“We have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine, the working of which we do not understand.”


When Keynes wrote this, thirteen months had passed since the crash of 1929 and the world was living, in Keynes’s words, in “the shadow of one of the greatest economic catastrophes of modern history.”

This is a quotation in “Lords of Finance,” an authoritative work by Liaquat Ahamed, a veteran hedge fund manager and a trustee of Brookings Institution. The book is an impressive and comprehensive description of a world that has long ago ebbed from memory: the world after World War I, a time of economic fragility, of bubbles followed by busts and of a gushing series of events that eventually led to the Great Depression.

By the term “delicate machine” Keynes here refers to the global economy. During 1930, the West was in ominous shape. “Industrial production had fallen 30 percent in the United States, 25 percent in Germany and 20 percent in Britain,” Ahamed writes. “Over 5 million men were looking for work in the United States, another 4.5 million in Germany and 2 million in Britain.” A fatal combination of inharmonious postwar politics, a refusal to break away from economic orthodoxy and a series of policy errors by the four most important central banks in the world — the Federal Reserve, the Bank of England, the German Reichsbank and the Banque de France — had resulted in the near collapse of capitalist economies in the West.

In the book, Ahamed confides that he got the idea to write this book after he read a 1999 Time magazine cover story, headlined “The Committee to Save the World,” about Alan Greenspan (then the Federal Reserve chairman), Robert Rubin (Bill Clinton’s Treasury Secretary) and Lawrence Summers (Rubin’s No. 2). This made him realise that during the 1920s, the four top central bankers had acquired a similar mystique and fame. In fact they were sometimes described as “the most exclusive club in the world.” He decided to write the account of “the descent from the roaring boom of the ’20s into the Great Depression” by “looking over the shoulders” of the four bankers.

The protagonists of this book are the four central bankers who dominated that postwar era: Benjamin Strong of the Federal Reserve Bank of New York; Montagu Norman, the Head of the Bank of England; Émile Moreau of the Banque de France; and Hjalmar Schacht, who headed the Reichsbank. They constitute the “Lords of Finance”. Each one of them was a powerful personality, with the full range of strengths and weaknesses, insights and idiosyncrasies. Strong was a domineering American; Schacht the arrogant, headstrong German; Norman and Moreau the prideful Europeans.

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The four bankers are profiled as follows in the book:

Montagu Norman of the Bank of England: He was the first among equals. In the words of Émile Moreau, his French counterpart, Norman seemed “to have stepped out of a Van Dyck painting, elongated figure, pointed beard, a big hat ... Very mysterious, extremely complicated, one never knows the depths of his thoughts”. For Norman, the return to the gold standard at the prewar rate was not just a matter of national pride, but also a moral commitment to those who had placed their assets and their trust in sterling. He was intolerant to the idea that London should play second fiddle to any other country in the global capital markets. According to him, short-term economic pain would be worth the financial long-term gain.

Benjamin Strong of the US Federal Reserve: One of the strongest supporters and a close friend of Norman, he believed that the return to gold standard was a prerequisite for monetary stability and for this to be possible, Britain had to take the lead. He was strongly committed to the idea of European reconstruction. Like Norman, Benjamin also had a fragile health and was on long periods of convalescence at key moments in the drama. There was a political vacuum within the US central bank when he died in 1928 and this was to have serious consequences.

Hjalmar Schacht of Germany: According to Ahamed, he had an extraordinary capacity of making enemies and was a prominent supporter of Nazi party. He was close to Norman.

Emile Moreau of France: Moreau was one who was not close to Norman and the dislike and distrust was mutual. According to Ahamed, a Bank of England note-taker at their first meeting observed that he was “stupid, obstinate, devoid of imagination and generally lack of understanding, but a magnificent fighter for narrow and greedy ends”.

As the narrative of the book makes it clear, it seems a little unwarranted to describe these men as “the bankers who broke the world,” as the subtitle of the book puts it. Mr. Strong had died in 1928 and by the middle of 1931, Norman was the only one of the four still in his job. Also, each of them is legendary because of their accomplishments.

Ahamed gives an example for this: Mr. Schacht who was a prosperous banker, was nominated as Germany’s “Currency Commissioner” in November 1923, when Germany’s hyperinflation was completely out of control. To give a picture of how shocking it was, Ahamed writes “On Nov. 5, the price of a two-kilo loaf of bread had soared from 20 billion marks to 140 billion, sparking off nationwide riots.” In a brilliant decision, Schacht created a new currency, the Rentenmark, fixed it to the mark at the right moment (at 1 trillion marks to one!), thereby restoring faith in Germany’s currency and beat back inflation. The German press even called him the “Miracle Man.”

Moreover, during that time, the prevailing belief among the central bankers was that a sound monetary policy had to be based on the gold standard and they were cramped by this economic orthodoxy. Gold standard meant that the Reserve Bank of every country had to have a certain amount of gold in its vaults to back up its currency and “all paper money was legally obligated to be freely convertible into its gold equivalent,” as Ahamed says.

This snag compelled the central bankers to take decisions in support of the Gold Standard i.e, decisions so as to allow their respective countries to hold on to their declining supplies of gold. They would raise the interest rate, even when the larger economy earnestly needed help in the form of lower interest rates. Of all the four bankers, Norman was the most passionate advocate of gold standard.

According to Ahamed, much of the economic turmoil of 1930s was due to a problem, over which the central bankers had no control. The problem was, according to the war reparations, Germany was supposed to pay the Allies and the insistence by the Allies that Germany pay up, even though it was far beyond its means. Norman was the only banker who, in particular, strongly opposed the reparations demanded by the Allies, contending that it would spell doom to the German economy — which was exactly what happened.

In the early 1930s, nearly eight years after the hyperinflation was bought under control in Germany, it was effectively bankrupt. The building antipathy of the Germans over the demanding efforts by the Allies to wring out billions as war reparations eventually smoothened the way for rise of Hitler and Nazism in Germany.
Ahamed reiterates that the Paris peace conference held at the end of the First World War was probably from where one of the major set of blunders arose. The war ravaged economies were weighed down with an unimaginable burden of debt – the claims which polluted the international relations over the next decade. It created a capital imbalance which was the fault line in the financial system of the world and when the stress became too intense, it cracked.

The main players of the book recognized the many political blunders of the peace process and sincerely did what they could to deal with the consequences. In the process, they made the second fundamental error of economic policy i.e, the decision to return to the Gold Standard, that too at a wrong time and the wrong rate.

In the book, Ahamed, states that period was “a reflection of how adaptable and elastic the notion of money can be”. He interestingly points out that when the FDR imposed a bank holiday in 1933, “Americans adapted to life without banks remarkably well” as barter, IOUs and scrip replaced traditional money.

One of the most notable aspects of the book is the description of a dinner in March 1925 at 11 Downing Street. It was the time when Chancellor Winston Churchill was trying to make up his mind about the gold standard: Norman, the strong propogater of Gold Standard and whom Churchill could not stand, is not invited. Hence the senior treasury officials were to argue his corner. Keynes does make the case against gold, but disastrously it is not on best form. As the discussions and dinner progresses, Churchill is influenced by the idea that the failure to act would be perceived as a public acknowledgment of Britain’s diminished role in the world. The final word of the night goes to Reginald McKenna, a banker and former Liberal chancellor. “There is no escape. You will have to go back; but it will be hell.”

Economic catastrophe that followed was the cost of that dinner. The world’s gold reserves were not ample to take the strain. Because sterling had been set at the wrong rate, the Bank of England was under constant pressure and Britain’s manufacturers were priced out of their export markets. In the book, Ahamed argues that the four central bankers succeeded in keeping the show on the road only by holding down the US interest rates and keeping Germany buoyant on borrowed money. The Fed was torn between two conflicting objectives: to keep propping up Europe by cutting interest rates or to control speculation on Wall Street by raising the interest rates. Now the world was operating in a system that was bound to come to a crashing end. And the Crash did come!!!!

CONCLUSION

Apart from being a entrancing historical account, the book is also a skillful analysis of the many underlying economic issues. According to Ahamed, the Great Depression is best understood as a series of banking and currency crises occurring from misguided efforts to reintroduce the pre-war “gold standard” currency arrangement. Additional policy errors – particularly the failure to resolve the niggling issue of war reparations and war debts – contributed to the crisis.

The book is well illustrated with a lot of facts and figures which any reader who is economically inclined would enjoy. Ahamed’s work is a achievement of economic history, one which is hard to put down.