# UNIT 4 INTERWAR YEARS (1919-39)

**Structure**



## 4.0 OBJECTIVES

After going through this unit, you should be able to:

- discuss the effects of the First World War on the British economy;
- describe why the British economy slumped in the early 1920s when the world economy as a whole was enjoying the post-war boom;
- analyse the factors that led to the Great Depression of the 1930s; and
- find out why Britain lost out as the leading industrial and trading nation of the world in the inter war years.

## 4.1 INTRODUCTION

Fluctuations notwithstanding, the British economy had grown quite steadily till the First World War. It had already ceased to be the only or even the primary industrial power. Problems were already evident in the economy, in terms of falling growth rate of exports, inability to catch up with other industrial economies in the field of technological change, etc. But the situation looked, at least to most contemporaries, quite satisfactory. What Britain was losing in commodity exports was being made up by exports of services. While she was suffering from technological lag her network of trade and finance prospered. London reigned as the financial capital of the world and the wealth which it brought went a long way in making Britain, in the words of a contemporary observer "the best country to be rich and leisured in". Britain was primarily living off her colonies, her international capital exports and her position as the trading and financial centre of the world. But she was still living quite well. The First World War and the interwar years changed this, as the traditional economy of Britain not only ceased to grow but contracted. Britain emerged from the war as a much weaker economy and never quite recovered from it. The mantle of international leadership descended on the USA.

The evaporation of the old ways of doing business did not produce an equal change in the old ways of thinking. Much of what happened in Britain, and in other industrial countries, during this period can be put down with hindsight, to staggering intellectual myopia on part of the policy makers. The Great Depression which gripped the world in the late 1920s and early 1930s was in large part a creation of this outmoded orthodoxy. On the British case this was best exemplified by Churchill's decision to return to the gold standard in 1925. As we shall see below it was a very costly mistake. Keynes, the most incisive and often the only opponent of the ruling ideas, publicly wondered why Churchill did "such a silly thing". He was not heard; perhaps he made the mistake of being right, when men of greater reputation were wrong.

In any case policy makers in other countries also went on to do equally "silly things". Politicians and economists (most but not all of the latter group) gave poor accounts of themselves in this period, at least till middle 1930s. The recovery programmes launched then rescued many countries from the abyss of the Depression. For most part though the actions of those empowered to influence national economies were a striking example of Liebling's law: 'If men of adequately complex minds act with enough perversity they will succeed in picking themselves out of the door into the street.' Britain went out to the 'streets' in this period and enver quite managed to get back to the comfortable surroundings of the Victorian classical economy. The initial impetus was, however, through the 'shock' of the first War. We discuss the effectss of the War in the next section.

## 4.2 AFTER EFFECTS OF THE FIRST WORLD WAR (1919-25)

In this section we shall see how the immediate post-war boom which Britain enjoyed ended in a slump in the mid-twenties and how Britain gradually lost her status as the leading industrial nation of the world. We shall also see why the Gold Standard with its fixed exchange rate system did not prove to be a viable mechanism to save Britain from the impending Great Depression.

### 4.2.1 The British Economy

The difficulties of the British economy, as we had noted in Unit 3 Sec 3.7, had started in the 1870s. Industrial production from 1870s to 1913 increased at only 2% annually. This was already behind the growth rates of countries like the USA and Germany. This relative decline can be principally attributed to the relative fall in exports of goods, which were the 'engine of growth' in the early period of industrialisation. Exports grew less fast because other countries had meanwhile industrialised. No longer the 'workshop of the world', Britain could not hold on to its share of world exports. This loss in leadership had, however, less impact than one would have expected. The cushion provided by the large exports of invisibles (shipping, insurance and other commercial services) enabled imports to rise. The need for developing production for the home market was correspondingly reduced. Such a state of affairs could only have been temporary, since other countries could have developed their own services. The war accelerated the problems of the British economy. However the immediate effect of the First World War was a shortlived boom.

**The Boom**

The accumulation of pent-up purchasing power during the war and the reduction in the level of stocks created the conditions for a boom. As men were demobilised and factories were deluged with orders there was a sharp rise in economic activity. Production, employment and prices rose. The government maintained high levels of expenditure. By 1921, however, the boom had worked itself out. As imports from other countries started arriving, and domestic production caught up with pent up demand, credit restrictions were imposed, and the boom turned into a slump.

**The Slump**

When Britain was caught in an economic downturn, her principal competitors were still enjoying a boom. Constructon activity seemed to be the dominant factor in producing booms in the USA, France and Japan. Curiously, Britain was suffering from a housing shortage, and yet there was no 'housing boom'. Rent restrictions, high building costs and ineffective implementing authority (the much criticised, then as now, 'local authorities') were the reasons for the absence of the construction boom. However equally important reasons behind the British slump were its changed international position and the stringent credit conditions.

### 4.2.2 The International Setting

The war decisively altered the contours of the international economy. International power equations, in economic and political terms, were changed. The USA emerged as the strongest economy, while Britain and Germany were much weaker. Agriculture transformed from prosperity to poverty. The pre-war net-work of trade were altered: obstacles to trade both in terms of tariffs and currency fluctuations were recognised. In successive international conferences, including those in Brussels (1920) and Genoa (1922), recommendations were made for the removal of these obstacles, but to little avail. One major aspect of the pre-war international economy, in terms of its hold on the mind of the policy makers, came out unscathed: the Gold Standard. Although it was suspended during the War the idea was alive and kicking. The Genoa conference of 1922 reaffirmed the faith in the Gold Standard. The Cunliffe Committee appointed in Britain to consider its post-war monetary problems **assumed** that the gold standard would continue. Commitment to the Gold Standard was strong in the USA too, embodied in the form of Benjamin Strong, Governor of the Federal Reserve Bank. America emerged as the strongest economy after the war and made the adherence to the Gold Standard a condition for continuing to finance European reconstruction. Thus the pre-war manager of the Gold Standard, Britain and the post-war leader amongst the industrial nations, America were both steadfast in their belief in the 'old fashioned religion' — as Thomas Lamont had described the Gold Standard. The adherence to this system in the **changed** conditions on the post war era created the conditions for the Great Depression of the late 1920s. We discuss this in the next sub-section. Before that it will be useful to explain what the system of Gold Standard meant for the international economy.

### 4.2.3 The Gold Standard

The Gold Standard can be characterised by (1) free flow of gold between individuals and countries (2) the maintenance of fixed values of national currencies in terms of gold and hence each other (3) the absence of an international coordinating organisation. These three features meant that countries facing BOP deficits would experience outflow of gold to countries enjoying BOP surplus.

To maintain the fixed value of the currency, which comes under pressure when gold flows out, the economies would have to undertake deflation (forcing domestic prices to fall) so that the domestic price level can change suitably to maintain the exchange rate. The policy option of devaluation (downward revision of the value of one's own currency vis-a-vis foreign currencies) was ruled out in the Gold Standard. In the period between 1925-29, domestic and international policies of major countries were aimed to maintain the Gold Standard. The ineffectiveness of these attempts is a testimony to the altered conditions of the world economy and not to a lack of sincerity on the part of the policy makers.

## 4.3 BRITISH SLUMP AMONGST BOOMS AND THE MAKING OF THE GREAT DEPRESSION (1925-29)

1925 was a turning point in more than one way. The wranglings and recrimination about the treatment of Germany subsided with the Dawes Reparation Plan (1924) and the Locarno Pact (1925). This restoration of political stability (a fragile one, as it was proved later) was followed by the decision to return to the Gold Standard. For the world as a whole, the period between 1925 to 1929 was, by certain indices, good. Production of raw materials and food stuff increased by 11%, trade by 19% and trade in manufactures by 29%. America led the boom and lent to many other nations (2,192 million dollars, net) which enjoyed similar upturns. Two major nations were left out of the 'golden twenties' — Britain and Germany.

**Table 4.1: Indices for Manufacturing Production (1913–100)**

| | World | Britain | Germany |
|---|---|---|---|
| 1925 | 121 | 86 | 95 |
| 1929 | 153 | 100 | 117 |

**Source** : Lewis, A. (1949) : *Economic Survey.*

Note the considerably lower increase in the British and German indices by 1929 compared to the pre-war base, though over the four years, 1925-29, the percentage increase, is similar to that of the world average.

### 4.3.1 The British Experience

In Britain a grim reminder of the depressed conditions was the rate of unemployment, which was much higher than in other industrialised countries.

**Table 4.2: Industrial Unemployment as per cent of Work-force Rates: 1925-29**

| Country | Unemployment Rate, Percent |
|---|---|
| USA | 7.9 |
| France | 3.8 |
| Germany | 9.2 |
| U.K. | 12.0 |

**Source:** Eichengreen B. and Hatton T.J. (1988), 'Interwar Unemployment in International Perspective.

Almost all observers now agree that the British downturn was due to the decision to go back to gold at the pre-war parity; the consequence was an over valued pound. This harmed the British economy in two ways: (i) by making imports relatively cheaper thus restricting the development of new industries and (ii) by making exports dearer. The share of the British exports in international trade had been falling since before the war; but after 1925 it fell even in absolute volume. Added to this were specific reasons for the decline of particular export sectors: coal production was hurt because of mines being opened elsewhere and the development of water power, cotton owing to the development of Indian domestic production and Japanese competition in the Far East. Besides, iron and steel, ship building and metals were suffering from war time over-expansion. The combined effect of all these was a fall in exports and rise in unemployment. Most of the unemployment was concentrated in the export industries.

**Table 4.3: Exports and Export Prices, average of 1927-29 (1913–100)**

| Country | Export Prices | Export Volume |
|---|---|---|
| France | 101 | 147 |
| Italy | 123 | 136 |
| Switzerland | 149 | 101 |
| UK | 162 | 85 |

**Source: Lewis** ***ibid.***

It was not that the authorities were not concerned with the overvaluation of the pound. They were, but the Gold Standard meant that they could only deflate and not devalue (as we have seen in Sub-Section 4.2.3). So prices were sought to be reduced by reducing money wages. The adherence to the Gold Standard meant that wages (and through them prices) had to be lowered. But in practice this led to a major social upheaval in the form of the 'general strike' from 4th to 13th May, 1926. The strike was sparked off by attempts to enforce wage cuts in the most depressed industry: coal. Mine owners proposed a cut which was rejected by the unions. The mines were 'locked out' by the owners who called on other workers to come out in solidarity. For a period of 13 days the response was enthusiastic but after the Trade Union Council decided to call off the strike, the protest fizzled out with only the miners holding out. However the effect on wages (apart from the miner's wages) was not notable. The price index however did fall, from 160 in 1925 to 134 in 1929 (1913=100). This fall can be principally attributed to the restrictive credit policy adopted by the government. Interest rates were kept high by the Bank of England to attract short term capital and stabilize the pound. This had a depressing effect on domestic economic activity. Another contributory factor was the fall in agricultural prices, which was a result of substantial increases in production, relative to consumption (the former increasing due to technological breakthroughs and restoration of pre war acerage levels in Europe).

The later half of 1920s was thus a troubled time for Britain. The symptoms were known but the remedy was grossly wrong. No efforts were made to stimulate production for home consumption. It was an article of faith that come what may the Gold Standard was to be maintained — thus to this end, the domestic economy was compressed. The overvalued pound meanwhile merrily messed up British exports. All this was a very high price to pay for the 'pride of the British Pound sterling'. The sufferings caused by this myopia seemed grotesquely ironical in 1931, when, faced with increasing strain on the pound, Britain abandoned the Gold Standard. This double take did much to lessen the pains of Depression, but it implicated the political and economic leadership of Britain even more for causing the avoidable distress and privation of the 1920s.

We will now discuss the international operation of the Gold Standard to understand how the conditions for the Depression were created.

### 4.3.2 The Gold Standard and the Policies of Major Countries

As the British economy plunged into a crisis following 'the return to gold' other countries continued to try and prop up the system. In 1927, the US Federal Reserve undertook to lower interest rates so as to encourage capital flow out of the US and into Britain. This was to stabilise the struggling pound. However, the French Franc, which was undervalued (the French had declined to take on the full pains of deflation required by a return to pre war levels of exchange rates) attracted most of the gold. America and France accumulated gold, but they did not **have to** expand under the Gold Standard. But Britain **hand** to depress its economy because of the Gold Standard. Therein lies the asymmetry in the working of the Gold Standard as a system. Between them the USA and France held 60% of monetary gold by the end of the 1920s. This was clearly in excess of their requirement, for they did **not** account for either 3/5 of world production or 2/3 of world trade. Another way of putting the same proposition, i.e. the US and France had excess gold reserves, is to say that they were not expanding their economies sufficiently. Monetary expansion should have been greater and fiscal expansion was not even seriously contemplated. If France and the US had expanded the resultant higher incomes would have increased imports, probably more than proportionately. This would have raised the import share and gold would have flowed out decreasing the supply of reserves. Both the franc and the dollar were undervalued and revaluation (the opposite of devaluation) could have been undertaken. The Gold Standard however prevented such a move. Revaluation was not in the policy options. The burden of adjustment fell entirely on the debtor countries. In the context of the early 1930s the burden was too strong and it destroyed the gold standard. From 1928 the Federal Reserve followed a contractionary policy to combat the speculation in the New York stock exchange. The Germans were also trying to eliminate speculation. All in all the Atlantic economy was in the grip of contractionary policies. The basic reason was the revival of the Gold Standard and the attempts which were made to sustain it in conditions no longer suitable for it. Policy making everywhere was such as to depress economic activity.

**Check Your Progress 1**

1) Whatdo you understand by the 'Gold Standard'?

..........................................................................................................

..........................................................................................................

..........................................................................................................

2) What were the factors responsible for Britain's relative decline in the world economy after the first world war?

..........................................................................................................

........................................................................................................

........................................................................................................

........................................................................................................

3) In what ways did the over valued pound harm the British economy during the 1920s?

........................................................................................................

........................................................................................................

........................................................................................................

........................................................................................................

4) Why did the working of the Gold Standard create an asymmetry in global production and international trade?

........................................................................................................

........................................................................................................

........................................................................................................

........................................................................................................

........................................................................................................

........................................................................................................

## 4.4 THE GREAT DEPRESSION AND THE WORLD ECONOMY

Popular history dates and ascribes the Great Depression to the stock market crash in the US in Sept. 1929. The image of stock brokers plummetting to earth from the high rise buildings of the Wall Street is powerful, but it should not affect our judgement about the casuality of the depression. Nor can the cause of the Depression be pinned down to specific events like the bank failures in December 1930. The answer should be sought in overall policy regime within which the various economies operated.

The attempt to reconstitute the **status quo ante** by reviving the gold standard had two effects. It gave a deflationary bias to the policies of the member countries in the 1920s and it was the source of the opinion that deflation was the antidote for the ills of early 1930s. The first effect has been discussed in the previous section, in this section we will see how the conditions created in the 1920s were turned into the Great Depression.

### 4.4.1 Causes of the Great Depression

Contractionary policies in Germany (which was worried about foreign lending and reparations) and in the US (which was worried about speculation) had already produced decline in industrial production (from 1928 in Germany and 1929 in the US). Credit tightness, which spread to Europe, was severe enough to produce the initial fall in prices and production.

The continuation of this decline from mid 1931 to mid 1933 caused the major scares of the Great Depression. The fall in aggregate demand in 1928-29 was not counteracted. Neither in the fiscal nor in the monetary sphere did the authorities implement any expansionary policies — the gold standard told them that expansion was 'bad'.

In America the Federal Reserve Bank did not engage in any open market purchases to offset the deflationary pressures. In Germany this performance was bettered. The German Railway Company was forced to abandon its plans for large investments as a result of credit scarcity. The Reichsbank's inability to finance a deficit further strengthened deflationary impulses. The Chancellor, Heinrich Bruning introduced a series of austerity measures, increasing taxes, reducing benefits and cutting prices and wages. In Britain, although public spending rose, it was only a 5% rise in real terms and patently not enough to stop the Depression. Although going off the gold standard in 1931 helped Britain achieve a milder depression, the continuation of monetary and fiscal orthodoxy kept expansion at bay.

One of the contentions of this orthodoxy was that larger public expenditure would destroy confidence and 'crowd out' private activity. The Keynesian solution of greater public expenditure to combat the fall in aggregate demand, so pervasively lauded and used later, was dismissed as "lingering illusions on part of certain commentators". Keynes' spirited opposition during the Macmillan Committee hearings fell on absolutely deaf ears.

Increasingly the people began to expect the deflation to continue. Their expectation was that prices would be even lower in future. This generally produces two effects: (a) people hold back purchases to take advantage of the expected lower prices and (b) they are reluctant to borrow at any money rate of interest because they would have to pay back effectively more when the prices are lower and the money rate of interest falls below the real rate (i.e. money rate deflated by the price level).

This certainly happened during the Depression, although lack of sensitive expectations - indicators means that we cannot date the beginning of this phenomenon. But by the spring of 1931 expectations had caught up with events, and people began to expect more deflation and postpone expenditure until deflation ended. Deflation also increased the real burden of debt thereby further curtailing expenditure.

Government response all through these times continued to be deflationary, barring the British *volte*-face. It were these interactions of national policies and individual reactions which produced the depression. Specific events contributed to the general trend. The First World War had changed the world economy. The votaries of the gold standard ignored this and in trying to force their outdated system on the world generated the Great Depression. Like the physicians who treated Mozart with mercury to cure his ailments, they not only failed to cure the disease, they also killed the patient.

## 4.4.2 Effects of the Great Depression

Statistics are a useful but often inadequate guide to historical events, even events in economic history. However, the downturn in Great Depression was so catastrophic that figures speak eloquently in this era. Here we present some of the important measures of the great slump:

**Table 4.4: Production and Trade, 1929-37**

| | 1929 | 1937 |
|---|---|---|
| Food Stuffs | | |
| World Trade | 100 | 89 |
| World Production | 100 | 100 |
| Raw Materials | | |
| World Trade | 100 | 81.5 |
| World Production | 100 | 74 |
| Manufactures | | |
| World Trade | 100 | 59.5 |
| World Production | 100 | 70 |

**Source:** Lewis, *Op. cit.*

With the slump came a decline in foreign investment and fall in primary product prices. Most of the debtor countries were primary producers and this decreased their ability to import manufactures. However the reason why trade contracted more than production is because of erection of various trade barriers. Following the lead given by the American Hawley Smoot Tariff of 1930, tariffs all over increased sharply.

**Table 4.5: Impact of the Depression in various countries: Index of Industrial Production (1929 = 100)**

| Country | Industrial Production Index in 1932 |
|---|---|
| **USSR** | 183 |
| **USA** | 53 |
| **Germany** | 53 |
| **France** | 72 |
| **UK** | 84 |

USSR was of course insulated from the world economy. Japan attacked the slump with expansionary policies which were followed only mutedly, if at all, in Britain and completely cold shouldered in the US and Germany.

**Table 4.6: Unemployment in Industries (1930-38)**

| Country | Unemployment Rate |
|---|---|
| US | 26.1 |
| France | 16.2 |
| Germany | 21.8 |
| U.K. | 15.4 |

**Source:** Eichengreen and Halton, *Op. cit.*

Unemployment was the biggest social consequence of the Depression. The sharp rise in unemployment in US, France and Germany, relative to the 1924-29 period (compare Table 4.6 with Table 4.2) compared to the milder change in the British unemployment rate is a testimony to (a) British economy's decline in the pre-1929 period as compared to upswing in other economies (b) the fall of the other economies into an abyss in the post 1929 period as compared to a milder slump in Britain.

**Table 4.7: Wholesale Price Indices in 1932 (1929 = 100)**

| Country | Index |
|---|---|
| USA | 67.5 |
| Germany | 70 |
| France | 65 |
| UK | 75 |

Deflation, of course, was pervasive and substantial. The British figure is higher due to the effects of abandoning the Gold Standard in September 1931, but still appreciably less than 100.

Other figures and events can be cited. But the above figures do convey the depth of the slump. Our main concern is with Britain and now we turn to the depression in its British manifestation.

**Check Your Progress 2**

1) Was deflation an antidote for the ills of early 1930s? Explain.

..........................................................................................

..........................................................................................

..........................................................................................

..........................................................................................

..........................................................................................

..........................................................................................

2) What was the effect of the Great Depression on the macro economic indices of the developed countries?

..........................................................................................

..........................................................................................

..........................................................................................

..........................................................................................

..........................................................................................

..........................................................................................

## 4.5 THE GREAT DEPRESSION: THE BRITISH EXPERIENCE

As already stated the Depression in Britain was milder. The principal reason was because of the decision, forced and taken with great distaste, to leave the Gold Standard in September 1931. Such was the hold of the orthodoxy that apart from that little else was done to encourage activity. Britain escaped the worst but lost the chance to do much better.

### 4.5.1 Events Leading to the Departure from the Gold Standard

The slump from 1929 onwards affected trade and this in turn reduced the 'cushion' in British BOP, the invisibles. From 1929 to 1931 earnings from invisibles reduced by 180 million pounds. This produced a negative balance of trade (exports suffered by volume, the index falling from 104 to 69 [1927 = 100] but with primary prices falling the net barter terms of trade moved in Britain's favour, and thus exports by value fell by lesser amount). The adverse balance combined with a general loss of confidence in the British economy led foreigners to recall their assets. Together this resulted in an abnormal loss of gold for Bank of England. Pressure on the Pound increased in mid-1931. The Bank refused to increase the interest rate to punitive levels (fearing correctly, that the consequences would be apalling in an already depressed economy). Instead French and American credits were spent in defence of the pound. The Labour Government of the day somewhat dampened the fiscal contraction by refusing to cut unemployment benefits. Measures for sustaining the value of the pound would have been nothing short of being draconian. British policy was unprepared to go to the extent of the 'iron chancellor of Germany, Bruning, whose deflation was nothing short of being ruthless. Thus hemmed in, there was no choice but to abandon the Gold Standard.

### 4.5.2 Effects of the 'Reversal'

The devaluation following this agile policy shift was beneficial to the British economy. It lowered British export prices, relative to foreign prices and allowed the option of a more permissive monetery policy (which was taken up after a half year delay).

Imports becoming dearer, were cut. Devaluation checked the fall of prices in Britain (while they continued to fall in countries still on gold). Lower export prices (relative to foreign prices) helped maintain exports. The share of Britain in world exports increased between 1931 and 1933.

**Table 4.7: Exports, Imports and Balance of Trade: 1931 and 1933**

| | Imports (1927=100) | Exports (1927=100) | Balance of Trade (Million) |
|---|---|---|---|
| 1931 | 103 | 69 | –104 |
| 1933 | 90.5 | 70 | –51 |

**Source:** Mitchell B.K. (1980) *European Historical Statistics*, 1750-1975.

The effect of British devaluation on a world caught in throes of the depression was not particularly beneficial. If gold had flowed out of Britain allowing other countries to undertake monetary expansion the impact of the relative price change of those countries could have been mitigated. As it happened the Bank of England took this opportunity to build up its gold reserves — thus the effect on the rest of the world was deflationary.

### 4.5.3 Gold Loses its Glitter

Nothing not even the inflexible minds of the 1920s and 1930s policymakers could ignore the pressures created by depression. In 1933 the US came out of the gold standard and in 1936 the French followed suit. Other countries were not far behind. Most policy makers did not like it, but they had little choice by then. They had created and nurtured the depression, how the depression gobbled up their article of faith -- the Gold Standard.

The effect of this all round abandonment on Britain was to offset the gains she had made between 1931-33, when she was the sole devaluing country. British share of world exports, which had gone up to 10.37% in 1933 declined to 9.8% in 1937. However, the British colonial system, a great source of economic dynamism during the early years of British industrialisation came to the partial rescue of the mother country. The system devised was named, appropriately and without a trace of irony, Imperial Preference.

### 4.5.4 Imperial Preference

In 1932 countries of the Commonwealth met at Ottawa, Canada. They agreed to extend to each other increased import preferences to British goods.

Agreements were also 'worked out' with smaller countries, dependent on the British market so that they would increase their imports from Britain. Coal was the principal beneficiary of these later agreements.

The effect of these agreements on British trade was striking, as the following figures show:

**Table 4.8: Share of UK in Imports of Various Countries in 1929 and 1937**

| Country | 1929 (%) | 1937 (%) |
|---|---|---|
| Australia | 40.0 | 42.6 |
| Canada | 15.0 | 18.2 |
| South Africa | 43.1 | 46.3 |
| New Zealand | 48.7 | 50.2 |
| Argentina | 17.6 | 20.7 |
| Sweden | 17.3 | 19.0 |
| Norway | 21.2 | 24.6 |
| Denmark | 14.7 | 37.7 |

The first four countries in Table 4.8 belonged to the Empire and the latter group of four were the 'agreement countries'. Thus Britain increased its share of trade in these countries. One loss from this elaborate system of protection was that Britain did relatively poorly in unprotected markets. Foreign competition was deflected in these markets further worsening the British performance, which had already started lagging. The loss in unprotected markets was enough to outweigh the gain from protected ones and British share of world trade declined.

**Check Your Progress 3**

1) Why did value of British exports fall less than the volume of exports during the depression? What is its implication on Britain's capacity to import?

..........................................................................................................

..........................................................................................................

..........................................................................................................

..........................................................................................................

2) Why did Britain have to abandon the Gold Standard?

..........................................................................................................

..........................................................................................................

..........................................................................................................

..........................................................................................................

..........................................................................................................

3) What was the effect of devaluation on the British economy during 1931-33?

..........................................................................................................

..................................................................................................

4) What was the effect of competitive devaluation of currencies of other advanced countries on the British economy during 1933-37? How did the British colonies contribute to her rescue?

..................................................................................................

..................................................................................................

..................................................................................................

..................................................................................................

..................................................................................................

..................................................................................................

## 4.6 LOST CHANCES AND BRITAIN'S RELATIVE STAGNATION (1932-39)

Britain, we have seen, did not suffer as grievously as the other industrial countries did. Paradoxically she also did not recover as well as some of the others, especially the US and Germany. This was principally due to the vacillation by the government on the issue of expansionary policies. There was some support for the special areas (the euphemism for areas particularly hard hit by the depression) and unemployment dole was increased. But political support for further changes in fiscal and monetary policy was not forthcoming. The Bank of England raised the rate of interest, partly to replenish reserves and partly to fight inflation. Prices however were nowhere near alarming levels. The trust of the government's policy was, as Hawtrey put it, to cry "Fire, Fire in Noah's flood".

Some increase in economic activity was possible as world output and trade recovered, led by the expansionary regimes in Germany and the US. This external stimulus was joined by a housing boom of respectable dimensions. Partly this was because of a difference in interest rates between consols and mortgages, which meant that funds flowed into building society. Another reason which was also responsible for creating the rate differential, was that the Bank of England finally exercised the option of pursuing an easy monetary policy which helped lower interest rates. Construction and its allied industries accounted for 30% of the change in income between 1932 and 1937. Fiscal policy, however, continued to be influenced by the tenets of orthodox public finance.

Two other, rather ineffective, public interventions were made in this period to boost the stagnating industries. For some industries, the particularly hard hit ones coal, cotton, iron and steel and shipbuilding efforts were made to maintain rates of profit by supporting monopolistic arrangements. In case of shipbuilding and iron and steel some new investment was made, but generally the arrangements prevented the emergence of new and efficient firms since the policy was to protect markets by quotas for everybody, irrespective of their efficiency. In fact, such a policy also made the declining industries more inefficient than they otherwise would have been and restricted investment in them.

The second policy was of tariff protection, for both industry and agriculture. But the levels were too low to stop employment from declining in the protected sectors.

**Table 4.9: Annual Averages for Prices, Interest rates, Production and Employment; Britain 1921-29 and 1930-37 (1913=100, except for column 5)**

| Year (1) | Prices (2) | Interest Rate (3) | Production (4) | Employment (%) (5) |
|---|---|---|---|---|
| 1921-29 | 154 | 4.57 | 86 | 88.2 |
| 1930-37 | 102 | 3.52 | 99 | 83.2 |

Source: Lewis, *Op. cit.*

Figures clearly show the failure of the British economy to achieve a strong recovery.

## 4.7 BRITAIN ON THE EVE OF THE SECOND WORLD WAR

The two decades between the two great wars were instrumental in significantly altering the structure of the economy which had grown up during the 18th and 19th centuries. We will now take a look at these changes.

### 4.7.1 Industry

Industries like cotton, iron, coal and shipbuilding were hard hit and lost their primary positions in the economy. Most of these were export oriented, and as we have seen, exports in this period was adversely affected by a number of factors. The bleak international scene forced many industries to turn inwards. The lesson that home market can be an important source of growth was learnt, although not fully implemented, in this period. Still, on balance, industries concentrating on the home markets did better in this period than the export oriented ones. Industries like automobiles, metal products and various consumer goods expanded. Many of the new industries were also technologically complex and geared towards mass production. This also helped in the turn to the home market. Some of the move in technologically advanced industries like aircraft and electrical products also relied on government backing for their growth. The 'voodoo economics' of 19th century, which said that wages of workers must be minimum to promote expansion, was unlearnt in this era. Travails in export markets made the home market important and with it higher wages were recognised as a source of mass demand. Thus the industrial pattern changed, in terms of sectoral importance, technology and market orientation.

Another important change in industry was increasing concentration. Till 1914 Britain was one of the least concentrated economies, with the small family firm still dominating, barring some cases like public utilities and heavy industries. However the war, the slump and government encouragement helped to increase economic concentration markedly in this period. Before 1914 there were few monopoly products but by 1935 at least 170 products were mainly produced by industries comprising less than four firms. Compared to 130 railway companies in 1914, there were 4 in 1921. Most of these concentration were outcome of the idea of maintaining profit by eliminating competition. The result was restrictive and protective but not efficient. As in export sectors, in the domestic front too British industry was no longer competitive.

British industry also failed to regain the technological leadership which she had started to lose since the 1880s. In part this was due to the failure to undertake systematic research and development, especially the latter, namely turning discoveries or inventions to commercial practicability. A second source of this relative archaism was the availability of imports which often made obsolete technology profitable. Iron and steel industry did not adopt the Gilchrist-Thomas 'basic' process till late 1930s because they could import non-phospatic ores cheaply and easily. Other factors — mostly sociological in origin — may have also contributed. The result was that in 1939 British industry was neither competitive nor technologically dynamic compared to the other advanced countries.

### 4.7.2 Employment

As the pioneering in industries of Industrial Revolution cotton, coal and shipbuilding lost ground. Employment in these industries declined. We have already noted the high figures of unemployment of this period. What gave unemployment in these years special character was their concentration in selected areas, primarily those areas which were dependent on the industries which faced a crisis. Eight out of ten workers in Jarrow, a small town in North England, were out of work from 1933 onwards as this town was entirely dependent on a shipyard which closed down. Examples like this were strewn across the country where unemployment seemed permanent and the places became derelict. The government, wedded to the principles of 'sound' public finance, did not provide much succour. It renamed the affected areas a 'special areas' -- this mealy-mouthed euphemism being symptomatic of its virtual inaction. Even when expansion could have been promoted it was not, and the misguided efforts to help particular industries did not promote much employment (or for that matter much industrial growth). It was not until 1941 that unemployment rates came down substantially.

### 4.7.3 Foreign Trade

Britain's overseas transactions changed substantially in this period. The share of exports in production fell continuously. Imports ceased to grow more rapidly than industrial production. The balance on current account was negative from 1934 onwards.

**Table 4.10: Trade Relative to Production.**

| Year | Exports/Production percent | Index of Imports as ratio of Industrial Production (1913 = 100) |
|---|---|---|
| 1924 | 24 | 121 |
| 1937 | 15 | 114 |

**Source:** Mitchell *Op. cit.*

The process of adjusting the British economy to a smaller volume of trade had begun, but only partially. Imports, relative to exports were larger and financed through Britain's earnings on the capital account. The opportunity to restrict imports and promote domestic production more vigorously was lost in this period. In 1946 when invisible earnings declined substantially and terms of trade became unfavourable the problems of restricting imports came to the forefront. International trade lost its pre-eminent position in this period, although the decline had begun earlier. Appropriately one of the shibboleths of the Victorian era, "Free trade' also met with its formal demise in this period, when in 1931 Britain left the gold standard. The special conditions which had nurtured it had gone and with them its utility.

### 4.7.4 Government

The first war had seen the government taking over several industries. It also engaged in output control, licensing and price fixing. Import duties were imposed on some commodities (British automobiles being a lasting beneficiary of this, since the duties on them were retained even after the war). Although the post war decontrol was hasty and the ideology of *laissez faire* still powerful (exemplified by the return to gold standard in 1925), these public interventions showed that state involvement was both feasible and useful. One would resent state intervention but could no longer claim that they do not work. The slump produced more government actions in the sphere of industry. Most of these were in terms of promoting cartels and price fixing arrangements. It also started regulating prices and outputs by legal compulsion, especially in agriculture. Of course the other pillar of *laissez faire* namely free trade collapsed too, as noted earlier.

The sphere where orthodoxy held out was public spending and to a lesser extent monetary policy. Depression did not lead to a welfare state but rather its opposite. Salaries and benefits were cut producing a Naval Mutiny (1931) and hunger marches. In part such a difference in treatment of business and labour was a reflection of the political power balance of those years. Political pressures from the labour party declined after the 1920s (especially after the 'National Government' of 1931). It was also due to the convenient piece of reasoning by the representatives of business and their spokespersons; while increasing welfare expenditure was akin to "creeping socialism" (to borrow the words of a post Second World War British Prime Minister). Government help to industry was so vital for the national economy that the consequent observation of orthodoxy had to be tolerated.

Orthodoxy won the day, in the sphere of expansionary policy too, as noted earlier. Government's role in this period thus showed both signs of fundamental change and the hold of earlier ideas. It was Britain's misfortune that this continuity and change combination was unsuitable for the task of combating most of the economic ills of this period.

**Check Your Progress 4**

1) What were the factors responsible for Britain's not recovering as fast as other advanced industrialised countries? What were the roles of fiscal, monetary and commercial policies in this regard?

..........................................................................................

..........................................................................................................

..........................................................................................................

..........................................................................................................

..........................................................................................................

..........................................................................................................

..........................................................................................................

2) **Why did industrial production gear itself towards the home market and away from the external market during the 1930s?**

..........................................................................................................

..........................................................................................................

..........................................................................................................

..........................................................................................................

3) **When there is economic concentration, are the industries characterised by perfect competition, or by oligopoly?**

..........................................................................................................

4) **Was trade 'free in the 1930s'?**

..........................................................................................................

..........................................................................................................

..........................................................................................................

..........................................................................................................

## 4.8 LET US SUM UP

In this unit you have read of the factors contributing to Britain's continuing decline as the leading industrialised nation of the world. The changed economic circumstances were no longer compatible with continuation of the Gold Standard, for this implied that the value of the pound was fixed in relation to gold. Hence at a time when British export growth was slowing and she started producing deficits in her balance of payments, having taken the unwise decision to return to the Gold Standard in 1925, she could not devalue her currency in relation to gold and hence she could not devalue her currency in relation to the currencies of her trading partners who were also on the gold standard. The flexibility of the exchange rate for curing the balance of payments deficit did not exist under the Gold Standard and owing to an orthodox adherence to the standard, the British pound remained overvalued in relation to the foreign market clearing exchange rate. Britain had to exclusively rely on deflationary policies to reduce aggregate demand (and hence imports) by reducing the level of real wages and employment and thus try to overcome her balance of payments difficulties. This produced unemployment and social unrest. Britain also continued to lose out to Germany and USA in terms of technological innovation, efficiency and productivity. Thus her industrial production structure became inefficient and less competitive.

Even though the maintenance of the Gold Standard meant that the domestic economy had to be drastically compressed and a high price paid in terms of unemployment, yet the British policy makers continued attempts to maintain it till 1931. In the 1920s, Keynes's policy prescription for reflation coupled with devaluation of the British pound fell on deaf ears. After 1931, when the gold standard was at last given up, Britain devalued her currency which boosted her economy by increasing her exports and decreasing her imports.

Meanwhile, the economies of the advanced countries — Germany, USA and France were plunged into the Great Depression. The asymmetry of the Gold Standard was one of the major reasons behind the depression. Countries with surplus gold (i.e. favourable BOP) should have followed expansionary monetary and fiscal policies and thus increased imports by raising their aggregate demand. This would have boosted production and exports of gold deficit countries (i.e. countries with BOP deficit).

France and USA belonged to the former category while Britain belonged to the latter category. However, this did not materialise. Instead countries enjoying surplus also maintained old expenditure levels or even raised interest rates to curb speculation when reflationary policies were the need of the hour. This plunged the capitalist economies into the Great Depression. Industrial production, employment, volume and value of foreign trade and the price level, all fell drastically. Banks 'failed' and the stock markets crashed. While Britain was in the throes of recession for a much longer period, the impact of Depression in Britain measured by the indices mentioned above, was milder because Britain was the first country to devalue her currency in 1931 when she came out of the Gold Standard.

However, the beneficial effects of devaluation were only temporary as other competing countries also devalued their currencies later on to increase their share of world exports. Britain, then increasingly pursued protectionist policies by imposing tariffs and quotas. It also sought refuge in the protected markets of her colonies through a system known as Imperial Preference. Moreover, Britain increasingly relied on the home market for growth and expansion. However, the operation of the foreign trade multiplier with respect to Germany and USA offset to a certain extent the difficulties Britain faced in terms of price competitiveness.

## 4.9 SOME USEFUL BOOKS

Eichengreen B. and T.J. Hatton, 1988. *Inter War Unemployment in International Respectives.*

Hobsbawm, E.J., 1969. *Industry and Empire* Penguin Books, Chapters 9, 10, 11 and 12.

Mitchell, B.K. (1980). *European Historical Statistics,* 1750-1975.

## 4.10 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

**Check Your Progress 1**

1) Read Appendix to EEC-01 Block 8. Unit 18 and Sub-section 4.2.3 and answer.
2) Read Sub-section 4.2.1 and answer
3) Read Sub-section 4.3.1 and answer
4) Read Sub-section 4.3.2 and answer

**Check Your Progress 2**

1) Read Sub-section 4.4.1 and answer
2) Read Sub-section 4.4.2 and answer

**Check Your Progress 3**

1) Read Sub-secton 4.5.1 and answeer
2) Read Sub-section 4.5.1 and answer
3) Read Sub-section 4.5.2 and answer
4) Read Sub-section 4.5.3 and 4.5.4 and answer

**Check Your Progress 4**

1) Read Section 4.6 and sub-section 4.7.4 and answer
2) Read sub-section 4.7.1 and answer
3) Read sub-section 4.7.1 and answer
4) Read sub-section 4.7.3 and answer