CHAPTER 3

INFLATION, DEFLATION, AND THE RETURN TO GOLD

During the 1920s the economic performance of the Western world, especially of Great Britain, offered Keynes new opportunities to reflect on the perplexities of the capitalist system. The war and the peace talks had led him to consider the latent causes of instability in the process of capital accumulation; he had prophesied the enormous dangers to freedom and the menace to the democratic social order that would ensue from impossible exactions on the defeated powers. Now, European reconstruction and obstinate policies aimed at restoring prewar monetary mechanisms brought him face to face with a new and virulent form of instability: inflation (or, antithetically, deflation) and unemployment.

Keynes's early warnings against inflation appeared in *The Economic Consequences of the Peace*. If European reconstruction were based on pointless inter-Allied squabbling over looting the losers' remaining riches, instead of fostering a recovery of production, he believed inflation was inevitable. Within two years the prophecy was tragically confirmed by German and Austrian hyperinflation. The smashing of these countries' monetary institutions prepared the groundwork for the democratic crisis in which the advent of unemployment provided a fertile audience for Naziism. In Russia, too, the period between 1920 and 1923 was marked by a dizzy price explosion which made the ruble about as valuable as printed paper.

Between the summer of 1919 and the autumn of 1920, Britain and the United States both experienced rising prices—in Britain the increase was somewhat higher. There followed a period of deflation which lasted until autumn 1922.

The violent fluctuations in the purchasing power of money thus appeared as a concrete threat to any resumption of growth in
an atmosphere of stability. Instead of being an exceptional and occasional occurrence tied to unusual events such as a great war, inflation risked becoming a way of life, a sacrifice on the altar of reconstruction. In many quarters even broaching the idea that the authorities should exert some kind of control over the sequence of expansion and recession was looked on with grave misgivings. In Great Britain, large sectors of public opinion, as well as the Treasury and the central bank, tended to see government wartime manipulation and intervention in the economy as the actual cause of the price disorder. The corollary to this interpretation was the opinion that the only good solution was a return to the "rules of the game," meaning mechanisms capable of automatically regulating the monetary system. For almost a century the gold standard had been an article of faith. What then was the cost of a return to gold? Was it a simple nostalgic yearning for the past stemming from barely concealed vested interests, or did it rest on solid economic rationality?

These were the options of "informed" debate in Britain in 1922. Analysis of reality merged with value judgments, with class interest conflicting with righteous statements of moral principle and each side sustaining its propositions by a selective use of economic theory. Keynes had published a brief book in January 1922, *The Revision of the Treaty*.\(^1\) Now that his mission to mold and inform public opinion about the peace treaty was over, and as the force of events was pushing to validate the results he had foreseen, he published a series of articles in the Reconstruction Supplements of the *Manchester Guardian Commercial*.\(^2\) A year later he used part of the same material for a more rigorous analysis of the effects of inflation and deflation, at home and in foreign relations, and of the monetary policy options available to achieve the alternative goals of price or exchange-rate stability.

In *A Tract on Monetary Reform* Keynes once again attacked a burning public issue of his time.\(^3\) He clarified the terms of the

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1. (London: Macmillan); reprinted in *C.W.K.*, vol. 3.