9 Surplus reversals in large nations: The cases of France and Great Britain in the interwar period

Christopher M. Meissner
University of California, Davis and NBER

By studying two important surplus reversals from the interwar period, the authors illuminate several lessons relevant for today. Global imbalances, as well as surplus reversals induced by policies and external forces, have been a part of the global economy for a long time. Imbalances and reversals that involve large players have important impacts at home and on the global economy, so remedying them before they get too large or last too long will lead to greater economic stability. Moreover, as key currency systems pose threats to global stability, greater monetary cooperation would be of great benefit.[1]

Global imbalances are an enduring aspect of the international economy and a perennial subject of study for economists. Such imbalances have been theorised about since the 18th century when David Hume wrote about the price-specie flow mechanism.

Today, as in the past, surplus regions fund others' deficits, debt accumulates and exchange rate changes rebalance. In economic models without market failures and policy interventions distorting the behaviour of economic actors, such imbalances would be equilibrium phenomena and would naturally dissipate as fundamentals and prices evolved.

Naturally once fixed exchange rate policies, other policy interventions such as demographic controls, monetary sterilisation, capital controls, financial frictions, information problems, financial crises and uninsurable risk are introduced, the smooth adjustment process of equilibrium models fades, imbalances become more and more problematic as they impose costs on other nations and welfare losses are on the table for discussion.

In any event, the modest goal here is to illuminate several lessons from reversals from surplus to deficit in the past. Such reversals in systemically important countries have been rare in the past but are quite topical today given the nations involved in the current imbalances. We study two important reversals which occurred in France and Great Britain in the interwar period.

1 The author would like to thank - without implicating - Abdul Abiad, Daniel Leigh and Marco Terrones for proposing his initial foray into surplus reversals and for useful dialogue on these issues.

The French franc was undervalued for several years prior to 1931 but it then appreciated sharply, which rapidly diminished the French trade surplus. The surplus reversal in the 1930s was also associated with sluggish economic growth. Importantly, France was a systemically important player on the global scene in terms of reserve accumulation. Exchange rate and monetary policy that sponsored surpluses and reserve accumulation led to great potential for instability and volatility in international capital markets. The French policy of undervaluation also helped diminish the British surplus. This led to accumulation of sterling reserves in France and ultimately large capital losses when Britain decided to devalue in 1931.

Britain experienced a secular decline in its current account surpluses, but the overvaluation of sterling in 1925 as the gold-standard was re-instated, led to exceptionally weak economic performance and high unemployment until after devaluation in 1931.

The case of Britain has one other lesson for countries experiencing large and persistent surpluses. In Britain, some evidence suggests that current account surpluses may eventually contain the seeds of their own demise, generating their own problems when they are eventually unwound.

A surplus reversal in France (1926-1938)

The franc was successfully stabilised in late 1926 at a historically low level against sterling and the dollar. The franc was widely viewed as being undervalued at this point. To keep the franc from appreciating, the Bank of France engaged in foreign exchange intervention - selling the domestic currency repeatedly as capital was repatriated in expectation of an appreciation (Cairncross and Eichengreen 2003).

Monetary policy in France remained far too restrictive after 1928, according to the influential British Treasury official Ralph Hawtrey. French policymakers disputed the British allegation that the franc was undervalued and denied that policy was too restrictive.

France experienced significant current account surpluses throughout the late 1920s (figure 1). The Bank of France also aimed to attract gold reserves to back the franc but it also accumulated a large volume of foreign exchange reserves especially dollars and sterling. These accumulations would prove to be problematic for the stability of the international financial system as described below.

During the surplus years, the French economy boomed posting growth rates of 6% or more, which was far superior to those of other industrial economies in Europe like Britain and Germany. However, significant inflation accompanied the surpluses of the late 1920s. Money wages increased by some 7% between the end of 1926 and the end of 1929. Low real interest rates, partially due to the inflationary environment, along with government incentives kept investment rates high (see figure 2).

The devaluation of sterling in 1931, the dollar in 1933, and restrictive foreign trade policy and economic depression abroad led to a major decline in the current account surplus after 1931.

France resolutely rejected devaluation and monetary expansion and continued to focus on currency stability as a means of attaining a global recovery. Its fear of monetary instability based on the experience of the 1920s cast a long shadow. In any case, tariff retaliation to a franc devaluation would have been likely. French policymakers unsuccessfully advocated an internationally coordinated policy of supply manipulation (Simmons, 1994). The French could not get assurances in early 1935 from the British or the Americans that their currencies would not be allowed to depreciate further in the face of a franc devaluation. In 1935 the Bank of France approached the US to provide a joint loan to stabilise sterling. This advance was rejected by the US, as were most other attempts at coordination during the period. It took until 1936 for the idea of devaluation to become acceptable in France. By then, France's gold reserves were draining rapidly and social unrest was on the rise. An internationally agreed upon devaluation of the franc of 20-25% was agreed in 1936. Recovery commenced from this point onwards.

Fiscal policy sustained economic growth if monetary policy could not in the early years of the surplus reversal. From 1926 to 1931 the government undertook major public works projects although the budget surplus actually grew. The net effect of this policy was a "crowding in" with increased investment concurrent with the deterioration of the current account (figure 2). This investment shock in fact helped delay the onset of the Great Depression which had begun affecting countries from 1929. Eventually, however export markets dried up and monetary orthodoxy- an unwillingness to abandon the gold standard like Britain in 1931 or the US in 1933 – led to a comparatively severe economic slowdown that persisted well into 1936 when the franc was finally devalued (see figure 3).

The roots of the staunch defence of the gold standard and the unwillingness to engage in expansionary monetary policy are found in the stabilisation program of 1928. This program prioritised monetary stability given a recent period of high inflation and uncertainty prior to 1926.

The Bank of France had its hands tied being prohibited from engaging in open market operations and unable to buy bills in the money market. Although changing the discount rate was a possibility, the thin money market of the period limited the effectiveness of this tool. These constraints were viewed as a precaution against 'loose' monetary policy that might have contributed once again to a return to inflation.

During the surplus years, the inability or unwillingness of the monetary authority to accommodate rising money demand through open market purchases helped spur a massive accumulation of gold in France, both by the public and by the Bank of France. By 1928, France held 20% of the world's monetary gold stock and it continued to hold a large amount of gold in 1929. By this point, the percentage of gold reserves held in France far outweighed its relative economic size. Another reason for the gold influx was that the Bank of France was worried about the value of its (large) foreign exchange reserves. It actively aimed to trade

its significant sterling reserves into gold in London in the late 1920s. It wished in some sense to push adjustment onto the British (Cairncross and Eichengreen 2003)

The build up of large foreign reserves (sterling and dollars mainly) and then gold stocks in the late 1920s bears a striking resemblance to the situation of financial globalisation today where surplus nations are highly exposed to the debt of deficit nations. And it highlights the potential for systemic instability in such a situation.

Accominotti (forthcoming) calls this situation a 'sterling trap'. France accumulated large amounts of sterling and dollar reserves by 1928. From 1928 it ceased to acquire foreign exchange reserves, instead preferring to sell existing stocks of sterling for gold. The motivations were diverse. Worries about capital losses are cited, as well as a French insistence that holding foreign exchange reserves gave rise to a tendency for expansionary policy in reserves countries which could have been destabilising.

Because France was a large player in the market for sterling assets, it could not rapidly liquidate its sterling holdings without incurring devastating capital losses even in late 1930 and early 1931 when it became evident that a sterling devaluation was highly likely. Despite early attempts to extinguish its sterling holdings in late 1928 and 1929, by late 1930 and into 1931 it was playing an active role in supporting sterling (Accominotti 2009).

The dangers of accumulating large reserves during surplus periods are easily illustrated. Sterling's devaluation in September of 1931, led to an immediate and large capital loss on existing sterling reserves. This was the equivalent of twice the amount of available capital and reserves of the Bank of France (Accominotti forthcoming). The capital loss was covered by the French government but it led to an extreme loss of autonomy of policy at the Bank of France. Having been burned badly by external policy changes in Britain, dollar and sterling reserves were liquidated and replaced by gold at the end of 1931 leading to increasing pressure on the dollar.

To summarise, the French case itself illustrates three important points in relation to imbalances.

- First, unbridled reserve accumulation arising from external surpluses can lead to significant losses for both the buyer and seller of such assets. There may also be systemic fallout from the shock when such losses come due to the fact that the parties involved are usually large key players in the global economy.
- Second, surplus countries that delay engaging in an adjustment process may have adjustment imposed on them by trading partners. The devaluation of sterling in 1931 strengthened the British balance of payments and forced capital losses on France. The US devaluation in 1933 had a similar impact although reserve losses were limited by early and anticipatory diversification out of dollars.
- Finally, in response to a surplus reversal, use of expansionary fiscal and monetary policy can offset the loss of foreign demand to obtain domestic balance. The investment boom sparked by government expenditure

and private sector incentives in 1929/1930 delayed the onset of the Great Depression that ravaged other industrial economies. From 1931, the opposite occurred. France avoided monetary expansion and fiscal expansion while other industrial nations did the opposite - many opting to leave the gold standard. Recovery in these countries commenced immediately despite the fact that export markets were not immediately recovered. Domestic demand took up the slack.

Great Britain's surplus reversal 1880-1930s

Great Britain suffered a long-term decline in its strong current account surplus between 1870 and the 1920s. The sharpest declines in the surpluses (ignoring the effects of World War I) were felt in the mid to late 1920s.

British surpluses arose out of industrial superiority and the rise of sterling as in international currency reflected dominance in international trade from the mid-nineteenth century. Sterling came to be a global reserve currency in the nineteenth century much like the dollar today. Some voices in China express the hope that the renminbi will become an international currency in a similar way in the future.

In the century ending in 1914, the British current account showed a deficit in only two years (Cairncross and Eichengreen 2003). Britain's surpluses emanated from strong exports of shipping and financial services (or invisibles) and income from earnings on earlier foreign investments. Surpluses remained but were diminishing in size throughout the 1920s and they finally evaporated totally in the early 1930s.

Between 1870 and 1914 the British economy ran a persistent and large trade deficit on goods but remained a world leader in exporting shipping insurance and financial services. British producers of industrial goods increasingly lost international market share after 1870 to the newly industrialising countries like Germany and the US. Still, invisible earnings reliably offset this deficit and a strong balance of payments position was reaped on the back of overseas long-term investments that exceeded large short-term capital inflows. During the heyday of the gold standard, 1880-1914, Britain was the world's largest trader. Britain also financed a large fraction of foreign infrastructure development aimed at primary commodity extraction within its formal empire in Africa (note the similarity between this and China's interactions with Africa today) and even outside of it in countries such as the US, Argentina and Brazil.

By becoming the world's largest exporter and largest economy in the mid-late nineteenth century, Britain's currency, the pound sterling, came into demand as a means to settle nearly all international transactions. Its financial sector, already strong, developed further to service international trade finance and also to provide long-term funds for development abroad. Britain came to play its central role in the global capital markets of the day and sterling became the international reserve currency. Increasingly, foreign agents kept a large amount of short-term sterling balances in London. This eventually had a debilitating impact on the real

economy (particularly the tradable sector) as demand for sterling assets rose. The events had a familiar ring to those following debate on global imbalances today and in the Bretton Woods period.

> ...foreigners (were) effectively giving Britain interest free loans by holding sterling and by sterling's enhancement of world liquidity... by analogy with the role of the US dollar after 1945, the key currency system contained the seeds of its own destruction… British industry had to export less in order to buy a given quantity of imports than if sterling had not been a reserve currency… The adjustments of prices in the British economy and of the industrial structure, necessary to maintain a balance of payments equilibrium, were reduced… If Britain had been forced to adjust faster the structure of her industry, not only would the eventual adjustment have been less wrenching, but the rate of industrial growth in the late 19th century might have been higher (Foreman Peck 1995).

In the event, adjustment occurred in the 'interwar' period. Britain faced numerous challenges between the wars. First, it was widely argued that sterling was overvalued from 1925 when it returned to the gold standard. Cairncross and Eichengreen (2003) note that even though the real effective exchange rate did not necessarily display a major overvaluation, significant price compression would have been required to regain market share. Competitors developed new products to suit changing industrial and consumer demands while British exporters had failed to make such changes (Eichengreen and Cairncross, 2003). Exports consequently suffered although long-term foreign investments proceeded apace. Further reliance on short term capital inflows in order to fund imports was the outcome. Invisibles payments also declined in the late 1920s and by the 1930s trade deficits, decreased invisibles, foreign defaults and economic depression abroad pushed the British current account into deficit.

During this process of decline in the 1920s, unemployment was high and showed little sign of decreasing. And although the government was wary of tight monetary policy, the Bank of England proved reticent to keep the discount rate too low as gold outflows mounted. Britain suffered critical losses of gold reserves repeatedly in the three years prior to 1931, which threatened their adherence to the gold standard and monetary orthodoxy which was a major policy goal. Britain also maintained a tight fiscal policy running budget surpluses in the 1920s even though rising unemployment outlays threatened fiscal orthodoxy. As the world sank into Depression in 1929, British exports collapsed in 1930-31. A political battle raged over the appropriate monetary and fiscal policy response with loud voices calling for devaluation and an expansionary monetary policy. This led to further speculation that the pound would eventually be devalued. In September 1931 such speculation was vindicated when sterling was devalued.

Three lessons can be learned from the British case:

- The end of a surplus did not spell an economic disaster precisely because of the policy response. In 1931 the British current account went into deficit—a singular event in over 130 years of economic history. Due to devaluation and expansionary monetary policy (though not to

expansionary fiscal policy which Britain resisted) and economic recovery abroad, the current account improved greatly by the mid-1930s. Britain's relative and even absolute economic performance in the 1930s was superior to many countries especially France which kept a tight monetary policy (see Figure 3).

- Did the long-standing surplus position of Britain contain the seeds of its own demise as Foreman-Peck suggests? This is a crucial possibility to be considered for countries like China and other countries running persistent surpluses as part of a development strategy even though the historical circumstances are not exactly parallel to those today. In some respects the British experience outlines one possible future if Chinese policymakers carry out plans to internationalise the renminbi in a bid to de-throne the dollar. Such a policy would entail an increase in the use of the renminbi in international transactions, more development capital and assistance for commodity producers, and making Shanghai a global financial centre with obvious benefits. However, the costs imposed on the tradable sector may be notable especially in the long run.
- Key currency nations are exposed to international sales of their liabilities much like emerging markets are exposed to sudden stops. If the renminbi achieves the status of a global reserve currency in the coming decades due to China's size and importance in world markets, China, like Britain and the US before it, could eventually face the prospect of unexpected foreign sales of renminbi held by foreign actors. Such pressures aggravated monetary policy in the late 1920s when France attempted to sell sterling in exchange for the gold reserves of the Bank of England. Britain could not maintain its commitment to a sound currency and full employment and eventually devalued in 1931. It is argued that the US may face similar constraints today and it is one reason that Japan has shied from pushing for a global role for the yen.

Conclusions

Global imbalances induced by policies and other distortions have been a part of the global economy for a long time. Deficit countries often are portrayed as those that bear the burden of adjustment due to external forces. This is so since small developing economies are usually perpetrating such deficits, and so large countries are spared much of the pain of adjustment. But history shows that surplus reversals in large systemic countries have also occurred due to policy changes and external forces in the past.

As these case studies show, imbalances and reversals that involve large players have important economic impacts at home and on the global economy. Such reversals have not always been painless or smooth. If surpluses and imbalances persist due to intervention in the world's economies it is likely to be the case

that remedying them before they get too large or last too long will lead to greater economic stability.

History also shows that key currency systems pose threats to global stability. In this regard more thought could be put into the design of mechanisms to enhance the international monetary system. Specifically, greater international monetary cooperation would be of great benefit, as Frieden (2009) amongst others, has highlighted.

References

Accominotti, O., (forthcoming) "The Sterling Trap: Foreign Reserves Management at the Bank of France, 1928-1936." *European Review of Economic History*.

Cairncross, Alec and Eichengreen, Barry (2003) *Sterling in Decline: The Devaluations of 1931, 1949 and 1967*. Basil Blackwell: Oxford.

Frieden, Jeffry A. (2009) "Global Governance of Global Monetary Relations: Rationale and Feasibility" *E-conomics* vol. 3 March 9, 2009.

Simmons, Beth A. (1994) *Who Adjusts? Domestic Sources of Foreign Economic Policy during the Interwar Years*. Princeton University Press: Princeton.

Figure 1. France, current account to GDP ratio and the real effective exchange rate, 1925-1938

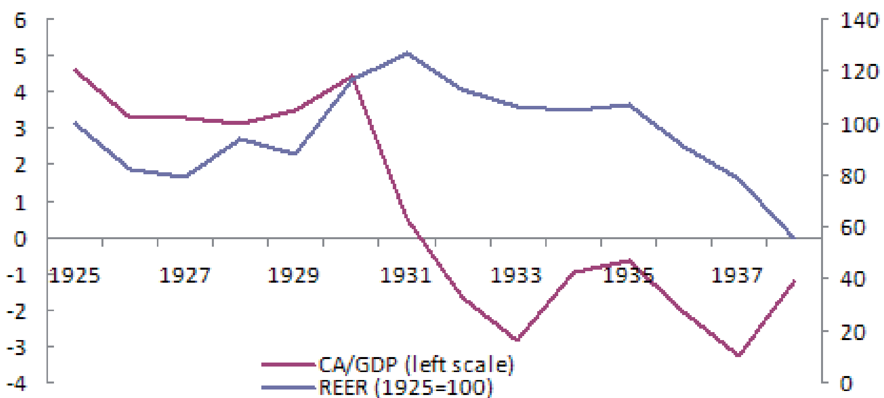


Figure 2. Investment in France, 1926-1936 (1913=100)

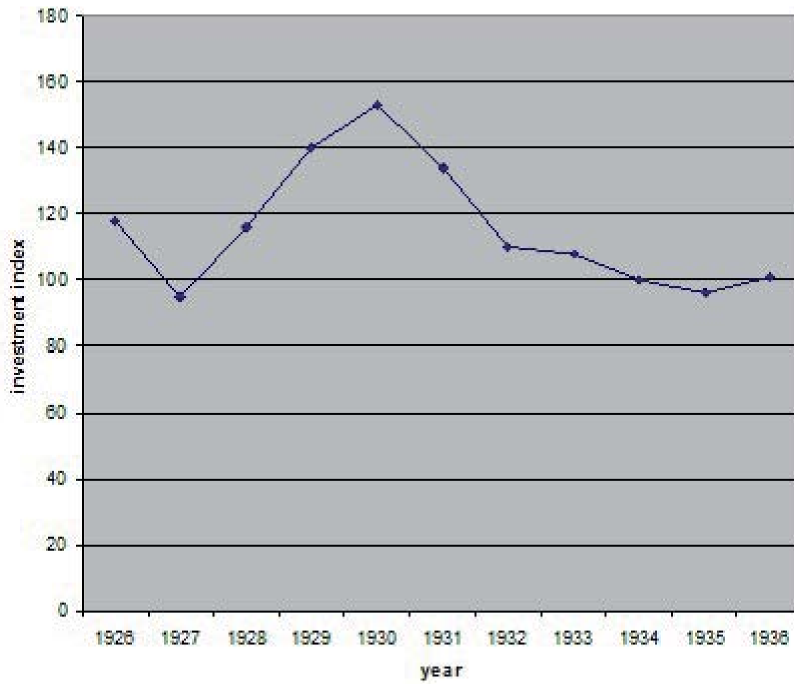


Figure 3. Real GDP per capita in France and Great Britain, 1927-1938

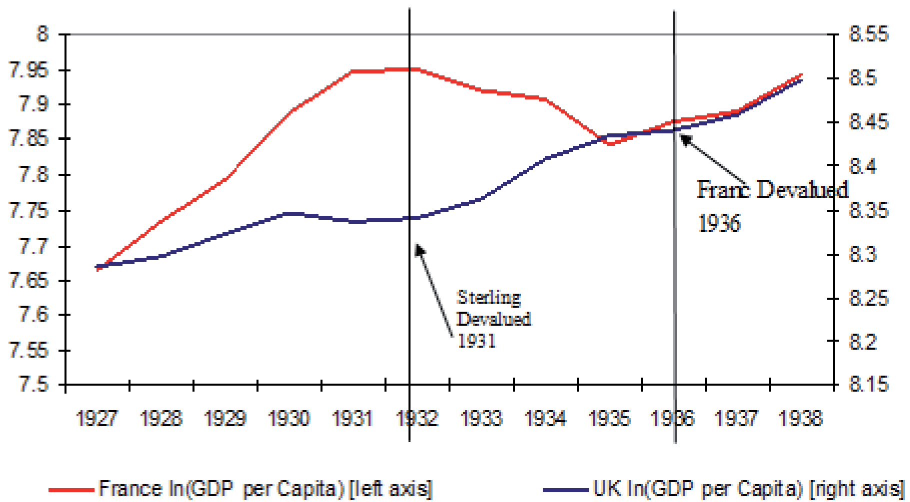
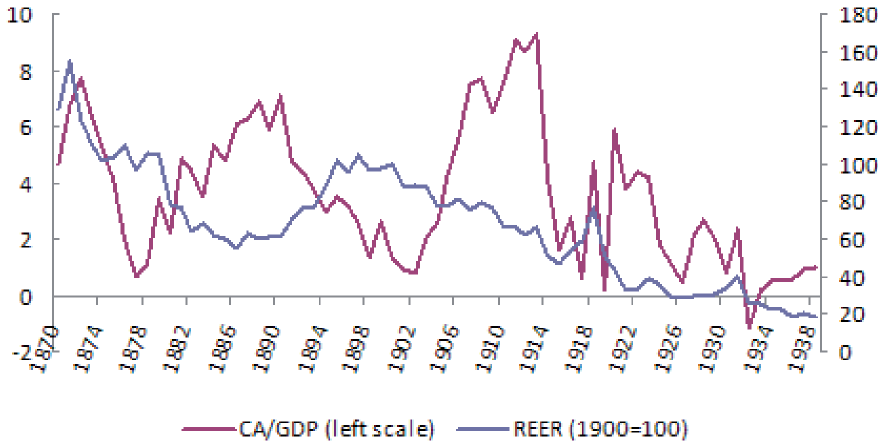


Figure 4. Great Britain, current account to GDP ratio and the real effective exchange rate 1870-1938



About the Author

Christopher Meissner is associate professor of economics at the University of California, Davis. His research focuses on the economic history of the international economy particularly between 1870 and 1913. He is also a Faculty Research Fellow at the National Bureau of Economic Research (NBER) in the Development of the American Economy (DAE) program. Previous to joining the faculty at Davis, Meissner was at the Faculty of Economics at Cambridge University. In Cambridge he was the Director of Studies in Economics and a Fellow of King's College. He has held visiting scholar positions at the International Monetary Fund and Harvard. He was also a Houblon Norman fellow at the Bank of England. Meissner has consulted for Development Strategies UK, the World Bank and Acadametrics Meissner earned his PhD in Economics from Berkeley in 2001 and his AB from Washington University in 1996.