follows, we examine Pigou's

thinking on this matter, which was reflected in committee reports, summarized in a memorandum for the League of Nations International Financial Conference in Brussels in September-October 1920, given in evidence before various commissions, and published in magazines, newspapers, and books for the general reader between 1918 and 1930.

Costs: Maintaining the Status Quo

The wartime currency peg weakened the tight connection between currency and gold. The postwar currency float severed it altogether. The resulting inconvertible currency system lacked the adjustment mechanism of the gold standard that Pigou believed automatically corrected currency, credit, trade, and price imbalances (HMSO 1918, 3-4).[6] Unlimited credit issues enabled the banking system to make funds available to the public at low interest rates. Pigou argued that low interest rates created two problems. First, they encouraged borrowing at the expense of savings, impoverishing real capital markets, where savings—funded through household choices to sacrifice current consumption—were made available to borrowers. Capital markets provided the only reliable source of funds for postwar reconstruction (HMSO 1918, 6; Pigou 1920d, 9). Second, unlimited credit issues reduced British interest rates below those in other countries, leading to increased foreign lending when the economy required funds for reconstruction (HMSO 1919b, 3).

The most disturbing consequence of a monetary system not anchored in gold was its inability to correct the unsustainable rates of inflation it was prone to create. The British policy of funding government expenses through credit and unlimited issues of notes had created historically high inflation rates. The consumer price index jumped by 22 percent in 1918, 10.1 percent in 1919, and 15.4 percent in 1920 (Historical UK Inflation and Price Conversion). A

decision to maintain an inconvertible currency system threatened to create the hyperinflationary economies that Germany and Austria experienced following the war.

Inflation was dangerous because it redistributed income unfairly in three ways. First, it was an implicit income tax, a forced levy that transferred funds from the public to the government. There was a limit to this method of public finance: “so long as notes have any value at all, a government can always raise *some* real revenue by issuing new notes, it may soon become impossible for it to raise a substantial real revenue without issuing so large a mass of them as practically to annihilate their value” (Pigou 1923b, 197). Second, inflation redistributed income from holders of debenture stocks—equities that paid fixed dividend payments—to investors who received ordinary dividends. Third, inflation eroded the purchasing power of wages and salaries. This would drive workers to demand cost of living adjustments, generating “great friction” (Pigou’s 1920d, 8; 1921a, 161). In the British postwar political economy, this concern was acute. In 1919-1920, 4.6 million workers had been on strike, resulting in a loss of 61 million workdays. The three-month coal stoppage of April-June 1921 had raised the unemployment rate to22-23 percent (Pigou 1947a, 164-65, 40).

Continuous inflation could catastrophically depreciate the currency and erode trust in its credibility. Currency depreciation could be very large—Pigou’s examples included not just Germany and Austria but also Italy and France (Pigou 1920d, 8). Domestically, citizens would be reluctant to use the currency as a medium of exchange, which would diminish production and exchange. Depreciation of the currency and loss of currency credibility could create a vicious circle, causing higher domestic inflation. Wide fluctuations in the exchanges damaged cross-border trade and credit transactions (Pigou 1920d, 12; 1921a, 161). For instance, uncertainty about future exchange rates would weigh heavily on merchants who purchased raw materials. If

they planned to conduct the transaction using currency, they faced the uncertainty that competitors could obtain the same goods at more favorable exchange rates at a later date. Purchasing materials on credit was bedeviled by its own uncertainties. The exchange rate at the time of contracting could be much lower than the rate at payoff (Pigou 1920d, 12; 1921a, 167-68). In Pigou's view, the prospect of such an economy was truly abysmal. In the worst case, which was not an unrealistic possibility, the continued "debasement" of the currency and the loss of its credibility could render it worthless, irreparably damaging international trade and causing the industrial fabric of the nation to unravel (Pigou 1921a, 161-62).

Currency depreciation could create an immanent, self-perpetuating dynamic that would continue to operate even after the government decided to adopt more responsible instruments of public finance. National solvency could be threatened if the government that issued the currency were deemed untrustworthy (HMSO 1918, 2; Pigou 1921a, 163). Under these circumstances, the ability of the state to raise funds through loans would be gravely compromised. The permanent danger, according to Pigou, was floating, or short-term, debt. If holders of Treasury bills refused to renew them at maturity, the government would confront a dilemma: significantly higher rates on securities or creation of further credit (Pigou 1920d, 9).

Costs: The Return to Gold at the Prewar Parity Rate

The Chamberlain-Bradbury Committee members, including Pigou, have been criticized for discounting costs of the return to gold. In the case of Pigou, this criticism misses its mark. He regarded it as evident that overvaluation of the sterling would require painful adjustments. A return to par would require reductions in British relative prices. Although such a reduction could be achieved by increasing British productivity relative to American productivity, this scenario

was extremely improbable, because the war had created much higher levels of financial and real dislocation in the British economy. Alternatively, American prices could increase relative to British prices, requiring no further action by London. Obviously, this possibility depended on American monetary policy as well as contingencies that neither country could be expected to control. Stable or falling American prices would require deflation to restore prewar relative prices. Deflation would favor neither industry—which would be compelled to accept lower profit margins—nor workers, who would be asked to reduce nominal wages. Moreover, the state would be forced to service its war debt using a more expensive currency. This prospect would be unfair as well as fiscally damaging, necessitating either budget deficits or extremely high tax rates (Pigou 1921a, 176-77).

The cost of the transition to the gold standard also depended on the monetary policy of the British government. In a letter to the editor of *The Times* of February 12, 1920, Pigou lamented the depreciation of the exchange rate—at the time $3.30—which he thought was caused by a policy of expanded credit and low Bank rates. Pointing out the broad national consensus on the merits of returning to par, he questioned an easy monetary policy that, at the height of the postwar boom, had lowered the Bank rate below rates prevailing in Japan and the United States, where the economies were much stronger. Failure to increase the Bank rate would cause higher prices, trade imbalances, and foreign lending—a dynamic for which there was no foreseeable end. Although a moderate rise in the rate to 8 percent would damage wage and salary earners, businesses, and the highly indebted government, it would not create financial havoc. However, costs would rise enormously if interest rates did not increase, requiring much more drastic subsequent hikes in the Bank rate. In another letter to the editor of *The Times* of May 1, 1920, Pigou reiterated the need to elevate the Bank rate, even though the slump had already

begun. If the ban on gold exports were lifted, low interest rates would lead to a gold flight. Massive gold exports could be forestalled only by astronomical Bank rates. The result: further financial crises that would produce unforeseeable consequences. Failure to act, Pigou argued, would increase the risk of shattering the creditworthiness of the country and its financial standing.

In his publications, Pigou specified conditions necessary to minimize costs of the return to par. Responsible credit and currency policies would be required to end high rates of inflation, reducing domestic and international fears of further inflation and depreciation (Pigou 1920d, p. 12). In Pigou's view, restoration of the gold standard would succeed only if the gap between par and the exchange rate at the time of the return was below 20 percent. It followed that British-American relative prices could not deviate significantly from their prewar levels. Moreover: "industry and the general export trade of the country must be already so far restored, and the loans we are making to foreigners so far stopped, that the gap between immediate obligations to make payments and immediate claims to obtain payment elsewhere is reduced to more manageable dimensions" (Pigou 1920e, 173).

In September 1924, Pigou was working on a draft of the Chamberlain-Bradbury Committee report. Costs of not returning to gold at this point seemed decisively higher than costs of returning. Relative prices had moved in favor of Britain (Dimsdale 1981, 308). The country had experienced deflation for every year of the period 1921-24. With the exception of 1922, American prices had stagnated or increased over the same period.[7] The British financial position was still weak due to war debts European allies owed Britain as well as corresponding payments Britain owed the United States. However, there were grounds for optimism, resting on the British current account balance. Although some industries had lost their international prominence,

considered collectively, export, insurance, shipping, and foreign investment revenues generated adequate funds to support British debt obligations and imports (in HMSO 1925b, 373-74). The difference between the actual exchange rate and par was 10-12 percent. Although the gap was below the 20 percent Pigou had identified as the maximum limit in 1920, it was still significant enough to justify a "waiting policy in the hope that the disparity would disappear through a rise in American prices (of the probability of which there appeared to be indications)." Transient but severe deflation could impose high economic and social costs on the economy. It was prudent to wait a few more months to determine whether the gap would disappear as the result of an expected rise in American prices. It "could not be regarded as a matter of such extreme urgency as to justify a credit policy calculated to bring down domestic prices if the same practical results could reasonably be expected to be attained within a very few months by a policy designed merely to prevent them from rising concurrently with a rise elsewhere" (HMSO 1925b, 375). By January 1925, the actual-par exchange rate gap had shrunk to less than 2 percent. In addition, the country could maintain its limitations on the fiduciary note issues proposed by the Cunliffe Committee. In consequence, costs of the return to gold seemed much lower than costs of not returning.

Devaluation and Alternative Currency Systems

In his testimony before the Macmillan Committee on May 29, 1930, Pigou was asked to explain why the Chamberlain-Bradbury Committee had recommended a return to par. Why were other options—devaluation or a currency system not anchored in gold—not taken seriously? Keynes, a member of the Committee, posed the following pointed question to Pigou: "Did the Terms of Reference of the Committee rule out one or the other of the alternatives?" In

responding to Keynes, Pigou emphasized the impracticability of alternative options at the time. "The real practical alternative in my view was, to go back now or later" (HMSO 1931, 54). Examination of Pigou's writings shows that his analysis of this matter was grounded in postwar economic and institutional constraints facing the international and domestic sectors.

In autumn 1920 (September 24-October 8), the newly established League of Nations organized an international financial conference in Brussels. Thirty-nine countries answered the call to assess the postwar international financial disarray and to devise measures to restore economic stability. As national governments responded to questionnaires on budget and debt, trade, money supply, and official reserves, five leading economists—Gijsbrecht Weijer Ian Bruins (Holland), Gustave Cassel (Sweden), Charles Gide (France), Maffeo Pantaleoni (Italy), and Pigou—prepared memoranda on credit, currency, and exchange-rate fluctuations.[8] In addition to individual memoranda, the five experts issued a joint statement, emphasizing the need to end runaway inflation, stabilize exchange rates, revive international trade, and develop a policy for disposition of international credit (Decorzant n.d.). There was remarkable consensus among the Conference delegates as well. They urged governments to return to the prewar principles that had guided their internal policy, balance their budgets, end inflation, and restore currency credibility (Pauly 1996, 8). Although they recommended that each country determine its own rate of recovery in re-establishing a sound currency, return to a gold-based standard was emphasized as the foundation for a world currency policy. The international economy required a common standard for determining exchange rates. Gold was the only generally acknowledged standard (Pauly 1996, 8; Decorzant n.d.).

The question of establishing a stable basis for determining exchange rates was also discussed at the Genoa Conference, held between April 10, 1922 and May 19, 1922. Although

the Conference failed to achieve its political agenda of promoting European reconstruction and restore economic relations with the Soviets (Fink 1986, 41), it produced a resolution on an international convention for a gold-exchange currency regime. The report of the Financial Commission of the Conference, drafted by Hawtrey, Keynes, and Sir Robert Horne—Chancellor of the Exchequer—recommended what can fairly be described as a precursor of the Bretton-Woods system. Most world currencies would maintain stable exchange rates relative to a few major currencies such as the US dollar or the British pound. Only hard currencies would maintain direct convertibility to gold. This proposal begged the question of the exact magnitude of exchange rates. Should countries return to gold at prewar parity rates, or should they devalue? The proposed solution to this problem was arbitrary. It was conceivable that currencies that had lost less than 50 percent of their prewar value could still return to prewar parity. Currencies with a 60 to 90 percent loss of value could return to a rate that fell between their current and prewar exchange rates. Entirely new rates consistent with current prices were recommended for hyperinflationary economies (Eichengreen 1992, 157-63). As Hawtrey later explained, the effective operation of a gold-exchange system required the cooperation of independent central banks willing to manage their credit and currency policies on a regular basis (Hawtrey 1922, 292). In a world where many countries had not yet established central banks—Chile, Argentina, Mexico, Canada, and Australia are examples—this was a formidable requirement. In sum, the international community was not yet prepared to adopt either a modified version of the gold standard or a system completely divorced from it.

In his memorandum written for the League of Nations and in other writings as well, Pigou considered three alternative international systems—essentially, three possible options for currency reform. The first option was to follow the current course, provided that governments

returned to fiscal responsibility in financing their expenditures and taming runaway inflation. Maintaining the status quo would require one of the following two policies: deregulating gold markets and facing a drain on gold reserves, which would lead to an inconvertible currency; or a permanent ban on the export of gold. In either case, the result would be the same: a permanent breach between currency and prices on the one hand, and gold, on the other. Broad fluctuations in prices and exchange rates would ensue, with concomitant effects for trade and industry (Pigou 1920d, 10). In his testimony before the Macmillan Committee, Pigou warned Keynes and others, who had advocated this course of action, that their position was naïve and unrealistic. A currency policy based on the status quo would probably have further depreciated the pound, increasing the price of imported staples. Increases in the cost of living would also have increased wages in industries that used sliding scales. In other industries, British workers would have fought for wage increases. In short, a failure to return to gold would end in unstable prices and exchange rates (in HMSO 1931, 54-55).

A second, "theoretically attractive" currency regime was to abandon the gold standard altogether (Pigou 1920d, 11). In principle, such a system would not necessarily create volatile exchange rates. As he explained to the lay public in 1921, a "whole world of nations each with separate inconvertible currencies, could, if their governments were sufficiently firm and able, maintain a system of approximately stable foreign exchanges." In fact, however, such a dispensation was out of the question: "in the present state of the world, governments are not strong enough, nor yet sufficiently trusted, for a system of this kind to be likely to work. Something less directly dependent upon the conduct of politicians is needed" (Pigou 1921a, 168).

Another impracticable monetary regime would tolerate foreign exchange volatility but attempt to establish domestic price stability (Pigou 1920d, 11). This solution, inspired by Irving Fisher, would require governments to maintain purchasing power stability by buying and selling currency (Pigou 1912, 437; 1924a, 119-20). In Pigou's view, operationalization of this system faced impressive obstacles. In testimony before the Committee on the National Debt in March 1924, he argued that an unconventional approach to settling the war debt—a capital levy—would fail unless there was "general assent"—broad consensus—on its practicability. Solidification of current opinion against the policy made it very difficult to implement (HMSO 1927, 443). For the same reason, general assent was a prerequisite for operating a non-gold currency standard. Before Britain decided to return to gold, Pigou reminded the Macmillan Committee, there was an international consensus that the gold standard was the only viable currency regime. In an oblique reference to results of the Brussels and Genoa conferences, he pointed out that, before 1925, "it had been the decided policy of all Governments to go back to gold and, as a matter of practice, it was felt that nothing else could be done" (HMSO 1931, 54). This view was corroborated by actual events. Within the British Empire, Australia, New Zealand, and South Africa returned to gold in 1925, Canada in 1926, and India in 1927. In 1923-27, many European countries—Austria, Belgium, Denmark, France, Germany, Holland, and Switzerland—made the same decision. Outside Europe, Japan reintroduced gold in 1927 (Eichengreen 1992, 188). Pigou told the Macmillan Committee that he did not think "you can work a non-gold currency unless it is generally agreed, and at that time [1925] it seemed to me it was quite impossible" (HMSO 1931, 54). The year before Britain returned to the gold standard, Pigou explained why a Fisherian system would not work:

> In practical affairs, to introduce large changes the meaning of which most people cannot understand is dangerous. So far as the United Kingdom is concerned, until the gold standard has been re-established, more elaborate improvements in our monetary system are not practical politics. When it has been re-established public opinion is unlikely, for some time, to sanction any formal departure from it. If this is so, both the Fisher plan and any thorough-going attempts at stabilization by discount policy are ruled out of court (Pigou 1924a, 121-22).

In light of the above constraints, Pigou concluded that restoring the gold standard was the only realistic policy option (Pigou 1921a, 168). A return to gold did not necessarily signify a return to prewar parity. However, he argued that devaluation was "just as impracticable as the other [non-convertible currency], perhaps even more so" (in HMSO 1931, 54). A lower parity could create more inflation, which would be extremely unpopular in the post-inflationary economy of the time (in HMSO 1931, 54). It would, for example, impose hardship on lenders who had extended loans when the currency was stronger. For this reason, the government might be expected to increase the nominal amount of loans in order to reduce the burden on lenders. The frequent exchange of securities on open markets would make such compensation schemes extremely complicated (Pigou 1920d, 12). For Britain, the most devastating impact of devaluation would be a loss of trust in the government that espoused the policy and a decline in the international financial prestige of London as a center of finance (Eichengreen 1992, 163). A government that devalued the currency once could perhaps be expected to do so repeatedly. As Eichengreen put it: "Credibility and $4.86 were not just linked. They were regarded as synonymous" (1992, 163). This was Pigou's position as well. Deliberate devaluation would

"reduce general confidence in the financial probity of the devaluating country" (Pigou 1921d, 174; see also Pigou 1920d, 11; and Pigou in HMSO 1931, 54).

The consequences of this loss of confidence and Britain's capacity to fight another major war were intimately connected. Recall Pigou's fear in 1916 that a punitive peace accord with Germany would cause another war. In the years following World War I, he regarded the European peace as fragile and was preoccupied—"obsessed"—with the likelihood of another war. In 1924, he even estimated that "there might quite well be a war in 20 years" (HMSO 1927, 444). Breakthroughs in nuclear physics suggested the potential devastation of another general war. The following observations were written in 1926, twelve years before Otto Hahn and Fritz Strassmann discovered nuclear fission.

> It would be rash to set a limit to what may be possible here. No man, for example, can be certain that there will not some day be discovered a means of releasing and controlling the stupendous energies that are stored inside the atom. Should this be done mankind will become possessed of powers utterly beyond the reach of our present imaginings; powers which they may, indeed, devote in war to mutual annihilation, but which there is at least a hope may serve a better end (1926b, reprinted in Pigou and Robertson 1931, 25).

Pigou's experience of the Great War had taught him that wars of the magnitude he envisioned could not be funded exclusively through taxation, the burdens of which would cause public animus against the war. This was the reason, he claimed, why the British did not attempt to fund World War I through taxation. Like the 1914-18 war, a subsequent European conflagration could be funded only through significant borrowing (HMSO 1927, 438). The

national credit—in Pigou's understanding, the terms under which a government would be able to borrow—depended on public confidence "in the ability and willingness of the Government to honour any obligations that it may incur" (HMSO 1927, 39). Devaluation—"manipulation of the currency" (HMSO 1927, 42)—would shatter this confidence, because the public would be convinced that the government did not intend to honor its commitments or secure the sanctity of contracts (HMSO 1927, 42, 57).

CONCLUDING REMARKS

Several observations. Pigou's analysis of the problems surrounding the return to gold and the conclusions he drew from them were based on utilitarian reasoning—weighing the costs of returning to gold against the costs of other policies, principally maintaining the status quo. He seems to have disposed of other options—for example, a non-gold system, which he preferred personally (1912, 437; Pigou in HMSO 1931, 54), or a devalued currency based on gold—in some measure because he was committed to a theory of economic policy quite different from the view held by Keynes, who as a member of the Macmillan Committee, interrogated Pigou as an expert witness. Two points are apropos here. Pigou believed that novel policies—unfamiliar to the political class and the public because they represented a departure from convention or were not legitimated by tradition—could not be expected to succeed. Stated in the academic discourse of our time, a policy that constituted a paradigm shift would fail unless measures were taken to embed its elements in the public consciousness, establishing a consensus in its support and developing an effective framework for its implementation. Pigou, unlike Keynes, was profoundly suspicious of intellectually clever innovations in the political sphere. In this respect, it was Pigou rather than Keynes who was the authentic Burkean political economist. Second, Pigou reserved a

much more modest role for economists in the social order than Keynes was prepared to accept. In the Pigouvian scheme, statesmen and not economists made economic policy. Although he investigated policies and drew inferences from his conclusions, he regarded himself, together with all legitimate economists, as an analyst, not a maker, of policy. This position is quite clear in the cover letter to his draft of the report to the secretary of the Chamberlain-Bradbury Committee he wrote in 1924.

> On the main issue, which is one of practical politics rather than economics, whether the Government should take the plunge now or denounce no renewal of the embargo, I am only *just* in favour of a "wait and see" policy. It would be very inappropriate for me as an academic person to *press* for heroism; but if the rest of the Committee had been in favour of it, I doubt if I should have opposed (in Moggridge 1969, 34, emphasis in the original).

In his book on economic history, Pigou revisited the return to gold, explaining why British officials were intent on reducing inflation at the time. They had hoped to prevent the exchange rate from falling, which would have occurred if prices in the UK had dropped gradually at the same time that American prices were "rushing downward." What did in fact happen? British prices fell less precipitously than American prices, and the exchange rate in the UK dropped. Pigou explained the reasoning of British officialdom as perhaps based on an error. Not an economic error, however, but a political miscalculation. "The mistake of the British authorities, if it was a mistake, was not one of technical analysis but one of broad policy." The broad policy was to "restore our currency to pre-war gold parity in the near future." In politics, good timing and an acute sense of contingencies are indispensable. Pigou thought that the economics of the

British decision was sound, even though the decision itself may have been flawed because the political sensibilities of the decision-makers were not sufficiently acute. However, once the decision was made, further analysis of the return to gold became moot. With "American prices moving as they did, to allow the monetary Slump here to become profound, in spite of the damage thereby done to industry and employment, was a necessary means to an accepted end" (1947, 197).

An end, that is, accepted by the British political class, Pigou's "philosopher-kings." In his early philosophy of economic science, articulated in his 1908 inaugural lecture as the Cambridge professor of political economy, economists were handmaidens who sat at the feet of the moral philosopher, taking their course from his pronouncements. In his actual scientific habitus, however, Pigou was the scientific expert who whispered into the ear of the prince, informing his decisions with knowledge based solely on empirical investigation and logical analysis. When the prince made his decision, the course of history changed, altering the desiderata and the scientific agenda of the economist. In consequence, Pigou's analyses as well as his choices of problems to analyze changed with shifts in the political winds and reassessments of national priorities that occurred in Westminster, Downing Street, Whitehall, and the City of London.

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ENDNOTES

[1] For a full discussion of Pigou's theory of economic policy analysis, see Aslanbeigui and Oakes 2012.

[2] By December 1920, currency notes outstripped Bank notes by a factor of 3.22 (Federal Reserve Bank of St. Louis 1928).

[3] On calculating the British unemployment rate, see Feinstein 1972 and Garside 1990.

[4] Historians have criticized the Committee for employing this locution. However, its use in the present context does not seem to have been extraordinary. In notes Keynes wrote after an interview on February 4, 1920, with Austen Chamberlain, Chancellor of the Exchequer, he referred to the effects of high inflation as "social unrest and other inconvenient consequences which that will bring with it" (in Howson 1973, 458).

[5] Keynes and McKenna did not want the country to return to gold at that time.

[6] Garside argues that the success of the gold standard before World War I was due to "a number of fortuitous circumstances unlikely to operate again as favourably as they had done in the past" (1990, 116).

[7] See Historical UK Inflation and Price Conversion, n.d., and Historical Inflation Rates: 1914-2013, n.d.

[8] Walter Layton, the first Director of the Economic and Financial Section of the League Secretariat, chose the economists based on their prominence. But he also hoped to improve the prospects for acceptance of their proposals by a selection along the lines of diversity in nationality and ideological disposition (Decorzant, n.d.).