The End of Global Capital Flows During the Great Depression

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International capital markets froze up during the Great Depression, and the capital movements that did take place in the aftermath of the depression were regarded as destabilizing "hot money" flows. Previous debt crises in the nineteenth century era of globalization had resulted in the penalization of the problem area for substantial periods of time (decades), but capital flows from the major centers had resumed to new areas quite quickly. What distinguished the Great Depression was:

- that several areas of the world were hit simultaneously in a general crisis
- that the crisis undermined the financial structure of the major financial centers
- that the response to the crisis in many countries involved the suspension of debt service and an imposition of capital controls
- that lending countries regarded the volatility of capital flows as an economic problem but also as a security issue
- that in consequence the climate of opinion shifted to a belief that capital flows were the major source of the destabilization.

1. The General Crisis

The First World War was clearly a major shock to the international economic order: the gold standard was suspended, there were major debtor defaults (the Russian Empire), and countries adopted highly inflationary war finance. But capital flows resumed quickly after the war, as they had after nineteenth century debt crises. Many U.K. and U.S. investors thought the depreciated currencies of central Europe attractive, and bet on recoveries (foolishly, as it turned out). After the currency stabilizations of the mid-1920s, capital flows were not deterred by continuing political uncertainty and instability, or by the priority of reparations payments (which later came to play a role in the creditors' panic).[1] This looks like similar behavior to that of the classic gold standard era, where crises were followed by a suspicion of certain areas, but not a turning away from all international engagement. Thus in the 1890s after Argentina and the Barings crisis, capital flows to South America were greatly reduced, but there were large flows to Russia and the Ottoman Empire.

Between 1924 and 1930 $9 bn.(and possibly as much as $11 bn.) flowed, 60 percent of this sum coming from the United States. The United Kingdom lent some $1.30 bn. and France $1.34 over the same period.[2] Most of the flows from Britain and - more significantly in quantitative terms - the United States took the form of long term capital:

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[1] On this, see Albrecht Ritschl, "Deutschlands Krise und Konjunktur 1924-1934: Binnenkonjunktur, Auslandsverschuldung und Reparationsproblem zwischen Dawes-Plan und Transfersperre" (Habilitationsschrift, Munich, 1997).

[2] Charles H. Feinstein and Catherine Watson, "Private International Capital Flows in the Inter-War Period," in (eds.) Charles H. Feinstein, Banking, Currency, and Finance in Europe Between the Wars (Oxford: Oxford University Press, 1995).

Table I: Average annual Long Term Capital Exports:
(m. U.S. $)

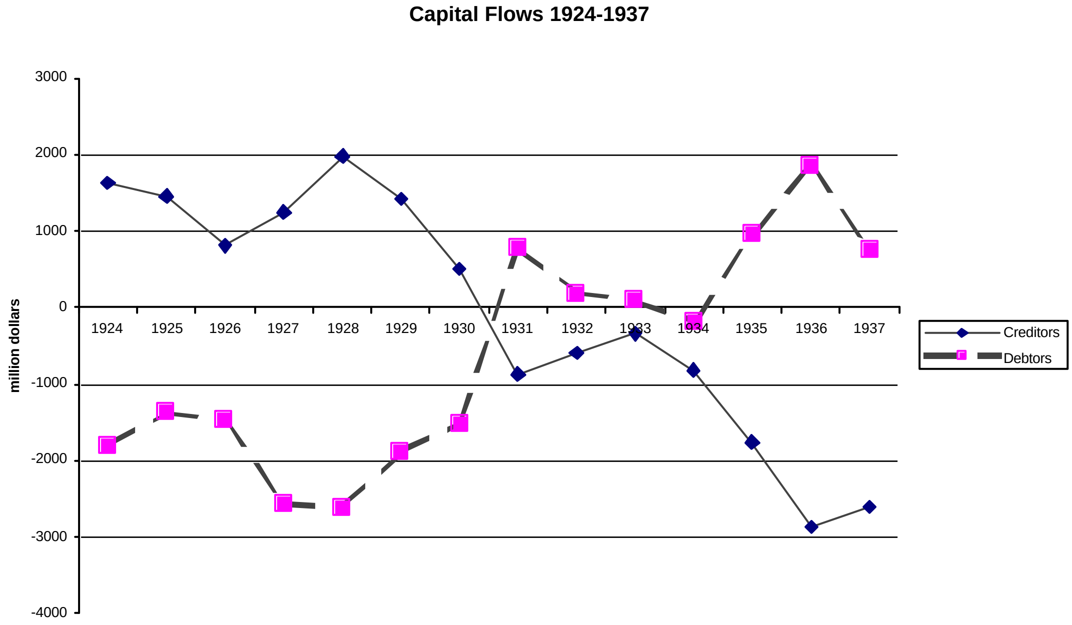
	1919-23	1924-28	1929-31	1932-8
US	531	1142	595	28
UK	416	587	399	143

(Source: United Nations, Dept. of Economic Affairs, International Capital Movements During the Inter-War Period, Lakes Success, 1949, p.25)

The capital flows in the interwar period were considerably lower than those of the pre-war period, and do not really justify the frequent description as an orgy of over-lending. This becomes apparent once we consider the direction of lending. For 1911-1913, the average annual capital export of Britain, France, Germany and the United States to the rest of the world was $1,400 m. From 1924-1928, this dropped to $860 m., or in price-deflated terms $550 m. In other words, if Germany - as a major recipient of the capital flows of the 1920s - is removed, the stream of international lending looks rather modest.[3] And the reasons for German borrowing were highly peculiar.

The shape of international capital flows in the 1920s and 1930s, however, looks similar to the boom-bust episodes that were characteristic of the nineteenth century of or the restored capital markets after the 1970s. A flow of capital to debtor countries was followed by a collapse of confidence and then by a period in which the direction of the capital flow was reversed. Capital in the second phase returned to the creditor countries, and debtor countries were forced into adjustment.

(Figure I)



For both Britain and the United States, the peak year of capital outflow was 1927. After that, the U.S. collapse was much more dramatic, and after 1931 capital long term outflows practically ceased. Britain still exported capital, but mostly to the Empire and Dominions.

Britain, however, was also a major short term debtor (as she had probably been already before 1914). So, in the 1920s, were Germany (then the world's biggest debtor), and the United States. The BIS estimated total world short term indebtedness in 1930 as 70 bn. s.f. or $13.5 bn., of which only $4.3 bn. related to commercial transactions. Germany accounted for $3.9 bn., the United States for $2.7

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[3]. W. Arthur Lewis, "World Production, Prices and Trade 1870-1960," Manchester School of Economic and Social Studies 20 (1952): 130.

bn. and UK for $1.9 bn.[4] Figures solely for banking liabilities, however, show a higher British than U.S. net liability. Both Britain and the United States played a similar role: they converted short term deposits into long term lending.

Table 2: Short term banking liabilities 1927-1930
(millions of $U.S.)

	Britain		United States	
	Gross	Net	Gross	Net
1927	2037	1359	3096	-
1928	2444	1470	2892	-
1929	2192	1338	3078	1512
1930	2112	1330	2794	1069

Note: Liabilities = total short-term funds due to foreigners on banking account

Source: League of Nations, Balances of Payments 1930 (Geneva: 1932), pp. 165, 181.

The origins of the relatively high short-term indebtedness of Britain and the United States lay not so much in their domestic problems as in foreign inflows that followed political uncertainty on the European continent and in Latin America. It would be wrong to see in British indebtedness a sign of economic vulnerability or an early

4. Bank of England Historical Archive OV50/6, Oct. 1936, F.G. Conolly memorandum (BIS) “International Short Term Indebtedness.” ($ = s.f. 5.165.)

symptom of industrial decline. The deposits originated in the turbulent circumstances of the postwar European continent. In the social explosions and inflations, large amounts of capital fled: out of Central Europe, but also out of France.

As an example, the McKenna Committee in 1924 which set out to examine the extent of German capital abroad produced the figure, almost certainly too low, of 6.75 bn Gold Marks ($1,600 m.). Germans bought foreign exchange, while foreigners in turn used the Marks they received on order to buy nominal assets which frequently depreciated rapidly as a consequence of inflation. Foreigners' deposits in the Berlin Great Banks, which were estimated at 31.3 bn Marks (1.8 bn GM or $429 m.), were worth only 0.14 bn GM by the end of 1922 and 0.03 bn GM in 1923. [5]

There continued to be short-term inflows to the United Kingdom in the period of the great credit boom of the second half of the 1920s. After the great crisis of 1931, however, the general direction of the flows shifted. A massive wave of capital flight - estimated by Feinstein and Watson at $3.5 bn. - went to the U.S. and the U.K.[6] At first the motivation was fear of economic crisis and renewed currency instability; but as economic crisis had its poisonous and corrosive effects on political stability, there came an increasing political fear, of the likelihood of European war.

The capital-importing countries faced increasing difficulties as commodity prices fell, at first slowly from 1925 and then precipitately from 1928. In 1930,

[5]. Carl-Ludwig Holtfrerich, The German Inflation 1914-1923: Causes and Effects in International Perspective (Berlin New York: de Gruyter, 1986), pp. 178, 288.

some Latin American bonds fell sharply in price on the U.S. market, with Brazial and Bolivia both now priced below 50. The rating agency Moody's down-rated Peru to Baa, and Bolivia, Brazil and Venezuela to Ba.[7] The first debt default came in a country with a very unfavorable debt/export ratio. In December 1930, Bolivia defaulted on the old government sinking fund; and in January 1931 on the general payment of interest. Peru, by now engulfed in civil war, defaulted in March 1931. Some countries (such as Chile) however still even managed to raise long term capital in 1930, as investors believed that the collapse of the copper price was only a temporary blip; but the country descended into political chaos, with a revolt in September. In March 1931 import tariffs were raised, but this was not sufficient to deal with the balance of payments deficit. In June 1931, following the Hoover moratorium on war debts, Chile suspended interest and service charges, and imposed exchange controls. At the end of July, the government resigned and was followed by a short-lived "Socialist Republic". By this stage, a general regional panic began. Colombia defaulted first on municipal and departmental bonds, in 1931, and on central government debt in 1933. Cuba defaulted on $170 m. U.S. debts in August.

In Central Europe, a general panic affecting Austria, Hungary and then Germany spread after May 1931. Bankers' committees eventually agreed to short-lived standstills, initially for six months, that were later renegotiated and renewed in annual Credit Agreements. Germany also defaulted on part of its government debt in 1933 and 1934.

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[6] Feinstein and Watson, Private International Capital Flows, p. 115.

2. The Vulnerability of Financial Centers:

The central European and South American collapses severely damaged the international financial centers. Britain's role as a lender collapsed after 1931. The United States became vulnerable to short-term outflows, as did other countries which acted as ersatz bankers in the wake of British and American weakness: in particular France and Switzerland.

Britain and the United States were vulnerable because of their position in the international capital markets. Bad debts in foreign countries endangered the stability of financial institutions, and played a big part in the drama of the end of Britain's gold standard.

In memoranda produced in the course of the 1931 crisis, the Bank of England's officials repeatedly referred to the high costs of staying on the gold standard. What did they mean? What were the high domestic costs that were being imposed as a consequence of maintaining the gold convertibility of sterling? We should refrain from adopting the anachronistic view that these costs lay in the forced reduction of public expenditure, the cuts in pay or the reduction in the dole. On the contrary, the Bank and its world was convinced that these were necessary -whatever the exchange parity - if a stable rate were to be maintained at all.

[7] Barrie A. Wigmore, The Crash and its Aftermath: A History of Securities Markets in the United states 1929-1933 (Westport Conn.: Greenwood Press, 1985), p. 205.

In fact the domestic costs lay in the vulnerability of the British financial system. This was already made apparent in one of the first Committee of Treasury (the critical decision making body at the Bank of England during the crisis) meetings on the crisis. On 27 July 1931, the meeting was joined by a representative of the British Treasury, Hopkins, who had just set out a memorandum in which he formulated very clearly the British danger:

> We cannot control that we are in the midst of an unexampled slump, nor the fact that Germany is bankrupt, that great assets of ours are frozen there, and that foreign nations are drawing their credits from there over our exchanges. Nor can we control the fact that foreign nations have immense sums of money in London and will try to get them away if distrust of the pound extends. . . the first thing at which foreigners look is the budgetary position.[8]

At the same time the British clearing bank (the British term for commercial banks) representatives met to hear the Bank's view and to present their own demands.

On the 27th, Hopkins's task was to present Chancellor of the Exchequer Philip Snowden's view to the bankers: “If such credits [from France and the United States] are raised, and indeed in any present contingency, the Bank should be prepared to use its gold to the extent necessary and H.M. Government will be ready to increase the fiduciary issue to enable such gold to be released.” But he also added a warning about the penalties for failure: “If credits cannot be arranged and gold continued to be

[8]. Quoted in Alec Cairncross and Barry Eichengreen, Sterling in Decline: The Devaluations of 1931, 1949, and 1967 (Oxford: Basil Blackwell, 1983), p.64.

withdrawn, British banks must be entirely free to withdraw credits from Germany."[9] Yet the latter could not be a realistic option. The London conference just recommended the maintenance of foreign short term credit to Germany on the insistence of the world financial community, and everyone realized that it would be impossible for banks to extricate themselves from Germany without bringing the whole credit structure crashing down.

The most energetic and persistent pressure on the Bank to end the gold standard commitment came from bankers who feared for their own position. Most striking is the position of Sir Robert Kindersley, one of the most active and vigorous directors of the Bank, and chairman of the threatened bank Lazard Bros. & Co. The bankers also turned to the politicians. On 16 September 1931, Sir William Goode, who in the 1920s had played the role of informal adviser to the National Bank of Hungary, wrote to MacDonald, stating that the gold standard could not be kept unless long term loans "for the other countries" of Europe started to flow again and thus reduced the strain on British banks [10].

It was not just Central Europe that presented a threat to the English banks. The final blow to sterling in the judgment of foreign markets came with the announcement of British difficulties in South America. The Echo de Paris reported that "the news that the Brazilian coupons would not be paid on 1 October increased the disarray. England is the largest creditor of Latin America."[11]

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9. Bank of England Historical Archive G14/316 27 Jul. 1931 Committee of Treasury.
10. Bank of England Historical Archive OV48/9 18 Sep. 1931 Goode to MacDonald.
11 . Echo de Paris, 20 Sep. 1931.

Concerns about the stability of English banks explain the otherwise mysterious failure to support sterling in the Paris market on 5 August: by letting the exchange slip, the Bank was warning of the possibility of an end to support and depreciation of the speculative attack continued. It was not, however, a very skillful way of restoring confidence, and the reaction of the Banque de France made necessary the sterling pegging which continued until 20 September. On 20 September, the cabinet prepared the legislation and the announcement abandoning the 1925 Gold Standard Act. In much greater secrecy, it also drew up a scheme for a banking holiday on the German model "in case any panic should occur."[12]

The absence of a rise in interest rate at which the Bank of England lent (Bank Rate) falls into the same category, although a 6 per cent level was briefly considered. The Bank did its best after 5 August to minimize the drama of sterling, in order to protect British banks. Raising the rate would be an acknowledgment of the strain and an encouragement to get out while it was still possible. Raising the rate was also rejected because higher interest levels would send up the politically sensitive unemployment rate, and that might encourage a further speculative attack on the pound.[13] Using reserves was likewise ruled out, since there was no point in doing this just to allow British banks to continue to pay out foreign short-term depositors and thus slide into illiquidity.

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[12]. British Public Records Office (PRO) Cab 60 (31) 20 Sep. 1931 "Very Secret, No Distribution."

[13] See Barry Eichengreen and Olivier Jeanne, Currency Crisis and Unemployment: Sterling in 1931, Centre for Economic Policy Research Discussion Paper 1898, June 1998.

Interpreted in this light, the devaluation of sterling in September 1931 was a wholly successful operation. It did not remove the pressure for budgetary control. On the contrary, the National Government won the general election on an austerity program designed to combat inflation, and continued to pursue balanced budgets. But it did halt the deposit loss; and deposits even increased as foreigners - and in particular Indians - exchanged gold for sterling. In that way, shaking off Britain's "golden fetters" ended the British depression. It set the stage for a recovery based on a more relaxed monetary policy, which encouraged credit-driven spending on housing and consumer durables.

The U.S. difficulties with the gold standard, gold losses from the Federal Reserve system and large-scale banking panics all started almost precisely with the ending of Britain's struggle to maintain gold convertibility (21 September 1931). In response to the appearance of a crisis structurally similar to that of the European trauma of 1931, policy makers believed that they had no choice except to respond to the psychology, irrational as it might be, of the market. There was no room for fiscal maneuver, not because of any economic analysis of the consequences of larger deficits, but because of the (quite reasonable) belief that nervous markets would immediately punish fiscal deviancy. The same psychology explains why the Federal Reserve was so reluctant to pursue the monetary expansion - via open market securities purchases - which Friedman and Schwartz in retrospect reasonably believe might have stabilized the monetary situation.

The foreign defaults also prompted a wave of criticism of bank behavior in the boom of the 1920s, and a demand for institutional reform that culminated in the separation of investment and commercial banking in the 1933 Glass-Steagall Act.

U.S. banks had issued large quantities of central European and south American bonds in the 1930s. One quarter of the new capital issues floated in New York for foreign borrowers went to Latin America, and $2 bn. worth of bonds were issued in the New York bank market.[14] Such loans were marketed very aggressively in the United States. By 1932, an estimated one and a half million held foreign securities, and in 1937 the Securities and Exchange Commission estimated that 600,000 to 700,000 investors held defaulted bonds. After the financial crisis, as was the case with the central European bonds, the issuing and underwriting banks were accused of carelessness in the promotion of their bonds and of grossly under-estimating the risks involved. The debate contributed to a widespread feeling that a fundamental reform of banking was needed. Charles Mitchell, the chairman of National City Bank and one of those accused of misleading the public, informed the Senate Committee on Finance that “those bonds were bought by Tom, Dick and Harry . . . without reference to the solidity or the solvency of the bonds . . . but entirely on the faith of the house issuing them in New York.” Other bankers gave evidence of how American banks had used high pressure tactics to sell loans to Latin American countries. There were 29 bank representatives in Colombia. Thomas Lamont, a partner of one of the two banking houses that did not aggressively pursue such business, stated disapprovingly in a speech in 1927: “I have in mind the

[14] Erika Jorgensen and Jeffrey Sachs, “Default and Renegotiation of Latin American Foreign Bonds in the Interwar Period,” in (eds.) Barry

reports that I have recently heard of American bankers and firms competing on an almost violent scale for the purpose of obtaining loans in various foreign money markets overseas . . . That sort of competition tends to insecurity and unsound practice."[15]

U.S. banks also engaged in substantial short-term lending to Latin America, both to governments and to corporations.

In the light of the investigations and the public hostility to activity in lending and bond-issuing, banks largely withdrew from this sort of operation in the 1930s. In 1934, the Johnson Act, fundamentally designed to punish the French default on war debt, forbade the issuing of bonds to countries that had defaulted.

For smaller financial centers than Britain and the United States, the instability of the 1930s posed big problems. Short term money deposited because of nervousness about other financial centers could and did easily flow out again. As the difficulties in the United States began, France and Switzerland experienced big inflows. In 1935 and 1936, these flows were reversed, and banks became quite vulnerable. In June 1936 the Swiss government issued a decree imposing penalties on "speculation against the Swiss franc" that was predictably ineffective. After the Swiss and French devaluations (September-October 1936), the Swiss National Bank negotiated a so-called Gentleman's Agreement with the private banks: these committed themselves to prevent the

Eichengreen and Peter H. Lindert, The International Debt Crisis in Historical Perspective (Cambridge: MIT Press, 1989), pp. 51-2.

[15] Ilse Mintz, Deterioration in the Quality of Foreign Bonds Issued in the United States 1920-1930 (New York: National Bureau of Economic Research, 1951), quotations from pp. 66, 81.

inflow of flight capital, and to pay no interest on foreign-domiciled accounts.[16] Despite these measures, foreign deposits increased again in 1937, and then fell sharply in 1938 and 1939.

3. Capital Controls:

Most of the over-indebted countries could not maintain capital account convertibility and imposed exchange controls, often generating complex systems of multiple rates for different countries and different goods.[17] These systems meant that interest and amortization on bank credit and portfolio investment was channeled into FDI, with commitments to maintain the investment for a substantial period of time. The best known provision to this effect was Clause 10 of the German Credit Agreements after 1932.

4. Security issues:

Volatile capital flows constituted a security problem, since sudden outflows would destabilize governments and require fiscal adjustment measures in order to restore confidence. Fiscal austerity at this point almost always meant cutbacks in military expenditures, so that there would be a direct and obvious connection between an attack on the currency and an undermining of defensive capability.

One more detailed case from the 1930s should suffice to show how worry about capital mobility interacted with

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[16] The most recent data on foreign deposits in Swiss banks is published in Unabhängige Experten Commission, Nachrichtenlose Vermögen bei Schweizer Banken (Zurich: Chronos, 2002), pp. 61-2.
[17] The classic study is by Howard S. Ellis, Exchange control in central Europe (Cambridge, Harvard University Press, 1941).

security concerns to produce a new doctrine of economic control, as well as a deeply divided political culture. Nowhere was the debate about capital flight and its link to national strategic weakness conducted more intensely, even paranoically, than in France. France after 1931 was hit by successive waves of capital inflow (as central European capital looked for a secure haven) and outflow (as investors became nervous about France's political, social, economic, and military stability). A secure defense was needed in an increasingly insecure world. However, through its effect on the budget and thus on financial confidence, rearmament rocked the already unsteady French boat yet further. By early 1936 it had become very difficult to sell French government bonds to the public.[18] Policy-makers had to weigh up the relative merits of military preparation and financial stability. Excessive military spending might actually make France more vulnerable because of a financial threat to influence politics.

This was not new in 1935 or 1936. Germany had already used economic diplomacy in 1932 as a way of maneuvering France into accepting the Lausanne reparations settlement. German efforts to use finance to influence French policy became more intensive after Hitler's seizure of power. Already in December 1933, during one of the early runs on the franc, the French domestic intelligence agency, the Sûreté Générale, presented evidence that Germany was launching a speculative attack. It reported that: "Dr. Schacht and the Berlin bankers Fritz Mannheimer and Arnold had formed a syndicate à la baisse using two brothers in

[18]. Banque de France Historical Archive Devaluation file IX, Feb. 1936 André Bouton note: Note sur l'état dans l'Ouest de l'opinion concernant les finances publiques.

France, Zélik and Grégori Josefowitz (alias Zebovik) who `had received a mission from the Führer to especially work the Paris market'. French banks in their turn had joined in the attack with the motive of overthrowing the ministry. They sent Bons de Trésor and commercial paper to the Banque de France for discount and used the proceeds to buy gold."[19]

In March 1936 a new speculative attack on the franc followed the remilitarization of the Rhineland and accompanied the Popular Front elections (the first round was held on 26 April, the second on 3 May). The Army General Staff anxiously surveyed a large range of German newspapers to try to establish how German propaganda was working against the French position: the German press, the French soldiers discovered, was proud to announce that the Banque de France discount rate increase of 28 March showed that "the confidence of French capital had been shattered."[20] As in previous speculative attacks in central Europe, rate rises were read by the market as a sign of weakness, not of strength.

The military and security aspects made it much more urgent for France to attempt to obtain a currency stabilization. In 1935 and 1936, the Banque held frequent talks with the Bank of England about ways of preventing currency speculation.[21] In March and April 1936, the panic was so great that the Banque de France lost control of the money market altogether.

In 1936, a new center-left government, the Popular Front, took power after the April elections under Prime

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19. FFM B18675.
20. FFM B18675 2 Apr. 1936 Etat-Major de l'Armée: 2e Bureau.
21. Bank of England Historical Archive OV45/84 29 Jan. 1935 Cobbold note. Banque de France Historical Archive England, 8 May 1936 Tannery letter to Norman.

Minister Léon Blum. But its financial policy dilemma had already existed for over a year before the elections that put it in power, and had been exacerbated by German action in March. To make their problems worse, the Popular Front leaders, in the course of the political campaign before the elections, had made promises which tied their hands on the issue of devaluation. The communist party campaigned against devaluation, claiming it meant an expropriation of wage earners for the benefit of capitalists. There was, they said, a conspiracy between French capital and foreign interests. One of the most emotive headlines of Humanité read: "The Fascists organize the Hemorrhage of gold." The communist leader, Jacques Duclos, wrote: "The evil doing potentates of the Bourse and the Banque, having robbed the country through deflation now wish to rob her through devaluation." Devaluation meant a way of avoiding a property tax on the rich [22]. But the (non-socialist) Radicals took a similar line. Edouard Herriot, scarred by his memories of the financial crises of 1924 and 1932 announced in an election speech in Lyons: "Devaluation, that would be I know not what dangerous road towards zero."[23] The socialist leader, Léon Blum, accommodated the beliefs of his allies by keeping to a slogan, "neither devaluation nor deflation", which seemed to give no room for policy maneuver at all. In public Blum had always opposed the idea of devaluation. Instinctively he preferred capital controls: in late 1934, he had told the Chamber in response to a pro-devaluationist speech by Paul

[22]. Humanité 22 Nov. 1935, 5 Nov. 1935.
[23]. Le petit parisien 13 Apr. 1936.

Reynaud that devaluation could be prevented by putting an end to exchange speculation [24].

In practice, however, he and other socialists had contemplated in private devaluation, but only in an internationalist setting which would not leave France humiliated or on its own.

After April 1936, the financial panic demanded some kind of action, and it became apparent that the choice lay between franc devaluation and exchange control. Both possible choices had unpleasant aspects: devaluation was humiliating, but exchange control distorting. There were also non-economic, security, aspects. This debate formed the core of a famous and influential conversation between Blum and Mönick, the French financial attaché in London. Mönick argued powerfully that exchange control presented a "German path" that would bring France close to the German war economy; whereas an agreement with the USA and Britain would prepare a path for a parallel political collaboration of democracies against dictatorship. "If we follow the German path, we are beaten from the start, because our country does not nearly possess the same resources in manpower and raw material that our neighbor across the Rhine enjoys."[25]

For a considerable time there existed uncertainty between these two courses. In the early summer, devaluation seemed certain. In late June, Mönick went to Washington to agree a new parity,[26] and in July Blum visited

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[24]. Chamber of Deputies 3 Dec. 1934, p. 2947.
[25]. René Girault, "Léon Blum, la dévaluation et la conduite de la politique extérieure de la France," Relations internationales, 13 (1978): 98. Also Robert Frankenstein, Le prix du réarmement français 1935-1939, Paris: Publications de la Sorbonne, 1982, pp. 130-1.
[26]. John Morton Blum, From the Morgenthau Diaries: Years of Crisis 1928-1938, Boston: Houghton Mifflin, 1959, pp. 155-9.

London to agree the basis for a devaluation and a tripartite currency pact.

In fact nothing happened until a new franc crisis in September. Many steps pointed to exchange control rather than devaluation. The position of the Banque de France in particular was highly ambiguous. One of the most important steps taken by the Popular Front was the reform of the Banque de France, which effectively ended its autonomy. The Governor (whose appointment had already been highly political) was replaced. A new statute ended the role of the Regents, who had represented the old financial and banking oligarchy, which had been vigorously attacked by the Popular Front. As the Regents departed, the new Governor Ernest Labeyrie gave them a lecture on how it was the duty of the Banque to obey the elected government of the Republic. Labeyrie also believed that money markets and speculation should be controlled; by the summer of 1937 he was being described as a "victim to his anti-speculation mania."[27]

Labeyrie adopted a corporative approach to the issue of capital flight, obliging Roger Lehideux, the representative of the French banking association, to send out a circular instructing French banks not to give credits for speculative purposes. The Banque de France also began extensive investigations into the mechanisms of capital flight, seeking an answer to that question which obsessed central bankers in the 1930s: who did it?

In May 1935, the Banque had already kept a day to day account of the gold transactions on the Paris market. A surprisingly large amount came from just one bank, Lazard

[27]. Bank of England Historical Archive OV45/12, 19 July 1937.

Frères, which accounted for 16 per cent of the movement to London, 9.5 per cent to New York and 13 per cent to Brussels[28]. At the same time, we know from other sources[29] that Lazards already began in 1935 to exercise some pressure on the government to devalue the franc: in other words the bank was moving its money in direction with its advice.

The inquiry of 1936 went much deeper: it looked at regional variations in capital flight. The police started to attack the speculators. One Inspecteur des Finances, Bloch, examined activity in the Lille-Tourcoing-Roubaix area (on the frontier with Belgium). He found plenty of small-scale activity, thousand franc notes being taken across the Belgian frontier, but also much more systematic movements. Most of the textile businesses ran down their current accounts during the franc crisis; and at the same time the leading banks (BNCI, Crédit Commerciel, Banque Joire, Lloyds Bank) gave large credits to the textile owners which allowed purchases of raw material in foreign exchange.

Police operations such as Bloch's were intended to prepare the way for an exchange control, which could only be implemented on the basis of a great deal of local and particular knowledge. In June 1936, Vincent Auriol, the new Popular Front Finance Minister, issued a decree legislation including penalties for the non-declaration of capital held abroad, and authorizing the government to take action against those who attacked the state's credit (i.e. those who organized the flight of capital). In an address

[28]. Banque de France Historical Archive B34.

to the Chamber on 20 June he ruled out the possibility of devaluation. On 11 June the French financial attaché in Berlin sent in a memorandum drawing on Germany's experience with exchange control since 1931, and explaining in detail how it could be applied. [30]

Then came more dramatic foreign political events: the eruption of the Spanish civil war, German lengthening of military service, and a need to prepare a new French armaments program [31]. The result was devaluation after a new franc crisis. Auriol now defended devaluation as a better alternative than exchange control.[32]

But the devaluation did not guarantee stability, or make the franc immune to further attacks. The recognition that the best way to restore stability lay in permitting capital flows (because illegal exchange operations would continue anyway) required a new change in the leadership of the Banque de France, and indeed in the whole direction of French economic policy (a reversal of policy which would not really be achieved until the late 1950s). Pierre Fournier, the Deputy Governor of the Banque, replaced Labeyrie, and represented a much more traditional style of management. He had argued that a large proportion of French capital was now abroad in the aftermath of the franc panics, about a third being in USA and half in Britain [33]. The only way of getting it back would be a liberalization, and a revocation of the Lehideux circulars.

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[29]. Bank of England Historical Archive OV 34/10 14 May 1936 Rowe-Dutton to Waley. Commentaires, 24 Nov. 1935 claimed that Paribas (as well as Lazards) was sympathetic to devaluation.
[30]. Frankenstein, Le prix, p.129.
[31]. See on the connections between these events, Frankenstein, Le prix, p. 137.
[32]. Bouvier, “French Banks,” p.114.
[33]. Bank of England Historical Archive OV45/86 8 Dec. 1937 memorandum on Paris visit.

The fundamental cause of French instability, the massive public deficits, partly the result of armaments, remained: and without this there could be no long lasting stabilization. 13.8 bn f. of Treasury bonds were written off, but there was still a new plafond on government spending, and the military budget went on rising. When new budget deficits were predicted for 1937, the outflow of capital began once more. On 13 February the government was forced into retreat.

A £40 m. British loan provided a temporary relief, while Blum declared a “pause” in the radical social and economic program of the Popular Front. Traditional liberals such as Jacques Rueff (who had become Directeur Général of the Mouvement des Fonds in November 1936) took the lead in directing the policy not just of the Finance Ministry, but also of the nationalized Banque.

Neither the devaluation of the franc to a new parity (the “franc Auriol”), nor the Tripartite Pact that accompanied it and promising coordination of British, American and French monetary policies[34] (and was primarily motivated by security concerns), nor yet the liberalization of capital movements and the encouragement through tax incentives and the issue of reserved government paper on favorable terms of flight capital to return, brought a major respite for France.

The monetary crises continued, and France suffered in consequence both from financial instability and continued worries about the instability of the franc, and from

[34]. See particularly on the relative insignificance of the Tripartite Pact, except as a political statement of solidarity with Britain and the United States: Ian Drummond, London, Washington and the Management of the Franc 1936-1939 (Princeton: Studies in International Finance, No. 45, 1979).

restrictions on military spending imposed by the need to keep the franc stable and respect the sentiments of small investors as well as foreigners.

The U.S. government left no doubt that it considered that French arms spending lay at the bottom of French troubles. U.S. Treasury Secretary Henry Morgenthau told Roosevelt that: “The world is just drifting rapidly towards war. We patch up the French situation every so often but with the constant increased percentage of their budget going for war purposes we really cannot help them. The European countries are gradually going bankrupt through preparing for war.” And at the same time Morgenthau asked the British Chancellor of the Exchequer for “suggestions whereby he and I might make some start to stop the arming that is going on all over the world.”[35]

The franc continued to jitter. In March 1937, after the Blum pause, the Germans attempted once more to destabilize the franc by massive sales on the Amsterdam market[36]. The instability of the government increased international anxiety about France [37]. In June, new drains brought down the Blum government, and a new administration under Georges Bonnet carried out a further devaluation and a floating of the franc. It also cut defense spending, and the new air program was severely pruned. [38]

By 1938, the United States estimated French capital flight at $2.5 bn., $1 bn. of which had gone across the Atlantic. Morgenthau now proposed to help France by locating where exactly this money had gone, since the

[35]. Blum, Morgenthau, pp. 457-9.
[36]. Bank of England Historical Archive OV45/11 4 Mar. 1937 HAS (Siepman) note on phone call from Leith Ross (Treasury).
[37]. Bank of England Historical Archive OV45/12 8 Jul. 1937 Cobbold memorandum: “Some views expressed by M. Jean Monnet this afternoon.”

movements “may gradually undermine the basis of the Tripartite Accord [while increasing] the danger of a movement toward autarky and political dictatorship.” He thought that France should simply “make it a jail offense not to take your money back.” [39]

Blum came back in March 1938 with a government formed just before Hitler's *Anschluss* of Austria. He intended to use rearmament as an economic stimulus, and the result was a new franc panic. Within a month, Edouard Daladier succeeded him with an administration still committed to arms, but also now to the removal of the limitations on production imposed by the 40 hour week (the most spectacular social achievement of the Blum government).

In July 1938 a memorandum from the office of the President of the Council (Prime Minister) explained the grounds for the new attack on the franc. The immediate cause was an article written by Charles Rist and published in London that presented a grimly realistic account of the state of French government finance: the reaction was such that “the capitalists once more doubt the stability of our money.” But once again the Italian and German radio and press devoted their attention to the embarrassment of the franc.[40] The author recommended a drastic budget reform involving an end to the amortization of the national debt and an increase in the efficiency of tax collection through the strengthening of the Finance Inspectorate and the publication of tax returns.

The rather more conservative reign of Georges Bonnet and later Pierre Marchandeau in the Finance Ministry, the

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[38]. Frankenstein, Le prix, pp. 74-83.
[39]. Drummond, London, pp. 45-6.

presence of Fournier in the Banque de France, and the new strength of the Banque's position made for greater calm. The Banque now worked no longer through pressure on the government directly, but through a new and intimate relation with the leading firms in the Paris market. A large part of the influence operated through personal connections with the leading Paris banks. By mid-1937 of the Great Banks, only the Société Générale had no former Governor or Deputy Governor in a prominent management position. Whereas at the time of the German “Anschluss” of Austria in March 1938, and during the May war scare over Czechoslovakia, there had been financial panics in France, the markets remained rather steady during the Sudeten crisis in September 1938 and before and after the Munich Agreement. By early 1939 a large part (around 30 bn.f.) of the flight capital had returned.[41] The returning capital was mobilized for defense purposes through a new institution set up in 1938 by Marchandeau, the Caisse autonome des investissements de la défense nationale [42].

It was only after the two devaluations and the removal of the Popular Front's major social legacy that greater sums could be devoted to armaments without causing an immediate panic. But this was in 1939, and it was then rather late. The price of maintaining gold too long through the 1930s involved the security, and eventually indeed the existence, of the French Republic. The lesson learnt from the experience was that controls were needed to defend France’s national interest against the security

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[40]. Banque de France Historical Archive B34 15 Jul. 1938 Lacour memorandum.
[41]. Bank of England Historical Archive OV34/86 23 May 1939 N.E. Young note on interview with Charles Rist.
[42]. See Frankenstein, Le prix, p.101.

dangers posed by hot money flows. The experience of the 1930s convinced many observers, not just in France, that speculative money was immoral and dangerous. By the late 1930s, and especially in the war years, a consensus emerged that the instability of the 1920s international economy, and thus also the way in which the financial sector served as a transmitter of depression, was a consequence of unstable capital flows . This is not a particularly popular view today, when the orthodoxy among economic historians (expressed most powerfully by Barry Eichengreen in *Golden Fetters*) now holds that the fixed exchange rate regime (rather than the mobility of capital) provided the chief systemic vulnerability.

5. The New Consensus:

The contrasting orthodoxy of the 1930s, that capital flows are the source of vulnerability, had its classic formulation in a book published by the League of Nations, from its wartime base in Princeton.[43] Except for Chapter VI (on Exchange Stabilization Funds) this book, *International Currency Experience: Lessons from the Inter-War Period*, was written by Ragnar Nurkse, although it was extensively commented on by members of what had become the League's "Economic, Financial, and Transit Department", and in particular by the director of the department Alexander Loveday.

[43] . On this, and the conflict between Nurkse's interpretation and that of Gottfried Haberler, see Michael D. Bordo and Harold James, The Adam Klug Memorial Leture: Haberler versus Nurkse. The Case for Floating Exchange Rates as an Alternative to Bretton Woods, NBER Working paper 8545, October 2001.

That book distilled a series of lessons from the interwar experience that expressed in the form of a historical analysis the philosophy underlying the Bretton Woods solution. Nurkse’s viewpoint was that of the principal actors in the preparation of Bretton Woods, John Maynard Keynes and Harry Dexter White.

In the Second World War it had become clear that an examination of international monetary issues would be critical for the making of the postwar settlement, and the League Economic and Financial Organization set about preparing a survey of interwar currency experience. That work was mostly written by Ragnar Nurkse.

It is worth thinking about Nurkse’s personal trajectory. Nurkse was born in Estonia of an Estonian father and Swedish mother, but his family emigrated to Canada and he studied in Edinburgh and then in Vienna, where he worked with the major figures of the Austrian school – Haberler, Hayek, Machlup, Mises and Morgenstern. Vienna was crucial; not only was it the center of a tradition of economics; but with the Creditanstalt collapse of May 1931, it provided the epicenter of the world financial crisis. At a critical time for Nurkse, with the experience of banking and currency crises of 1931, capital flight appeared as the pressing issue for contemporary economics. Machlup in 1932 in *Weltwirtschaftliches Archiv* published a paper (which he later tried to suppress) in which he examined how capital flight contributed to banking collapses as well as to obvious balance of payments difficulties, in that in order to carry out foreign exchange transactions, speculators withdrew deposits from banks and endangered the banking systems. If central banks tried to compensate with increased liquidity for such withdrawals, they lost reserves and their exchange rate was endangered. Governments reacted with exchange controls, “police measures, penal sanctions and confiscation” which diminished the propensity to save, to invest capital, and added to the “psychological roots of capital flight.”[44]

It is striking that there is in Nurkse’s argumentation one continuous villain, which explains why cumulative depreciation got under way in the early 1920s, why stabilization took place at the wrong levels, and why competitive devaluations wracked the 1930s. That villain is the movement of capital. There seems to have been a general consensus among the League economists on this issue. The director of the EFO Alexander Loveday, explained that “international lending was a bad method of combating economic depressions. When times were bad, the default which eventually ensued intensified the existing depression and led to currency depreciation.” He recommended a negative attitude on this point and personally preferred the export of capital on an equity, not on a bond basis.[45]

The consensus exemplified in *International Currency Experience* was embodied in the Bretton Woods agreements, which famously required a quick restoration of current account convertibility but held capital controls to be a long term necessity. The IMF was specifically obliged not to assist with problems arising from capital movements: “A member may not make net use of the Fund’s resources to meet a large or sustained outflow of capital, and the Fund may request a member to exercise control to prevent such use of the resources of the Fund. If, after receiving such a

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[44] Fritz Machlup, Die Theorie der Kapitalflucht, Weltwirtschaftliches Archiv, 36 (1932), p. 527.

request, a member fails to exercise appropriate controls, the Fund may declare the member ineligible to use the resources of the Fund.” (Article VI(1))

On the other hand, current account transactions were to be liberalized, and the Article on capital transactions added: “Members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions.” (Article VI(3))

In practice, it proved hard in the 1960s to liberalize the current account without creating room for large capital movements. The rather odd lesson that had been drawn from the 1930s was that capital restrictions worked, whereas the 1930s was actually full of examples of how they did not work. A more reasonable deduction might have been that the capital markets had been destroyed by the banking panics of the depressions and the damage done to financial systems in lending as well as borrowing countries. While such collapses produced a demand for regulation of capital movements as well, they encouraged the short term flows that capital restrictions were intended to control.

The legacy of the 1930s in this way shaped a crucial part of the institutional framework for the postwar world. The legacy was reflected in Keynes’s 1933 injunction in “National Self-Sufficiency”: “Ideas, knowledge, art, hospitality, travel – these are things which should of their nature be international. But let goods be homespun

[45] United Nations Geneva, League of Nations Historical Archive R4453, June 30, 1938, Minutes of Delegation on Economic Depressions.

whenever it is reasonably and conveniently possible; and, above all, let finance be primarily national."[46]

[46] From Collected Writings of John Maynard Keynes, XXI (London: Macmillan, 1982), p. 236.