

THE DISCOUNT MARKET IN LONDON

ITS ORGANIZATION AND
RECENT DEVELOPMENT

BY

H. W. GREENGRASS

CERTIFICATED ASSOCIATE OF THE INSTITUTE
OF BANKERS



SECOND EDITION

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PREFACE

TO SECOND EDITION

DURING the year that has elapsed since this book was first published there have been several new developments in the London Money Market, and it may be alleged against this new edition that, if not ignored, they have received but scant attention. The truth is, that while advantage has been taken to bring the work up to date, the author has resisted the temptation to criticize dogmatically features which are either too recent to be viewed in their true perspective or the development of which is, as yet, incomplete. The underlying principles of the book as originally printed are, however, unaffected.

On its first appearance, the book was fortunate in its reviewers. The majority were well-disposed and many offered criticism of a distinctly constructive nature. To these latter the author feels himself to be indebted, particularly to the reviewer for the *Journal of the Institute of Bankers*, and also to Mr. Hedley Robinson of Lloyd's Bank.

To them he offers his thanks for their suggestions which have been of considerable assistance in the preparation of this new edition.

PREFACE TO FIRST EDITION

MANY books have been written on the subject of the London Money Market, but none, for many years at least, has presented its aspect from the viewpoint of the bill broker.

He, being the intermediary between those who seek credit for periods of months and those who provide it for periods only of days, is peculiarly well-placed to judge the effect of the various factors governing the supply of, and the demand for, short loanable credits. The following pages are an attempt to survey the market from the angle of vision of this constituent of it.

Primarily, this book has been written for the benefit of banking students; the interest shown in lectures delivered to provincial centres of the Institute of Bankers on the subject of the Money Market encouraging the hope that it may be of some use to those who are not in close touch with movements in London. But in the last few years the events in this market have been given a much greater prominence, and therefore have aroused more public interest than formerly; hence the further hope is held that these pages may prove of interest to a wider circle than that formed by the students for whom they were originally written.

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THE DISCOUNT MARKET IN LONDON

CHAPTER I

INTRODUCTORY

“ECONOMISTS understand by the term ‘Market,’” says Professor Marshall, quoting from Cournot, “not any particular market place in which things are bought and sold, but the whole of any region in which buyers and sellers are in such free intercourse with one another that the prices of the same goods tend to equality easily and quickly.”

The London Money Market.

Were any illustration of this economic market desired, the London Money Market would furnish an admirable example. Its physical boundaries are certainly vague, for its business is conducted in the parlours of the banks, in the brokers' offices clustered around the streets and lanes adjacent to Lombard Street, and frequently in the streets themselves. The quantity of goods offered for sale in this market varies from hour to hour in a manner frequently bewildering, while, in such circumstances, the price paid for the commodities—in other words, the rate demanded by lenders of money—adjusts itself to the altering conditions with a rapidity that is little short of uncanny, particularly since convention still demands much in the way of personal visiting, rather than the extensive use of the quicker, if more irritating, method of telephoning.

A satisfactory definition of the term “Money Market” is none too easy to give, as each person dealing with it has his own idea, tempered according to the nature of his business, while the view, comprehensive, if theoretical, attained by the coldly scientific eye of the economist will certainly differ from

that narrower, yet more intimate, glimpse of the individual who experiences the actual working of a small section. Thus, to the merchant with goods *in transitu*, it connotes the market in which he may turn into cash the bills drawn against his commodities. He will do this by selling such drafts to a discount house, which will obtain the money necessary to pay for them by borrowing from the banks. To the discount broker, therefore, the market in bills and the market in bank loans are so closely allied as to be part and parcel of one whole. But there is a class of discount broker, known as the "running broker," frequently employed in bill transactions. He is merely an intermediary between buyers and sellers; unlike the discount broker proper, he does not carry the bills he buys on borrowed money, but immediately re-sells them at a fractional profit to himself. His business being of a purely turnover character, his interest in the market for loans is little more than academic, and hence, to him, the money and bill markets appear as two separate entities acting and reacting upon one another.

The discount broker, again, will regard the Stock Exchange as something quite alien from his own activities, but the banker will lump together his loans to both, under the heading of "Money at Call and Short Notice"; proof positive that he, at least, regards each as a constituent of the same market. The shipper of goods, too, will consider he is entering the sacred portals when he approaches an accepting house in order to make arrangements for financing his shipments, although the very banks that do so much of this accepting business will look upon it as cognate to their actual money market activities, but quite separate from them.

The economist who takes a more detached view is not so prone to avoid seeing the wood for the trees, but he in his turn finds a distinct difficulty in achieving a clear-cut definition, and is usually content to describe it as the market "in short loanable credits." Taking this definition as a starting point, an analysis of the various lenders and borrowers is necessary, and in addition, a very clear understanding is required of the

influences which determine the constantly varying aggregate of this loanable fund. For, as previously suggested, these fluctuations are at times rapid and numerous enough completely to change the aspect of the market in the course of an hour or two; a severe demand for accommodation in the early part of the day may be followed by a flood of money, the mysterious source of which becomes, for the moment, an absorbing topic. But, whether money miraculously appears, or whether it vanishes as surprisingly, the test of the ideal economic market applies, inasmuch as the rate for loans adjusts itself to the changed conditions as readily as a pulse responds to the activity or somnolence of the body.

How Funds Accumulate.

The concentration in London of a vast sum of credit is occasioned by the essential need of all banks to keep an adequate portion of their funds employed—profitably, it is true—in such a fashion that it may be turned into cash at a moment's notice in order to satisfy all legitimate demands that may arise from its customers in any given circumstances.

The growth of English banking during the past half century has resulted in the substitution of a very few banks with ramifications spread throughout the country for a multiplicity of small local institutions, and just as in the past each provincial bank lodged its surplus funds with its London agent, now every branch keeps an account with its head office. So far as may be, local demands for accommodation are satisfied out of local resources, but head office account is drawn upon whenever such resources prove insufficient to meet the requirements of customers, whereas, on the other hand, all surpluses find their way to London. Funds similarly accumulated in Edinburgh by the banks north of the border are sent to Lombard Street or Bishopsgate in like manner, and the few remaining independent provincial banks remit to their London offices or, in the case of those without an office in the Metropolis, to their clearing agents.

In addition to our domestic banks there are in London the

offices of both the colonial and many foreign bankers. Numerically these are much greater than our domestic banks, though their London funds are comparatively small and many of them, concurrently with their activities as lenders in the market, are also frequently absorbing money there by means of selling the London acceptances that have been remitted to them by their offices in other parts of the world.

However, the aggregate of the funds kept by these banks in London is far from negligible and it helps to swell the credit fund.

London as the Greatest Financial Centre.

The result of all this is to form in London a huge reservoir of money, the level of which, though always high, is constantly varying in accordance with the difference in pressure between the inflow and the outflow pipes, and to this pool come all those in need of money whose credit is sufficiently good to enable them to be accommodated. It is one of the factors that has made London the greatest financial centre that here credit is more freely given and, more important still, more cheaply given than anywhere abroad.

Apart from demands for loans on the part of the Stock Exchange and the discount houses, the British Government enters it regularly as a borrower, while periodically certain municipalities and corporations do the same.

Alien borrowers are always present and usually clamant, hence the extreme sensitiveness of London to foreign influences and the importance of the movements in the foreign exchanges to the London market. But apart from our being a creditor country in the sense of our satisfying the continuous colonial and foreign loans that are floated here, shipments of goods between all parts of the world are financed in London by means of bills drawn under our acceptance credits, and these bills form a great part of the stock in trade of that highly important subdivision of the London money market, the discount market.

Hence, we find a market in funds primarily supplied by the

excess of banking deposits over the traders' needs for banking accommodation, a market which is at all times sensitive to domestic demands, and most acutely so to increased or diminished foreign requirements.

A heavy foreign demand is always a most potent influence, because it so easily leads to the point at which complete satisfaction is only attained after the withdrawal of gold from the Bank of England, and the Bank of England's stock of bullion is the foundation upon which the credit structure of the money market is built.

In a word, then, the wares of this market are the cash surpluses of the banks over the requirements of their ordinary customers, the purchasers of these wares are the British Government, Colonial and Foreign Governments, municipalities such as the London County Council, Liverpool, Manchester, etc., the Stock Exchange, and the discount houses. To an analysis of the activities of these constituents of the market, and to a survey of the influences affecting it, the following pages are devoted.

CHAPTER II

THE FUNDS OF THE MONEY MARKET

SYSTEM of their concentration in London—Factors affecting their level—The various means of their employment

As already indicated in the previous chapter, after the satisfaction of the needs of local customers for loans and advances and after the provision of adequate till money for each branch, the banking resources of the country are concentrated in London.

The Extent of the Funds.

It is impossible to quote with any degree of completeness the extent of these funds at any one time owing to the entire lack of uniformity on the part of the numerous banks in publishing their balance sheets. Thanks, however, to the system adopted by the ten clearing banks in the monthly publication of their average weekly figures a tolerable accuracy of the most important portion of this accumulated fund may be attained, but when we turn to the statements presented by the others we meet with frequent instances of the combination in one item of "Cash" and "Money at Call," while here and there, to make the confusion worse confounded, "Bills Discounted" may be included in this entry and sometimes may be found wedded to "Investments." Hence the following figures can be taken only as an approximation to the total, but rough as such a calculation must be, it is sufficiently close to afford a useful idea of the funds with which the money market works. Before quoting these figures, however, it is important to remember that the whole of the money remitted to London is not available to the discount market. As much as prudence will allow is locked up in Government stock and bonds, and other securities of a character that justifies their being regarded as gilt-edged, for investments of this type are, next to his "Advances," that is, loans and overdrafts granted

to customers, the most remunerative form of employment a banker has for his money. In December, 1929, the clearing banks alone had so dealt with no less than £250 millions of their resources.

Cash at the Bank of England.

Coming to the other end of the scale every banker is obliged to keep an idle store of money, in addition to that reposing unprofitably in his till, in the shape of a balance with another bank. It seems an anomaly that this should be so, rather suggestive indeed, of a lack of confidence in himself, but the banker without a seat in the clearing house must employ one who has in order to collect the cheques his customers pay in to their accounts, and, as a consequence, is obliged to carry a substantial balance with his agent. It is also a convenience to the clearing banks to keep a balance that may be encashed on demand at the Bank of England rather than to lock up in their own vaults in the shape of currency all the money they deem it advisable to keep in order to be in a position to meet immediate demands for cash on the part of their multifarious branches.

But aside from the question of mere convenience it is desirable, and indeed necessary, that the Bank of England as the central bank with right of control over the whole of our financial system should be given charge of a substantial sum by those through whom its control must largely be exercised, especially, too, as in times of pressure the clearing banks indirectly obtain the help they need from the Bank of England. The statement issued by the latter on the 1st January, 1930, showed the deposit with it by bankers of a sum of £110 millions.

The Banks' Loans to the Market.

The ten clearing bankers showed by their combined return of their average weekly figures for the month of December, 1929, that they had, aside from their balances at the Bank of England and apart, too, from their "Investments," lent

directly to the money market £143 millions in the shape of "Money at Call and Short Notice," while in addition they had bought bills to the extent of £229 millions. Strictly speaking, the item of "Bills Discounted" is not entirely confined to transactions in the London discount market, as the total includes the local trade bills discounted for customers at all the branches. Years ago these trade bills filled a goodly proportion of the average banker's portfolio, but modern commercial developments have gone far to eliminate this class of paper. For example, a typical specimen of such a bill would be one drawn by a wholesale house in Wood Street for stock supplied to a small linen draper in the suburbs or the provinces, and after acceptance by the drawee it would be offered for discount by the warehouseman to his banker, the latter taking it, of course, on the security of the drawer's name rather than on that of the acceptor.

Many factors have contributed to the disappearance of such bills, among them being the growth of the "multiple shop" system of limited companies with big cash resources, and also the encouragement to pay cash given to the small trader by way of discounts. But although now a moribund form of finance, a few such bills still persist though hardly, we venture to think, in sufficient numbers to warrant any appreciable reduction in the bankers' figures in order to arrive at the total bought in the market, even after making allowance for the drawings of manufacturers on wholesalers. Only one of the clearing banks publishes its holding of treasury bills and commercial paper separately, and the latter, comprising both trade bills and bankers' acceptances, is usually only one-fifth of the amount represented by treasury bills.

On the assumption that we should find a similar position among the other banks were we privileged to probe into their domestic affairs, we should probably be making a full allowance for trade bills if we deduct £10 millions from the aggregate of bills discounted. This gives a total of £362 millions supplied to the money market by the clearing banks alone.

When we attempt to analyse the figures of the banks outside

the charmed circle of the clearing house the task is a very complicated one. Of the banks whose balance sheets are published in the *Banking Almanac* very few give their "Money at Call" as a separate item, and those doing so show a total of £16 millions. By far the majority couple it with their cash to present a total of £170 millions, and if they, in common with their bigger brethren, keep 11 per cent of their deposits in cash and 9 per cent at call, it follows that some £75 millions are in the market while their "Bills Discounted" amount to £202 millions.

Adding these various items together, we arrive at an aggregate of £655 millions employed in this market merely in the shape of short loans and bills discounted by the bankers whose figures are made public, quite apart from the money similarly used by the London offices of foreign institutions. Subsequent to the continued transfer of French sterling balances to New York during the latter months of 1928, it was estimated that the Paris banks alone had a sum of £40 millions in London. On this basis it would appear a conservative estimate to suggest £900 millions as the total applied to the satisfaction of the bill and stock markets. Some corroboration of this may be obtained by taking the amounts of the treasury bills outstanding at the end of December, 1929 (£780 millions), deducting from this, say, £200 millions as representing those held by the Bank of England as part cover for its fiduciary issue, and also those otherwise held outside the market, and adding to the resulting figure of £580 millions a further £300 millions for bank acceptances.

Accustomed though we have been to bloated figures since the immense borrowings by the Government for the conduct of the war led to so phenomenal a growth of bank deposits, it is a striking feature of our financial system that so huge a total should be maintained in so fluid a condition, a third, at least of this sum being liable to be repaid in cash within fourteen days, and all but a trifling portion of the remainder is in a security that is self-liquidating within a period of three months.

Bills Discounted.

An examination of the bill portfolio of any of the banks would show an astonishing variety of paper represented by the term "Bills Discounted." The trade bills, to which slight reference has already been made, would be there as well as bills of three, four, and six months' usance (to which the term "Bank Paper" may be applied), discounted by them for private customers at the market rate of the day, and then would be found a mass of "remitted paper" bought from the discount market. These bills have been drawn on London from all parts of the globe to finance the movements of goods from one country to another. After acceptance, parcels of them will be bought by the discount houses from the holders and resold, when of shorter date, by the discount houses to the banks. But by far the biggest proportion of the bill case would consist of Treasury bills, some of which the bank will have obtained by tender at the time of issue, whilst others will have been bought from the bill market in order to fill gaps in the bill diary. This register would show daily maturities with very large sums falling due at the end of each quarter of the year—the end of June and December maturities being particularly heavy—while the explanation of large amounts falling due on other particular dates is usually that those are days on which the banker knows in advance that he will have heavy commitments. In this respect, the regular weekly issues of Treasury bills by the Government have been a great convenience to the banker inasmuch as they simplify his task of supplying his needs for any given date. In the days when such issues were small in total and erratic in their appearance he was forced to buy from the market bank bills that would mature prior to the particular day on which he wanted the cash and then to lend their proceeds to the required date.

"Money at Call and Short Notice."

The most important of a banker's dealings with the money market is the employment of that portion of his cash surplus described as his "Money at Call and Short Notice." This falls

into two portions, first, his loans to the Stock Exchange, and secondly, those to the discount houses. Only once recently has any banker lifted the veil and made public the proportions of these loans granted to each class of borrowers. The occasion was when the Chairman of the Midland Bank, in his speech to the Annual General Meeting of shareholders in January, 1929, revealed the fact that the Stock Exchange and the discount market's borrowings from that institution were practically on an equality. Whether the same was true of the other clearing banks it is impossible, in the absence of published figures, to say, but it is obvious that the proportion of the one to the other must be liable to considerable variation from time to time.

Loans to the Stock Exchange.

The Stock Exchange will naturally require more accommodation at a period when market prices are much in excess of face values and tending to rise, and, as the proportion of "Money at Call" to "Investments" is fairly constant, this additional claim for money by Throgmorton Street will be satisfied at the expense of the bill brokers. The loans to the Stock Exchange are arranged to fall due for repayment on the following Account Day, and, excepting when the rather rare "three week account" occurs, the maximum length of such loans is fourteen days. The borrowers lodge as collateral against these loans approved securities with a margin sufficient to protect the lender against any likely fall in their Stock Exchange value before the expiry of the loan. Should, however, an unexpected fall reduce their value to that of the loan they represent—or less—the banker will expect further cover, and for the sake of his own reputation, the broker will provide this before it is necessary for the banker to demand it.

Loans of this character provide the banker with a means of employing money at a profitable rate of interest; the charge will usually range from $\frac{1}{2}$ per cent below bank rate in the case of loans against British Government securities up to some 2 per cent above bank rate for those secured by shares of a

speculative nature, and moreover, such funds are maintained in a fair condition of liquidity.

Loans to Bill Brokers.

But, after his cash at the Bank of England, the banker's first line of defence, is to be found in the rest of his money "at call and short notice"; his loans, that is, to the brokers of bills. Whereas three weeks represents the maximum, and a fortnight the usual, period for loans to the Stock Exchange, it is but rarely that a banker will make a loan to a discount house for longer than a week, and the amount of weekly money is balanced by the amount which is lent at "call," or, what is practically the same thing, from one day to the next.

Each clearing banker has his own method of dividing his loans to the bill market, some choosing to split the bulk of their money up into weekly fixtures maturing on each day of the week, whilst others prefer to keep all their loans running from day to day, but, each method achieves the same end, namely, that of having a very large sum liable to repayment daily, so providing the banker with an admirably liquid fund which is yielding him a substantial income so long as it may remain undisturbed, and actually most of it does remain undisturbed except in times of grave abnormality. It is quite a usual thing for a loan to be continued, either from day to day, or from week to week, for a year, or even longer, without ever being called in. Hence weekly loans, and the seldom changing portion of the day-to-day loans are known in the market as "good money."

Both sides are content; the bill broker knows that this money will remain with him more or less permanently, and so will not hesitate to lock it up in the purchase of bills which will represent cash to him only on their date of maturity three or more months ahead. The banker is equally happy in the knowledge that he has a large sum lent on undoubted security, that the borrowers have agreed to repay at his request. Each, however takes a chance; the bill broker that, having his funds locked up in bills not yet due, he may be seriously

embarrassed by heavy calling in of the money lent to him; the banker that, having called, the brokers may not be in a position to repay. It may be objected that the latter is a state of affairs which never arises. In the first place, a bank naturally satisfies itself that bill brokers are men of sufficient substance to justify the size of the loans granted and their due repayment. Secondly, although brokers do issue cheques many times in excess of the balance on their account when they repay their calls, they always meet them by the end of the day—and only crossed cheques are used in order that the brokers may have until the close of banking hours in which to make provision for them—by replacing their calls by equivalent borrowings from other banks with money to lend, or else by the sale of bills and, on such occasions when the calls are in excess of the new money on offer, as a last resource, the broker can borrow from the Bank of England, which will always lend, albeit at a penal rate of interest.

The answer to this argument is, that although it is a perfectly true picture of affairs in normal times, many members of the market have cause to remember an occasion when the Bank of England refused to grant loans to bill brokers, and in consequence the latter had to decline to pay off the loans called from them. This happened on the Saturday morning prior to Great Britain's declaration of war on Germany in 1914. On that day the Bank of England let it be known early in the morning that bill brokers applying for their usual facilities would be denied, feeling, no doubt, that at a time when its own reserve was being sadly depleted, the other banks should have lifted a portion of the strain from its shoulders.¹

The brokers had no alternative to a refusal to repay the banks the amounts due and demanded by the latter. Their emergency source of supply was cut off and had they tendered the banks cheques, and removed their securities, they would have had no means of making provision for the meeting of

¹ Later that morning the Bank of England reversed its policy, and immediately it was known that help was forthcoming most of the other banks cancelled their calls—proof that they were of a precautionary nature.

those cheques when they were presented through the Clearing House.

“Window Dressing.”

It was a rude shock to the brokers when they were forced to plead inability to meet their ordinary obligations, and a yet ruder one to the banks to realize that the most liquid of all their income-yielding assets was frozen hard, and obviously it was not a lesson to be lost upon them. Up to that time it had been the habit of each bank to call on one day in the latter part of each month a proportion of its loans from the market, so as to swell its cash balance at the Bank of England in order to make a heavy showing of cash in its published monthly figures. This custom, known as “window dressing,” was usually considered a futile expedient. It was argued by the critics of the scheme—and these included practically every bill broker in the market—that those who studied a bank’s balance sheet might be divided into two classes: those who understood it, and those who did not. The former were not impressed by the heavy cash balance, for they knew that it would be considerably lighter by the time the figures were in their hands; to the latter the whole thing conveyed nothing. It was merely a needless and irritating disturbance of the even flow of money in the market; indeed, it was a succession of small disturbances, for each bank in turn would do the same thing, and in the days before the advent of the post-war amalgamations, clearing banks were more numerous.

As a final result of the upheaval of this particular occasion the banks acknowledged the somewhat farcical nature of their “window dressing” by arranging to scourge the market with scorpions in place of a whip, by calling in a substantial amount, not once a month, but once a week.

One still hears complaints that this weekly “making-up,” as the process has been re-christened, is merely the fourfold absurdity of the monthly “window-dressing,” but the argument of the banks seems to be as follows: The experience at the outbreak of war shows that no method the banks could

possibly adopt would ensure repayment of the loans to bill brokers should the Bank of England ever again repeat its policy of that Saturday morning, but since the Bank of England would never refuse accommodation except in the gravest circumstances, the weekly "making-up" would definitely ensure absolute liquidity at all times except in that of a monetary crisis of the first magnitude. Further, since by arrangement between themselves the clearing bankers spread their "making-up" over four days of the week, there are only two days (and one of those a Saturday) when the full amount of loanable credit is available for lending to the market. This is most certainly a check upon overtrading, and the loss of interest on the part of the banks may be regarded somewhat in the light of an insurance premium paid by them against panic in a future crisis.

Undoubtedly the immobilizing of five or more millions of credit for the greater part of each week will provide a very useful buttress whenever a time of stress shall arrive, for then the weekly window-dressing can easily be waived, and indeed may perforce be temporarily discontinued.

The weekly loans and the steady day-to-day loans have been discussed, and it may be pointed out that the rate of interest paid upon them rarely alters, being fixed at 1 per cent below bank rate varying. True it is that on special occasions, such as the end of the calendar year, which is also the end of the financial year of the banks, a higher rate will be enforced, but at all ordinary times such loans stand indifferent to the constantly moving value of money in the market, and yield their fixed rate of interest. But there is another class of loan by the clearing banks to the bill market of a different character.

"Bad Money."

On the day following its "making-up" day a bank will be able to release the money called from the market and paid into the Bank of England the previous day and re-lend it. These loans will obviously last no longer than six days, since they are bound to be re-called on the "making-up" day of the

following week. The rate of interest on them varies, and were it not for the fact that the demand for accommodation has been very steady indeed during the past few years, the attitude of the banks towards the bill market in respect of this money would savour rather of a "Heads-we-win, tails-you-lose" nature. For the banks will not hesitate to take full advantage of a temporary embarrassment of the market in order to extort a half, three-quarters, or even one per cent more for these loans than they charge for their good money.

On the other hand, no matter what plethora of credit may be exercising a depressing effect, they will never accept less than 1 per cent below bank rate for any of their loans to bill brokers. Indeed, when money is so "easy" that the brokers are able to satisfy their needs from outside sources at lower rates of interest, the clearing banks, rather than break their rule, will allow brokers to pay off loans which are due and will keep the money unemployed until such time as a demand arises sufficient to ensure their rate being willingly paid.

This "bad money" may be lent to mature on the next making-up day, in which case the broker may not repay it in the interim, but, on the other hand, the rate of interest arranged at the time of lending will hold good until maturity. Very often however, this money is lent on a day-to-day basis; then the broker will have the opportunity of paying it off on any day it may suit his convenience to do so, but the rate of interest he will pay will vary according to the conditions of the moment, subject, of course, to the minimum charge on the part of the banks.

Other Loanable Funds.

A further class of money is also available to the market at the clearing banks, namely, the somewhat adventitious receipts on the part of the banks of money which may be withdrawn almost as soon as it is deposited. A good example of money of this character is the application money received by the banks who are responsible for the service of a popular issue.

A public loan may be many times over-subscribed, and the extent of the payments made on application cannot possibly be foreseen. Since, however, the physical work attendant upon the issue is so heavy that several days frequently elapse before the allotments can be made and cheques for the balance of the application money returned to partially successful applicants, in the meantime the banks can make use of these funds by lending them in the market. The bill broker will regard them as precarious; they are "bad money" of the worst description, but frequently useful to tide him over a day or two of stringency until the coming of a new spell of ease.

The banks outside the charmed circle of the clearing are more elastic in their dealings with the market. Some few base their transactions, it is true, on the lines followed by the clearing banks, but the majority have very little money of what the broker will consider a wholly good character, the great bulk of it being lent from day to day at interest rates varying with the conditions of the moment, and it is always more sensitive to disturbance than the steady daily money of the Big Five.

Variations in Loan Rates.

In fairness to the clearing banks, it must be admitted that often their day-to-day money is continued at the minimum rate when outside bankers are obtaining considerably more, but, on the other hand, these outside banks will reduce their rates below the clearing banks' figure when conditions justify the acceptance of low rates. On Saturday 25th August, 1928, *The Times* reported money to be practically unlendable, and whilst the clearing bankers refused to lend below $3\frac{1}{2}$ per cent, outside loans were negotiated at 2 per cent "for the night," i.e. repayable the first thing on the Monday morning.

But, no matter how much higgling may take place between lenders and borrowers, the average rate demanded and paid keeps remarkably close to the clearing banks' minimum rate. It is now nearly always above this figure, but since the bulk of the money in the market is "good money," lent by the big institutions, it is obvious that their "bad" money and the

activities of the outside banks are insufficient to draw the average rate far away from the fixed rate.

Although, when taking the long view, we see a very small degree of fluctuation in money rates—apart, of course, from the occasions of a totally altered complexion due to a change in bank rate—yet, individual days frequently show a record of very varied movement. If, thanks to a combination of circumstances, the big banks are all short of money on a given morning, some of the brokers may find themselves in danger of applying to the Bank of England to square their books, an expensive operation since they will never obtain loans there for less than a week, and even so, will be charged $\frac{1}{2}$ per cent above bank rate for the accommodation. On such occasions an outside bank with a little money to lend may be able to obtain for money till the following day the Bank of England's lending rate, the bill broker agreeing that it is better for him to pay that rate for one day and take his chance of easier conditions on the morrow than to go to the Bank and pay the same rate for seven days. But as the day wears on, money will begin to appear from other sources, for, the "making-up" operation apart, a bank calls money from the market only in order to pay it away, and, except when the Bank of England is its destination, it will drift round to some other bank or banks, and thus again become available for lending. The fluidity of money is akin to that of water, and the large sum called by A in the morning will be in the hands of B or C seeking re-employment in the market during the afternoon. If, however, there should be some obstruction to the flow, and the money is not offered to the market before the early afternoon, then the brokers will perforce seek assistance from the Bank, and being thus fully supplied, will be unable to utilize it should it appear later. Consequently, a considerable fall in the rate will be apparent, for the aim of the banker will be to have as little money as possible over his ordinary minimum balance lying unemployed.

The broker is, naturally, equally concerned to finance his business on the cheapest terms possible in order to obtain as

large a running profit as he can from the bills he buys with this borrowed money, and the rate finally agreed between the two parties is frequently a compromise between the personal view of each.

The following account taken from *The Times* is an illustration of a typical day in the market—

Short credits yesterday were in plentiful supply, the unexpected degree of ease being connected mainly with the incidence of Treasury bill payments and maturities. While $4\frac{1}{2}$ per cent was adhered to as the charge for renewals, and was the rate at which a considerable amount of new business was arranged, the relations between supply and demand were more clearly shown in the afternoon when some large sums came on offer at $4\frac{1}{4}$ to 4 per cent. The discount market remained steady in tone. For three months remitted bills the working rate was again $5\frac{1}{2}$ per cent, although occasional business in competition was reported at about $\frac{1}{32}$ below that rate. October maturities of varying dates for delivery to-day were negotiated at $5\frac{3}{16}$ per cent. The foreign exchanges showed very little movement, and the only transaction in gold at the bank consisted of the sale of £20,609 in bars.

The bank rate is $5\frac{1}{2}$ per cent, to which it was raised from $4\frac{1}{2}$ per cent on 7th February. The banks' deposit rate is $3\frac{1}{2}$ per cent, and the deposit rates of the discount houses are $3\frac{1}{2}$ per cent at call and $3\frac{3}{4}$ per cent at notice.

Loans (per cent)		Discount (Bank Bills) (per cent)			
Day to day $4-4\frac{1}{2}$	For short periods $4\frac{1}{2}$	60 days $5\frac{1}{2}$	3 months $5\frac{1}{2}$	4 months 6	6 months $6-6\frac{1}{4}$
Discount (Treasury Bills)			Discount (Fine Trade Bills)		
2 months %	3 months %	3 months 6	4 months $6\frac{1}{4}-6\frac{1}{2}$	6 months $6\frac{1}{2}-6\frac{3}{4}$	

How the Total of the Loanable Funds is Affected.

Following the discussion of the origin and methods of lending of money to the market, and also of its employment there, the

question at once suggests itself: What are the factors affecting the total of this fund of loanable credit? As already seen, there is a continuous ebb and flow between head office and branches, between London, that is, and the trading districts, so that at times, when trade is brisk, manufacturers will be calling for accommodation, and there will be an outflow of funds from London to the provinces and conversely, when trade is inactive, especially when the inevitable slump sets in after an unusually good period, money will find its own level by trickling back to London for employment in the money market, when it can serve no useful purpose in the provinces.

But whether the money is used in financing local trade or whether it is laid idle in the tills of the banks, or lent to the money market, will not alter the total of money in the country.

The Influence of Gold Movements.

The level in the London reservoir will vary, but the amount employed in the money market plus that used for financing local requirements would be a constant but for the intervention of several factors. The first of these factors is the influence of gold movements.

The bulk of the production of the gold mines of the Rand comes to London as a commodity to be sold in the open bullion market, and the receipt of such bullion has only the same influence over the foreign exchanges and on credit and prices as the advent of any other commodity, unless such gold fails to find a buyer in the open market and is sent up to the Bank of England, there to swell the "Reserve," which is, incidentally, the final banking reserve of the country. The market in this new gold is a limited one, both with regard to the dealers in it—there are only about half a dozen bullion brokers in London—and with regard to the limits of price. By the terms of the Bank Charter Act of 1844, fortified by those of the Gold Standard Act of 1925, the Bank of England is obliged to buy all gold offered to it at the price of 77s. 9d. per oz., 11/12ths fine.

Similarly, the Gold Standard Act lays upon the Bank the

duty of selling bar gold in parcels of not less than 400 fine oz. at the price of 77s. 10½d. per standard oz. These two figures, therefore, set definite limits to the price at which dealings may take place, for, obviously, no seller will accept a lower figure than he may command from the Bank of England, and, equally, no purchaser will pay a higher one than that at which he can legally fulfil his requirements.

In the open market, gold is quoted at the price of, not the standard, but the fine ounce, so that 12/11ths of the foregoing prices, i.e. 84s. 10d. and 84s. 11½d., are normally the extremes at which dealings will take place. The term "normally" is used advisedly, because a somewhat curious development took place during the second half of 1930. France had steadily been withdrawing gold from the Bank of England for a considerable period and always requested it in the shape of fine bars. Eventually, the stock of pure gold held by the Bank became exhausted, and, as the French demand still continued, the Bank was obliged to refuse to "oblige a customer," and was forced to fall back upon its statutory right to deliver bars of standard metal. Despite the fact that the French standard of bullion parity is lower than the British (9/10ths fine against 11/12ths), such gold was unacceptable to the Bank of France, and hence the consignments of gold withdrawn from the Bank had to be refined before the importing French banks could dispose of them to the Bank of France. Consequently, buyers of gold in the open market on French account were willing to add the cost of refining standard gold to the price of pure gold rather than to incur the delay occasioned by the process. The result was to raise the upward limit to a figure in excess of 85s. per oz.

As already stated, should there be no demand for the gold available in the open market, it will be sold at the statutory price to the Bank of England. Then, unless the authorities take steps to counteract its influence, such gold will become the basis of credit to the extent of from eight to ten times its own value. This statement is usually accepted without question, although members of the discount market have been known

to remark that the experience of a lifetime goes to prove that the receipt by the bank of a million in gold means an extra million of money in the discount market, no more and no less. The truth of the matter is that both statements, although apparently contradictory, are correct. The explanation is a simple one. A banker must preserve the ratio between each item of his assets and his liability for deposits, so that an increase of ten millions to his deposits will result in an increase of, roughly, one million to his "Money at Call and Short Notice."

If gold movements into and out of the Bank of England should be on a small scale the consequent expansion or contraction of credit is insufficient to have any appreciable effect upon trade, or the price level, but when, as has been the case since our reversion to a Gold Bullion basis, movements have been of large amounts, the Bank of England has usually seen fit to neutralize the effect.

During a period when trade was trying to raise itself out of its general depression, it was obviously wise to maintain the country's price level at as constant a figure as possible, and interference with this level, due to the automatic expansion or contraction of credit resulting from an influx or efflux of gold, was avoided by the Bank of England's policy of immediately selling securities to the value of the gold bought by them, or, in the case of an export, of buying them. A sale of securities by the Bank takes money off the market, and this money is not paid out again by the Bank, while a purchase, of course, releases money at once.

But, in 1930, a long period of trade depression degenerated into one of stagnation, accompanied by a heavy fall in wholesale commodity prices. The demand on the banks for accommodation by traders diminished accordingly, and, with the repayments of advances and overdrafts, the funds remitted to London for employment in the money market increased, until there was a redundancy of credit seeking employment in short term credit. Consequently, on those occasions when gold was withdrawn from the Bank of England, the authorities allowed the exports to exercise their full influence in reducing credit.

The reduction in no way harmed trade, for there was far more money available for financing it than was required; on the other hand, the Bank of England's control of the market was strengthened by the check to plethoric conditions.

Gold Points.

Apart from this "commodity gold," is the gold flowing in and out of the country as a purely banking operation. When no restrictions on the movement of the metal are in force gold will leave one country for another when this is the cheapest way of paying foreign debts.

The exchange value of one currency in the terms of another is based upon the comparison of the amount of pure gold contained in the standard coins of both countries, and a comparison of the bullion content of the sovereign and the American eagle shows the pound sterling to be worth \$4.8667 or approximately \$4 and 86 $\frac{2}{3}$ cents. An English banker can, therefore, have his account with his New York agent credited with \$4.8667 for each full weight sovereign that he sends across the Atlantic, but the English banker would be out of pocket to the extent of the freight, insurance, and cost of packing the bullion and would also lose interest on his money whilst the gold was in transit. These charges must be deducted from the mint par to arrive at the equivalent obtained in New York for the shipment of each sovereign from England. It must, of course, be remembered that whilst the mint par of 4.86 $\frac{2}{3}$ is immutable so long as the mint laws of the two countries remain unchanged, bullion points are variable, owing to fluctuations in insurance premiums or the other items in the cost of sending the gold. Of these charges, the loss of interest is the most subject to variation. Thus, when money rates in London and New York are as low as 2 per cent, each sovereign shipped will yield \$4.85 $\frac{1}{4}$, whereas, if the loss of interest is as high as 5 per cent it will only command \$4.84 $\frac{7}{8}$.

The point is, however, that so long as the American rate of exchange is higher than the gold point, bankers will satisfy their New York requirements by the purchase of drafts and

similar credit instruments payable in the United States, but when the exchange slips down to this figure gold will immediately be withdrawn from the Bank of England, and, failing steps being taken by the authorities to nullify the effect of this withdrawal, credit will be proportionately reduced and the money market will suffer accordingly.

This neutralizing the effect of gold movements is a policy new since 1925. When it is enforced, gold movements have a negligible effect on the country's fund of liquid assets, but when bullion shipments are allowed to exert their full influence the money market, the banks, trade and price level are all affected.

Interest and Tax Payments.

The country's stock of credit is at once influenced by any measure of inflation or the reverse. The half-yearly payment of interest on the 5 per cent War Loan causes the Government to disburse some £50,000,000, while the normal weekly receipts of the Treasury are totally inadequate to meet such a demand. Preparation is made, in part, by the issue of Treasury bills, during the week or two preceding the payment, of an amount exceeding the maturities, but the balance is invariably found by borrowing on Ways and Means advances (i.e. overdraft) from the Bank of England. The total of such borrowings, in the shape of dividend warrants, is paid in by the stockholders to their banking accounts, and the total of loanable credit at the disposal of the banks is accordingly augmented. This excess will rapidly disappear, for the application of tax receipts, drawn by the taxpayers from their bankers, to the extinction of these Ways and Means advances will soon restore the position.

The Danger of Funding.

A permanent lowering of the level of bank deposits upon a considerable scale is an unlikely happening for a long time to come, and could not be accomplished, even were it desirable, until it is possible to fund a substantial portion of the floating

debt out of the savings of the nation and not out of Bank and money market applications.

At present, all influences, the Treasury, the Bank of England, banking circles, and the commercial world, recognize the wisdom of maintaining as steady a price level as possible, and seem determined that any further deflation must be of a very gradual character, and this, in spite of the inherent danger of a large floating debt. At this stage the floating debt has the advantage that, as it is constantly maturing and being renewed, the benefit of temporary lower rates is secured, while the damaging effect of high money rates is only fleeting.

But were any attempt made to fund this floating debt at present, it would only be found possible to substitute long-dated stocks for a portion of it, and that at a price that would prove a heavy burden upon the taxpayer for many years to come. On the other hand, the danger of a large floating debt is that, should a commercial crisis of any magnitude arise, the holders of this debt have it in their power to refuse a renewal, and the Treasury, in such circumstances, would be forced to a policy of inflation in order to meet their obligations, and such a step would undoubtedly turn crisis into panic.

But the danger is, fortunately, far more apparent than real. The Treasury bills that form the greater part of the floating debt are held, with quite minor exceptions, by the banks and the discount brokers. In the event of a severe crisis a certain portion might at first be liquidated, but the Government could certainly count upon a steady renewal of their maturing obligations, as the market would show a preference for a gilt-edged security to that of bills, the parties to which might or might not prove to be of the undoubted standing hitherto enjoyed by them.

Since the end of the War funding operations have been attempted from time to time, and although a great deal of deflation has been accomplished since bank deposits and currency reached their peak, the extent of the deflation cannot be measured by the total of the loans of a funding character. The reason for this is that such loans were replacements and

only in part taken up by the investor who paid for them out of his savings; by far the bulk was subscribed by the banks and the discount brokers, whose drawings to pay for their investments do not reduce the purchasing power of the community, and hence affect neither prices nor the quantity of credit available to the money market—available, that is, over a period, for their instalments do, of course, withdraw money temporarily from the market, but it finds its way back there immediately the Treasury authorities apply it to the purpose for which it was raised.

When, however, the time of a general national prosperity comes, with a substantial aggregate of personal savings seeking investment, a funding operation that would successfully attract such savings would achieve a reduction of the funds available for the money market, and would cause a general lowering of the price level and of the amount of currency in circulation.

Even in this case the banking funds of the country would not show a reduction equal to the amount of the funding loan, although that would be the measure of the deflation achieved, since the increased prosperity that led to the funding would argue more trade and consequently greater demands upon the banks for accommodation, with the resultant increasing deposits, and, incidentally, an increased supply of commercial bills for discount.

Apart from the normal ebb and flow of the monetary tide between London and the provinces, it has been suggested that the pool available for the money market is affected, first, by gold movements (when no steps are taken to counteract them), and secondly by Government intervention in the shape of a policy of either inflation or deflation. But aside from these influences of a permanent or quasi-permanent nature, the sum total is affected by a whole series of temporary occurrences.

Do Banks Cause Inflation ?

It has been stated by a distinguished bank chairman that each advance made by a bank creates a like deposit, either

in its own books or in those of a kindred institution, and this theory has been vehemently contested by another bank chairman, whose utterances carry equal weight, he maintaining that inflation by a banker is an impossibility and can be accomplished only by the Treasury. Without attempting to thread a way along so thorny a path it may be permissible to point out that, indirectly at least, the banks may be responsible from time to time for temporary inflation. In a banker's balance sheet appears the item on the asset side of "Money at Call and Short Notice," and we know that this consists of his loans to the bill market and to the Stock Exchange, but we do not know at any time in what proportion these loans are divided between the two classes of borrowers. When a wave of speculation sweeps over the Stock Exchange and the "carrying-over" at the fortnightly account becomes unusually heavy, greater accommodation will be demanded by Throgmorton Street from the banks. If this is granted at the expense of the bill market the "Money at Call and Short Notice" will remain unchanged, as will also the proportion between each separate class of assets and the deposits, but the bill brokers will be so pinched for money as a result of the bankers' callings in order to satisfy the Stock Exchange that they will be forced to borrow from the Bank of England in order to maintain their position, and that action will increase for the time being the funds available to the money market as a whole—a temporary inflation in point of fact.

Any other set of circumstances that forces the bill market into the Bank have, of course, the same effect, and noticeable amongst these is the concerted calling-in on the part of the banks at the end of each half year. As soon as the half year is passed, the money borrowed from the Bank of England, both by loan and by the discounting of bills, is still in the market, and in addition a flood of money is caused by the bankers, who laid up so many millions in idle balances at the Bank of England on the last day of the half year, making the money previously withdrawn re-available to borrowers.

CHAPTER III

COMMERCIAL BILLS AND TREASURY BILLS

DIFFERENT classes of paper in the market—The function of the bill in financing trade—Specimen bills and how regarded by the market and the Bank of England—Treasury bills part of the floating debt—Effect of the floating debt upon bank deposits and the price level of commodities—The function of Treasury bills in the market, and the method of their issue and dealings in them

BILLS, in the table of rates of discount quoted by the newspapers, are divided into two categories, trade and bank bills, but a discount table is necessarily much condensed, and in truth the subdivisions of the second class are numerous.

Bank Bills and Trade Bills.

The first point to be noted about the quotations is the narrowness of the margin in the case of bank bills as contrasted with the three-quarters or even 1 per cent difference between the two rates given for trade bills.

The reason for this is that, as a security, there is not much difference between the various types of bank bills, whereas trade bills vary enormously. There is so much distinction between the names appearing on those classed as "fine trade paper" that every such bill must be treated strictly on its merits, and hence one with strong names upon it will command a much better rate of discount than another drawn and accepted by firms of lesser standing. But bank bills, a term which covers all bills accepted or endorsed by any of the banks but a very few weak institutions, or the acceptances of the first-class accepting houses, are a security of so undoubted a character that only the finest distinction can be drawn between the various names, and the quotations, in consequence, are very close to one another.

At the same time, other circumstances are always present to lessen the easy placing of certain bank acceptances in the market. First amongst these is the unvarying attitude of the

Bank of England towards the bills known as "Foreign Agencies." In times of monetary shortage the discount houses are obliged to approach the central institution for assistance, and this help is granted to them either by the purchase of "approved bills" from them or by the granting of weekly loans upon the security of "approved bills."

Approved Bills.

This term is naturally an elastic one; the Bank rightly exercises its discretion as to what bills are from time to time to be excluded from this category, but to one rule it adheres rigidly, and that is that all bills presented to it either for discount or as security must bear upon them at least two English names, one of which must be the acceptor. This immediately and always rules out of court the bills drawn on the foreign banks even though accepted by their London offices. It is a purely arbitrary action on the part of the Bank of England, and it may sometimes be irritating to know that a bill drawn under a confirmed letter of credit against the shipment of commodities and accepted by a bank of immense strength and unimpeachable standing should be undesirable from the point of view of the central authority.

It is an anomaly, too, that a bill accepted by a foreign bank and endorsed by an English merchant bank will be rejected, whilst one accepted by the same merchant bank and endorsed by the same foreign bank would be received were the bill broker to add his own endorsement to the instrument.

But the discrimination on the part of the Bank of England is sound, and its wisdom was amply justified at the outbreak of the Great War. For many years previous to 1914 three of the great German banks and two of the Austrian had established branches in London, and each was doing a large acceptance business. Indeed, in the years immediately preceding the War, the German banks, by means of the very advantageous terms their letters of credit offered to merchants, were obtaining a large slice of that particular branch of business in the London market, and were increasing their liability

upon bills to an alarming extent. Thanks to the embargo of the Bank of England the discount houses found themselves bound to stipulate when buying bills that no parcel was to contain a higher proportion than 10 per cent of "foreign agencies," and had it not been for this the flood of German paper would have undoubtedly reached a far higher mark than it did. Even as it was, the Government was bound to intervene after our Declaration of War and authorize the Bank of England to buy up all such bills in the market under Government guarantee.

The rule still holds good, and it is right that it should always be enforced, for it is an unthinkable thing that a potential enemy should have the power in its hands at the beginning of hostilities to provoke or accelerate a crisis in the London money market merely by encouraging the offices of its banks here to put their names to bills which in such circumstances would certainly be dishonoured owing to the entire inadequacy of their assets in this country and the interdiction of remittances from their own.

Normally, the other banks in their attitude towards the foreign agency are by no means so exacting as is the Bank of England, but they are bound to follow its lead, although perhaps at a respectful distance, and it is well understood that, at a period of crisis, they would not be so complaisant as in times when the financial horizon is clear, and such knowledge has its influence over the easy negotiability of this class of paper. In short, a moderate proportion may be included in any parcel offered for discount without detriment to the rate, but were agencies alone offered in fair lines a higher rate would at once be quoted.

Finance Bills.

Another point to be considered in appraising the value of a bill is whether it has been drawn against the movement of goods or whether it falls into the category of finance bills.

The essential function of a bill of exchange is to finance merchants during the time their cargoes are *in transitu*, and

the ideal bill, from the bill broker's view point, is one which is not only a banker's acceptance but which also shows on its face the history of the transaction out of which it arises. Practically all the bills drawn against the movements of cotton from the Southern States of the U.S.A. and the majority of those drawn in the Far East—the components of the familiar "Indian Mails"—fulfil these conditions, but others are by no means so easy to read.

Take the following as an example—

Drawn under L/Credit to arrive

No. 5431.

Exchange for £905 9s. 1d.

CALCUTTA, 21st March, 19..

Six months after sight of this First of Exchange (second of the same tenor and date being unpaid) pay to the order of ourselves the sum of nine hundred and five pounds, nine shillings, and one penny sterling, value received, and place the same to account of 15 bales of Hides shipped per s.s. *Oriental Prince* to Hamburg.

THOS. ROBINSON & CO.

To Messrs. Wm. Brown & Co., Ltd.,
901 Lombard St.,
London.

The history of this bill is that the Indian exporter of hides to Hamburg has had a credit opened in his favour by a London accepting house. His draft will be sold for rupees to a bank in Calcutta at the telquel rate for six months bills, and this negotiating bank will take charge of the documents relative to the shipment, forwarding them with the bill to their London office. On acceptance the drawee will detach and retain these documents, returning the completed bill to the presenting banker, who will discount it, in company with others, in the market. The documents of title will be sent to the Hamburg agent of the accepting house and released by him to the German importer of the hides when he, the importer, furnishes the agent with a sterling draft on London for the amount of the bill.

Legitimate Finance Bills.

But other classes of bank bills are not of the ideal character of the foregoing, since many fall into the category of finance bills which may be, but more frequently are not, desirable. The type of finance bill to which no exception can be taken is the one that regularly came into being in America every summer before the War. Our import trade with the United States was then, and indeed, still is, of a seasonal character, thanks chiefly to the immense quantities of raw cotton sent to us by them during the winter months. This causes a plethora of bills offered for sale in New York during the period of heavy shipments of American goods as contrasted with a comparative scarcity during the summer. The natural result of this seasonal ebb and flow of bills was to keep the New York exchange favourable to London throughout the time when there was a shortage of bills on London, but to cause it to drop sharply in the autumn and to remain at a low quotation until the cessation of the shipments.

These periodic movements in the New York exchange were much less violent than one might have expected them to have been, through the circumstances of the New York banks employing finance bills to bridge the gap between the end of one season's shipments and the opening of the next. That is to say, during the time when the shortage of London bills made it difficult for them to provide cover for the drafts they had issued to their customers to pay for imports from Great Britain, they would draw bills to sell in New York usually at sixty days' sight, on their London correspondents. The security for the payment of these bills, instead of being commodities shipped, was purely the credit enjoyed by the drawers and drawees. The payment of the earliest drawings of this nature was usually effected by a renewal; in other words, the drawer, being under the obligation of remitting funds to the acceptor in London to meet the payment of his drafts, would do so by drawing further bills of like type and applying the proceeds of their sale to the purchase of a cable transfer in favour of the acceptor of those maturing.

This process would be continued until the appearance in the autumn and winter of the cotton bills. These the American banks would buy and remit to their London correspondents in order to extinguish the outstanding finance bills as they matured. There was no harm in these bills; as previously pointed out, they fulfilled a useful purpose in keeping the movements of the New York exchange within much narrower limits than could have been expected in their absence, and they avoided a good deal of shipment of bullion backwards and forwards across the Atlantic. The only danger was—and that a very slight one—that unforeseen circumstances might prove the American bankers to have overdrawn by this method, subsequently to find an inadequacy of commercial bills to provide the necessary cover.

Undesirable Finance Bills.

But the finance bill to be discouraged, albeit a bank bill, is the one that was prominent during 1928 and 1929, namely, the bill drawn in New York on London for the purpose of borrowing money here in order to lend it to Wall Street at a considerably higher rate of interest. When a finance bill is also a bank bill it is impossible to tell from the instrument itself for what purpose it has been created; its undoubted security, too, makes it difficult for a discount broker to refuse it, but it is clearly a shortsighted policy freely to discount American finance bills at a time when it is highly undesirable to allow the New York exchange rate to sink to the figure at which gold would be withdrawn from the Bank of England.

£5,000.

NEW YORK,

1st June, 19..

Sixty days after sight of this Original Bill of Exchange (Duplicate being unpaid) pay to our order in London the sum of five thousand pounds and charge to our account as advised.

For The Fifth Avenue Bank of New York.

SILAS K. BROWN,
Manager.

To The Lombard Bank, Ltd.
London.

Finance bills are usually drawn for round amounts, and give no indication on their face of their *raison d'être*. A specimen is shown on page 33.

House Paper.

Somewhat allied to the bill that, naked and unashamed, proclaims itself to be a finance bill are the instruments that fall into the category known as "house paper." These are bills which have been drawn on a London firm by a branch established abroad. They are usually bank bills inasmuch as the branch which draws will dispose of them for local currency to a bank situated in the financial centre serving the district in which the firm is located, and this bank will, in turn, remit them to its London office, whence they will find their way into the discount market after endorsement by the bank. They are usually of a perfectly genuine character; the general explanation of their coming into existence being that the commodities in which drawer and drawee trade are sold in London whilst the greater part of the expenses incidental to their production are incurred abroad. These bills are for the purpose of reimbursing the producing branch out of the proceeds of the realization of the goods here.

Typical are those drawn by the tea planting companies of Ceylon on their London houses, and such drafts are regularly negotiated by the Indian banks.

But house paper can be very readily abused, and due care should be exercised to prevent a firm from drawing bills on its branches for the purpose of borrowing money cheaply upon the credit of its name; it should always be borne in mind that the ideal bill is the one that is self-liquidating, and it is the one drawn against the shipment of commodities that fulfils this essential requirement.

A form of house paper that should always be suspect is that which is for the purpose of financing goods whilst they are in warehouse instead of merely during the period of transshipment. Its creation has been much facilitated by the growth of combines, one firm in which will draw a bill which another

will accept. They are not, of course, bank bills except when negotiated to one which will endorse them and, aside from this latter circumstance, have in reality only one house liable upon them, although nominally they bear two names. The immense capital resources of the parties not only set the mind at rest in the matter of the due payment of such acceptances, but also ensure their being discounted at a figure little inferior to that commanded by bank paper. Consequently, the firms which get bills of this character discounted in the market are able to finance business at the market rate of discount instead of having to pay a bank the ordinary charge for loans upon the security of warehousekeepers' certificates.

The danger is that they enable goods to be kept off the market in the hope of advancing commodity prices, and to use them for the purpose of holding up goods is a prostitution of the function of the bill of exchange.

Construction Finance Bills.

A further undesirable type of bill which is frequently encountered is that drawn by firms of shipbuilders, or marine engineers, on shipping companies for the purpose of financing new construction. They are renewed again and again, are severely frowned upon by the Bank of England, and receive but scant encouragement from the other banks. It is difficult, if not entirely impossible, to exclude them altogether, but new construction should be met by raising fresh capital, or, alternately, out of the proceeds of an issue of debentures, and it is certainly straining the true function of a bill to employ it for such a purpose.

Foreign Domicile Bills.

Finally, there are the bills known colloquially as the "foreign domiciles." They are both drawn and accepted abroad, although made payable at a London bank—hence their name. Comparatively speaking, they are few in number, since they receive less encouragement in the market than any other class of paper, and can be discounted only at rates well above the Bank of England's rate for approved bills and a full 1 per

cent higher than the market rate for bank bills when the quotation for bank bills is little below Bank Rate, and relatively more, of course, at any time when the market rate and Bank Rate be not in harmony. The reason is not far to seek; as already explained, the objection to the foreign agency is the possibility in times of stress of the London funds of the acceptor being insufficient to meet its liabilities.

Here, however, there is no London house with assets at all, and the domiciles are by no means confined to drafts upon banks, so that not only are they inferior in point of security but the proceedings to be taken in case of their dishonour would be complicated by recourse having to be taken abroad, and in the case of the worse coming to the worst the holder would be faced with the inconvenience attending process in a foreign court of law.

Of the heterogeneous mass of paper that constitutes the money market's holding of bills, it is the acceptance of a powerful bank or accepting house under a letter of credit granted to a merchant to finance the movements of the cargoes he ships across the water that finds most favour. The Bank of England and all other constituents of the market welcome it with open arms as a self-liquidating and non-depreciating security. Not only is the acceptor undoubted but the documents of title representing the goods against which the bill has been drawn are under his control, so that, in the event of his not being put in funds to meet the bill by the importer of the goods, he may either realize the goods themselves, or recover from the importer under the latter's letter of hypothecation in favour of the acceptor.

The finance bill, if accepted by a London bank, meets with an equally favourable reception on account of the unimpeachable credit of the parties to it, although the circumstances of its inception have not been so fortunate as those of the bill drawn against the movement of commodities. When drawn upon the London house of a foreign bank, however, it has attached to it the disabilities of the foreign agency, with, consequently, some restriction upon its movements.

House paper, although taken in reason by both the clearing banks and the discount houses and not entirely taboo by the Bank of England, is somewhat less easy to negotiate in large lines even when belonging to the most justifiable section of such bills, while the class known as "pig upon pork" finds its market a distinctly limited one.

Continental Demand for London Bills.

Mention has been made of the purchases of London bills by the French banks, and their activities since the War have been a marked feature of the discount market.

A steady Continental demand has been familiar for a great number of years, the explanation being found in the fact that by holding London bills the foreign banks had it at all times within their power to place them on the market and withdraw to their own centres the proceeds in gold; indeed, the fact that the London bill was to all intents and purposes the equivalent of a bullion certificate led many years ago to the old Central Bank of Austro-Hungary being authorized to hold a proportion of such bills as part of the cover for its domestic note issue. Even when gold was not required the Continental banks were fairly regular sellers of their endorsements in London.

Since the War a considerable change in this respect has come over the market; it is a very rare thing indeed to find the Continental banks selling here, while on the other hand they are persistent buyers. The primary reason was the seeking of a form of investment free from risks of capital depreciation during the period of severe inflation which affected the principal Continental countries during the years immediately subsequent to the signing of the Armistice. The financial centres in Europe turned their attention to both the London and the New York markets, with the consequent transfer of vast sums to England and America. Thanks to our having what was almost entirely lacking in America, namely, a large and old established system of acceptance credits and, above all, the smoothly working machinery of an intricate discount market, immense amounts were invested in London bills in

preference to being employed in New York, despite the fact that at that particular period the pound sterling was at a discount when measured in terms of gold while America was on a full gold basis.

Although France has since then stabilized her currency by the Act of 1928, and much of the money that found its way here from Paris during the prolonged "flight from the franc" has been either withdrawn to France or was transferred by the lure of higher money rates to New York during the Wall Street boom of 1928-9, a large sum still remains in London on French account invested in London bills, and the re-investment of these funds as the bills mature gives holders of fine bank acceptances a constant outlet for their paper.

It is to be noticed that the charters of incorporation of many of the Continental banks forbid their holding more than a very slight proportion of bills having only one name upon them, and since they have curiously relegated British Treasury bills to this category, the latter have been neglected by them while they have persistently demanded the commercial bill, with the strange result that the inferior security has often commanded a better rate of discount than the bill issued upon the credit of the British Government. The term "inferior security" is, of course, merely a comparative one, for, with the exception of their buying a small proportion of first-class foreign agencies, the Continental banks have been as particular in their choice of bills as the Bank of England itself.

The time of depreciated Continental currencies is now past, and the incentive to invest here to avoid loss of capital no longer exists, but in nearly every case of a country's rehabilitation of its currency, authority was given to the Central Bank to hold a certain amount of "gold exchange" as cover for its notes—an extension of the provision of the old Austro-Hungarian Bank to which reference has been made. The most general method has been to divide the cover of the note-issue into two parts, 40 per cent and 60 per cent respectively of the total issue. The 40 per cent is to be in gold bullion, and gold exchange with a minimum proportion of 3 of the former to

r of the latter. The gold exchange has naturally taken the form of bills payable in London and New York, the bulk of them being London bills, and this has naturally kept the Continental investment demand both steady and continuous.

It must also be borne in mind that it is of the utmost importance from the point of view of the Continental centres to keep adequate short funds abroad in order to be in the position to draw upon them to prevent their exchanges from rising too far above the parity.

Thanks to the dislocation of trade caused by the War, and the painfully slow revival, even now the first-class commercial bill is not in such evidence as in the days before the great cataclysm, and for some years after the end of hostilities the Continental demand just discussed caused such paper to disappear from the portfolios of the banks and the discount houses; indeed, had it not been for the presence of the Treasury bills, the stock-in-trade of the bill brokers at least would have been at an exceedingly low ebb.

Treasury Bills.

Treasury bills are not, strictly speaking, bills of exchange at all, but promissory notes of the Treasury to pay their face value at a fixed future time. For very many years they have been a familiar method of temporary borrowing on the part of the Government. In the past they were invariably issued by tender, but the currency of each issue was varied to suit the requirements of the occasion, three months being the most usual currency, although six months and yearling bills were quite frequent in their appearance. The total of such emissions was very modest by comparison with the present, for, nowadays, there are maturities each week in the year, equivalent to, or frequently in excess of, the total of such bills outstanding twenty or even fifteen years ago.

But the War brought with it the necessity for expenditure that rapidly outgrew both the yield of possible taxation plus the amount that could be borrowed by means of Government loans from the public with the result that the Treasury had

to borrow from the banks and so "create" new money to the extent of its needs. Stress should be laid upon the difference arising between the Government's borrowings which are supplied out of personal savings and those loans which are subscribed by the banks and the discount houses. When money is lent by individuals their immediate purchasing power is diminished by the extent of their subscriptions and the banks' deposits reduced by the amount of the cheques the lenders draw for their applications, while the Government's balance at the Bank of England is correspondingly increased. In time the Government balances will be reduced as the loan is applied to the purposes for which it has been raised and the deposits of the other banks will rapidly recover their original level.

But when it is these banks which take up appreciable portions of these loans, the Government's balance is increased without a corresponding reduction in the purchasing power of the nation, whereas the disbursement of the money subscribed will increase the deposits in the hands of the banks. This was a familiar feature after the issue of each successive War Loan, and a practical justification of the academic Quantity Theory of Money, since the amount of commodities available did not increase proportionately the general price level advanced with each such inflation. Concurrently with the raising of money by means of long-dated loans the Government found it expedient to borrow for very short terms upon the security of Treasury bills, and the total of some twenty millions outstanding was increased tenfold within a very few months of the outbreak of the war. Its growth was steady and continuous, and ten years after the conclusion of hostilities there were still 700 millions in existence.

Treasury bills are a security almost exclusively held by the banks and the discount market, and thus this major portion of the floating debt represents a measure of inflation impossible to extinguish, even were it desirable to do so, until the taxable capacity of the country, together with the national savings available for lending to the Government, are sufficient to pay off this mass of short-dated indebtedness.

For a considerable period during and after the War these bills were, in the jargon of the market, "on tap" at the Bank of England, that is to say that borrowers were enabled to satisfy their requirements by application for the amounts they needed at a rate of discount determined and published by the Treasury. Since April, 1921, however, the old system of tender has been revived, with certain modifications, and has obtained ever since.

Method of Issuing Treasury Bills.

The method of issue is now as follows—Each Saturday morning the Treasury, through the Bank of England, gives notice that upon the following Friday tenders will be received for bills for a stated total to be issued during the week following the Friday on which the tenders are to be lodged. Only applications from banks, discount houses, and certain approved financial institutions will be considered, and no tender will be received for a less amount than £50,000, but the day of the week on which the bills shall be issued and paid for is at the option of the tenderer.

The value of bills in the market is always expressed in terms of rates of discount, but their value for the purposes of tendering has to be expressed in terms of the amount of money the would-be purchaser is willing to pay for each hundred pounds that may be allotted to him, hence the figure that will give the desired yield for the currency of the bill has to be calculated. For example, on the 24th May, 1929, tenders were received for a total of £45,000,000 of bills to be issued during the following week. Treasury bills are not subject to days of grace, so that they are payable on the corresponding date of the third month ahead, but the bills to be paid for on the Saturday of the week in question matured on a Sunday, and so had a currency of one day less than those issued on any other day in the same week—ninety-one days as against ninety-two. The feeling of the members of the market being that the rate of discount should have been $5\frac{7}{15}$ per cent, tenders were submitted on that basis; that is to say, that tenders for the bills having ninety-two days'

currency were put in at £98 12s. 7d., and for the Saturday bill at £98 12s. 11d., each price giving a yield of almost exactly $5\frac{7}{8}$ per cent for the period the bills had to run. Within an hour of the time for the receipt of tenders the Bank of England published the result; namely, that tenders at £98 12s. 6d. would receive about 16 per cent of the amounts applied for and those at £98 12s. 10d. for the ninety-one day bills would be allotted in full. Later in the afternoon a fuller publication was made, giving the total amount of the applications (in this case it was £50,310,000) and the average yield of the amount allotted—£5 8s. 2.06d.

The yield of the lowest tenders, that is, those which only offered £98 12s. 6d. per cent, was £5 9s. 1d. per cent, and since each penny in the price makes a difference of almost fourpence in the yield there must have been substantial applications at a figure above £98 12s. 9d.—an unusually wide margin between the highest and lowest figures. Since tenders may no longer be made in fractions of a penny, it is a tribute to the grasp which the members of the market have upon current fluctuations when it is realized that the average yield is rarely more and frequently less than sixpence per cent below that obtained by the cheapest tender.

Treasury bills have been since 1914 the sheet anchor of the discount market; with the exception already noted of the inhibition upon the Continental banks to hold large lines of them, they are always eagerly sought and are freely discounted and re-discounted throughout their life. The outstanding total is relatively stable over a period of months, though naturally the Treasury finds it a convenience, as a result of the weekly issues, to be in a position to adjust the total to meet the needs of the moment.

Amounts Offered for Tender.

During the first quarter of the calendar year when Government receipts from taxation are always the heaviest, it is a weekly feature of the Treasury bills to find invitations to tender for amounts considerably less than those maturing.

After the close of the Government's financial year, when the income-tax payments are comparatively light, the issue of bills will generally exceed the maturities; at any rate, until the smaller amounts issued in the early part of the year have all run off.

The issues of the last two weeks in May and November are again heavy ones in order to enable the Government to set aside money to disburse on the first day of each June and December in payment of the interest then due on the War Loan. The rate of discount, as in the case of commercial bills, is necessarily being adjusted in accordance with the influences exerted over the discount market and all those connoting a higher rate are correspondingly detrimental to the taxpayer. The Bank Rate stood at $4\frac{1}{2}$ per cent throughout the year 1928, and was, from the market's point of view, an effective one; that is to say, the market rate of discount was little below it, its average for the year being £4 2s. 9d. per cent.

Effect of the Bank Rate.

For 1929, Bank Rate averaged $5\frac{1}{2}$ per cent and was thoroughly effective, for ninety day bills averaged $5\frac{1}{4}$ per cent, but the rapid change brought about by the collapse of the Wall Street boom in the latter part of that year saw the Bank Rate reduced by successive steps from $6\frac{1}{2}$ per cent to 5 per cent. The bill rate slipped away from Bank Rate, and the downward movement in the latter continued until 3 per cent was reached. The average of Bank Rate for the year 1930 worked out at £3 8s. 3d. per cent, but, instead of the close control that had been characteristic of the past two years being maintained, the market discount rate slipped away yet further and showed an average of only £2 11s. for the year.

The consequence was that, in 1929, Government borrowing on Treasury bills was more costly to the taxpayer to the extent of $1\frac{1}{8}$ per cent, or nearly £8,000,000, than in 1928, whereas, in 1930, there was a saving to the Exchequer on this account of $2\frac{3}{4}$ per cent, or £19,000,000 over 1929 and £11,000,000 over 1928.

These fluctuating amounts of interest payable year by year on account of borrowing by means of Treasury bills do not directly affect the taxpayer; that is to say, no more is raised in taxation during a year when interest rates are high and no less when they are low, but the lower the rate of interest the more money becomes available for reduction of the National Debt, and *vice versa*.

Invaluable though the Treasury bills have been both to the Government and to the discount market, there can be no regret at seeing a smaller proportion of them in relation to commercial bills in the portfolios of the banks and the discount houses, in so far as the reappearance of commercial bills represents a growth of trade, and a study of a representative holding of the latter type of instrument does give a very enlightening picture of the channels through which the world's commodities are moving, quite apart from the fact that the bill is an ideal banking security. It is a fully negotiable instrument, differing from the cheque inasmuch as the latter may be merely transferable from its inception, whereas the bill can have its negotiability destroyed before maturity only by a restrictive endorsement.

The reason for this difference is no doubt that cheques, from the fact that they are payable on demand, rarely require negotiation, particularly in these days of the extreme extension of the principle of small banking accounts, whereas the bill, purely a commercial instrument, requires to be capable not merely of passing from hand to hand during the time it is in existence, but to be of such a nature that its easy transfer is encouraged. This is assured by its essential characteristic of negotiability, each successive holder, provided he satisfies himself that it is regular and free from any taint of forgery, is as unconcerned with the title to it of previous parties as he would be of the title of previous holders of the ten shilling note he receives in change from a shopkeeper. The more the bill is negotiated the better it becomes, since each endorsement improves the instrument, while the principle of recourse against prior parties ensures that in the event of the failure

of the acceptor, any loss must ultimately be borne by the drawer, the other original party to the contract out of which the bill arises.

London Still the World's Financial Centre.

London is not only the oldest financial centre upon which bills are drawn, but still, in spite of the grave financial difficulties arising from the War, the principal one. Our Bills of Exchange Act has been copied, with only slight modifications, by nearly every other country, so that the code governing bills is fairly consistent throughout the world. Foreign traders invariably seek credits in London in preference to approaching other financial centres, for it is easier and cheaper to obtain them here than elsewhere. Consequent upon the popularity of financing by means of the London bill, there has arisen the unique machinery of the London discount market, for in no foreign centre is there the occasion for a group of houses dealing exclusively in bills payable in that particular centre, and the lack of such a buffer between the Federal Reserve Bank and the member banks is a notable weakness of the American banking system.

In Paris, too, there are acceptance facilities available, and considerable efforts have been made to encourage their use, but with little success, for, lacking a discount market, the right to draw a bill is an empty honour.

It is a remarkable tribute to the steadiness of London's financial organization that foreign confidence in the London bill was not destroyed even during the time that exports of gold were interdicted save under a licence that was very sparingly granted. Now that our free gold market has been re-established, London's pre-eminence is again assured.

CHAPTER IV

ACCEPTING HOUSES AND THEIR CREDITS

THE part played by the accepting houses in financing international movements of commodities—Types of credits opened by them—The bills they accept and the documents of title relevant thereto

ONE of the most important features of the money market, and one that contributes so largely to the smoothness of its operation, is the system by means of which bills are drawn under acceptance credits, and it is one, too, which both simplifies and encourages the growth of foreign trade. Obviously when a foreign exporter dispatches goods to this country, it is of the greatest advantage to him to be able to get a cash payment for his consignments as soon as they leave his hands; it is equally important that the importer here before he need pay should be given credit for a time sufficient to enable him to deal with the goods he receives.

The Rise of the Accepting House.

If the exporter should draw a bill at ninety days' sight on the importer he might meet with considerable difficulty in negotiating his draft to a local bank, particularly should his customer be, as is frequently the case, a small man. Consequently, the granting of the credit to the buyer would fall upon the seller, who would be out of his money not only for the currency of the bill—three months—but also for the time taken by the draft in reaching the drawee and that occupied by the sending of a return remittance by the acceptor of the bill at its maturity.

One hundred years ago and more this difficulty was felt, and the small trading houses sought to overcome it by inducing the larger traders to allow bills to be drawn on them against goods shipped to their smaller brethren; the greater security their names offered enabled such drafts to be more easily negotiated by the drawers abroad. The commissions earned by thus lending their names proved so profitable that a number

of merchants not only specialized in this branch of business but first subordinated and finally relinquished their own trading in goods in favour of their acceptance business. A few houses even yet describe themselves as "merchant bankers," although the time when they were actual merchants themselves is earlier than living memory.

Emphasis is laid upon the importance of the growth of these accepting houses because their establishment ultimately brought to London an immense amount of valuable business that could not have been foreseen at their inception. Thanks to their high standing and to the readiness with which they granted credit facilities, they were rapidly approached to finance movements of goods between traders, neither of whom was established in Great Britain. In such cases as these the importers were under the necessity of sending remittances, usually in the shape of sight drafts on London or cable transfers on London, to reach the acceptors before the maturity of the bills. The joint stock banks were not slow to appreciate the value of this type of business, and they have undertaken for their own customers an appreciable share of it; indeed, the liability of the clearing banks in this respect amounted to £215 millions in the month of November, 1929.

War Difficulties.

How extremely considerable is the amount of the London acceptance business on account of merchandise that never touches our shores was demonstrated at the outbreak of the War. In the crisis that then arose acceptors felt it undesirable to renew credits, and, as a precaution, started to reduce their foreign commitments. In the extreme uncertainty of the moment foreigners found it very difficult, if not actually impossible, to obtain remittances to London; so much so, indeed, that at one time the New York exchange rose to the phenomenal figure of \$7 to £, and other exchanges similarly collapsed. So difficult was it for acceptors, as a consequence, to meet their maturities, that it became necessary to declare a general moratorium in London, the section of which relative

to bills empowered the acceptors to postpone their payments for a month with interest at 5 per cent added to the face value of the re-accepted instruments.

It was proof of the extent to which London held the world in fee, and the commissions so earned by the banks and accepting houses represent at all times a substantial proportion of our so-called "invisible exports," and pay for a large amount of the foodstuffs and raw materials which we receive from overseas.

But these commissions are very well earned since they are always charged at a low rate, while both the extent and the technicality of the work incidental to the granting of credits is considerable. The most usual rate of commission is only $\frac{1}{4}$ per cent upon the face value of each three months bill drawn under the terms of the credit, though it was reduced in 1928, particularly in the case of those granted on German account, to half this figure. This purely nominal charge by banks or accepting houses for the use of their names for three months—amounting to a mere £6 5s. od. on an amount of £5,000—has been felt to be inadequate to compensate for the work entailed, and the Chairman of Hambros Bank, in his speech to the shareholders at the General Meeting in May, 1929, suggested "that the opportunity was ripe for the accepting houses and bankers to come together to fix minimum acceptance commissions which had been cut too fine."

It is interesting to note that this gentleman, in the course of his speech, expressed the opinion that practically the whole of the pre-war acceptance business is now back in London, and that, thanks to international traders finding out that ours is the only stable money market, and our central banking system the best in the world, it will probably remain here.

The types of credit granted in London vary enormously, since they are adapted to meet every particular description of business that they may be required to finance, but the underlying principle is that the bank or accepting house granting the credit undertakes the financing of goods *in transitu* against the security of the documents of title relative to those goods, and the variety of forms taken by these documents necessitates

a great deal of care in ascertaining that due compliance with the terms of the credit has been observed. Two very favourite forms of credit sought by traders of good standing are those known as the Confirmed Banker's Credit and the Unconfirmed Banker's Credit. They are usually opened for a period of six months and frequently renewed again and again. In the case of the former the bank or accepting house issuing the credit at the request of an importer of goods definitely undertakes to accept—and having accepted, of course, to pay—all bills drawn in accordance with its terms. A credit of this description places the beneficiary in an exceptionally favourable position since any bank in his own centre will readily purchase his sterling bills on the most favourable terms after seeing that the bills conform with the terms of the letter of credit. Moreover, the shipper of the goods is virtually free from any liability upon his drafts. Technically, it is true, he is contingently liable as drawer to any holder in due course of the bills, but their dishonour is so exceedingly remote a possibility that his liability is really only a nominal one. The exporter who is to benefit by the issue of such a letter of credit naturally prefers it to be advised directly to him, since this gives him a freer opportunity of negotiating his drafts to whichever local bank will offer him the best rate, but the bank granting the credit will stipulate, as often as possible, that the letter of credit should not be sent direct to the beneficiary, but advised to him through its agent in the centre in which he resides. By this means, the Letter of Credit is retained by the agent, who will hope to negotiate the exporter's drafts, and to secure whatever profit there is to be made out of the rate of exchange. Even so, many bills do find their way into independent channels.

Each draft must be accompanied by a full set of shipping documents, but what comprises the full set varies according to the part of the world from which the goods are dispatched. The one document that is everywhere indispensable is the bill of lading, and it is of the utmost importance that this should be of the type specified in the letter of credit. If it should be stipulated—as is usually done—that the bill of

lading should be clean, the acceptance of any containing qualifications by the shipmaster of the phrase "received in good order" will render the negotiating bank liable for any loss that may be sustained by the importer unless, of course, the issuing bank is sufficiently foolish to accept the draft having so unsatisfactory a document attached, when the loss would be transferred to the acceptor.

This point was discussed in the case of *Hannevig's Bank v. National Bank of Egypt, Ltd.*, when the defendant bank accepted bills of exchange to which were attached bills of lading whose clean character was destroyed by the master's note that certain bags in the consignment showed signs of having been torn and subsequently re-sewn.

Again, a bill of lading which was the child of war conditions still persists, particularly in the Scandinavian trade—the "received for shipment" bill of lading—and this is frequently an embarrassing document. The bill of lading should state, without qualification, that the cargo has been shipped between certain ports by a specified vessel, but the uncertainty of transport during the War made this so impossible that shipping companies issued bills of lading that acknowledged receipt of the goods and undertook to dispatch them "by the next vessel sailing" or in some term similarly vague. Necessary as such stipulations then were, and harmless as they may be in the case of cargoes of timber or iron ore or commodities equally imperishable, as a general rule their use is to be deprecated, especially if the goods are a speculative market or of a character that may rapidly depreciate.

The bill of lading, though not a negotiable instrument, is transferable by endorsement if to "order or assignees," and, therefore, should either be endorsed in blank by the shipper of the goods or, preferably, specially endorsed to the bank issuing the letter of credit.

Next in importance to the bill of lading are the policies insuring the shipments against marine and fire risks, and here again the banker is often faced with a difficulty. When an exporter enters into a contract to supply goods over a period a

letter of credit will be opened to authorize his drawing against each individual shipment he consigns, and frequently a policy will be taken to cover the aggregate authorized by the letter of credit. Consequently application will be made to the insurance company for the issue of certificates to the effect that each consignment is covered by the general policy, and the certificate relative to each shipment will be attached to the bill of exchange.

These certificates vary enormously; some contain a copy of the policy and a perfectly unambiguous statement of the comprehension of the particular shipment in that policy, whilst others are vague enough to be of doubtful value.

The use of these certificates in place of taking out a separate policy for each shipment is an obvious convenience, but a banker will accept them in the case of a c.i.f. contract only after being furnished with an indemnity by the shipper.

In the case of *Diamond Alkali Export Corporation v. Bourgeois* (reported in the *Journal of the Institute of Bankers*, Vol. XLII) F. Bourgeois, of London, bought soda ash from the Diamond Alkali Export Corporation of New York. The terms of payment were cash against documents under confirmed banker's credit at London; price was c.i.f. Gothenburg. The buyers rejected the documents and succeeded on the grounds that (a) a proper bill of lading was not presented, (b) that a proper policy of insurance was not presented. The bill of lading was a "received for shipment" bill, running as follows: "Received in apparent good order and condition from D. A. Horan to be transported by the s.s. *Anglia* now lying in the port of Philadelphia and bound for Gothenburg, Sweden, with liability to call at any port or ports in or out of the customary route, or failing shipment by such steamer in and upon a following steamer, 280 bags dense soda."

The judge held that this document was not a bill of lading within the c.i.f. contract of sale. He reviewed the decision of the Privy Council that a "received for shipment bill of lading was a bill of lading within the meaning of Sect. 6 of the Admiralty Court Act, 1865," but he declined to extend this decision to a c.i.f. contract.

Turning to the other contention of the buyers that a proper policy of insurance was not tendered, the judge pointed out that "it seems plain that a mere written statement by the sellers that they hold the buyers covered by insurance in respect of a specified policy of insurance is not itself a policy of insurance within a c.i.f. contract. It seems plain also that neither a broker's cover note nor an ordinary certificate of insurance is an adequate agreement within such a contract."

The document tendered to the buyers in the present case was as follows—

"This is to certify that on the 8th November, 1920, this company insured under policy No. 2319 for D. A. Horan \$5,790 on 280 bags 58 per cent dense soda ash New York & London test valued at the sum insured shipped on board of the s.s. *Anglia* and/or other steamer or steamers at and from Philadelphia to Gothenburg. And it is hereby understood and agreed that in case of loss, such loss is payable to the order of the assured on surrender of this certificate. This certificate represents and takes the place of the policy and conveys all rights of the original policy-holder, etc."

Mr. Justice McCardie held that this was not equivalent to a policy of insurance, and that "a document of insurance is not a good tender in England under an ordinary c.i.f. contract unless it be an actual policy, and unless it falls within the provisions of the Marine Insurance Act, 1906, as to assignment and otherwise."

He added: "The difficulties indicated in this judgment can be easily, promptly, and effectively met by the insertion of appropriate clauses in c.i.f. contracts."

But the whole matter of insurance certificates had been succinctly expressed by the same judge in a previous case (*Mambré Saccharine Co., Ltd. v. Commercial Products Co., Ltd.*) when a letter stated that the vendors held the buyers covered by insurance under a policy of insurance in the vendor's possession. He said: "The essential feature of a c.i.f. contract as compared with an ordinary contract for the sale of goods rests in the fact that performance of the bargain is to be fulfilled by

delivery of documents and not by the actual physical delivery of goods by the vendor." He held that the letter was not tantamount to the tender of a policy of insurance, and that the vendors had not carried out the terms of the contract, and went further by saying: "Even if the defendants had tendered the policies actually held by them, I should still have held the tender bad, for they were policies which covered a quantity of goods outside those mentioned in the bills of lading."

In view of these judgments, particularly as in the former case quoted they were approved by the judges hearing subsequent actions, it is highly necessary for the drawees of bills either to insist upon a clean bill of lading and an insurance policy in respect of each shipment both of which documents should be in favour of the house granting the credit, or to act on the hint of the judge who tried the Diamond Alkali case by first having clauses to overcome the difficulty inserted in the c.i.f. contract.

In addition to the bill of lading and the insurance policy or certificate a certified invoice of the goods shipped must be attached; a freight receipt, should the bill of lading not state that the freight charges have been paid, and a consular certificate of origin where exemption from duty may be claimed in respect of goods produced in a particular country.

The *modus operandi* is for the shipper, after consigning his goods, to attach these documents to his draft and then to sell it to a local bank, when the amount of the drawing will be endorsed upon the letter of credit. The negotiating banker will have to satisfy himself that he is dealing with the beneficiary under the Letter of Credit and that the documents tendered purport to be those which the Letter of Credit stipulates.

After endorsing the bill, the negotiating bank may send it, with the documents still attached direct to the London house or agent, or may, as is frequently done with the cotton bills negotiated in New Orleans, send it for credit of its account with its agent in the principal financial centre in the country. In the latter case the recipient bank will dispatch it to London,

and the crediting here of the foreign bank's account with the value of the bill helps to provide cover for the bank's drawings on London on account of its own customers who have payments to make in this country. Naturally, each bank handling the bill expects to make its "turn" out of the business, and this is done, not by charging a rate of discount, but by quoting a "long" rate of exchange calculated from the basic rate for sight drafts by making allowance for the period to elapse before the bill's maturity, and in addition the charge for the British bill stamp appropriate to the bill and also a further deduction in respect of the banker's commission. Hence, for example, the "long rate" quoted by a New Orleans banker to his customer will be lower to the extent of his commission than that quoted the New Orleans Bank by the New York Bank.

A question frequently raised in connection with the calculation of a long rate from the sight rate is whether allowance should be made for the domestic as well as the foreign stamp duty.

It should not; when a bill is liable to the double duty—and, with the exception of the United States of America, this applies in most countries—the draft will either be stamped by the drawer before he negotiates it, or stamped on his behalf, and charged to him, by the negotiating bank, so that the rate of exchange is not affected, although it will be by the rate of stamp duty to be charged after arrival in the country of payment.

The bill and documents, having reached the London agent of the foreign bank, will be left with the drawee for examination and acceptance, and there will be a complete scrutiny of the documents before the bill is accepted, and, in the event of their not complying with the terms of the letter of credit, acceptance of the bill will either be refused or delayed until such time as the difficulty which has arisen may be overcome.

On acceptance the drawee will detach and retain the documents of title, returning the bill of exchange to the presenter, who, in the ordinary course of events will include it in a parcel

of similar acceptances, which he will discount to one of the firms of bill brokers. The position now is that the acceptor has made himself liable to pay the bill for the account of the importer, and holds the documents of title to the goods as his security for being put in funds to meet the bill by the merchant. The latter will most probably require the bill of lading before the date of maturity in order to get possession of the goods on the arrival in port of the vessel conveying them, and the practice is for the acceptor to hand over the documents of title to the importer, provided that he is of sufficient substance to warrant such a course, upon his signing a Letter of Hypothecation by which he undertakes to hold the goods or to earmark the proceeds of their sale for the extinction of the bill to which they have given rise.

The proceeding under the Unconfirmed Banker's Credit is precisely similar to the foregoing, the only difference between the two types of letters of credit being that in the case of the confirmed credit there is a definite undertaking on the part of the issuing house to accept all bills drawn under it, whereas this guarantee is entirely lacking in the other, while, moreover, the unconfirmed credit may be liable to cancellation. But it is extremely doubtful if the house granting an unconfirmed credit could legally dishonour a draft drawn under it before the notice of cancellation had reached the beneficiary. It would be unusual, to say the least, were such a thing to happen, and it has been maintained that there is an implied undertaking to accept on the part of the bank or accepting house opening such a credit. But the bills once negotiated, it makes little difference to the holder whether they have been drawn under a confirmed or an unconfirmed credit, and to the holder, after acceptance, none at all.

For financing the export of goods from this country one type of credit is used that enables the bills drawn to be discounted in London. This is known as the London acceptance credit. The drafts will be on the bank or accepting house opening the credit, and will have the documents of title attached to them before being left for acceptance. Here, again, the documents

will be retained when the drafts are accepted and the bills returned to the beneficiary, who may then, by discounting them in the market, realize the value of the goods he has shipped. In order to keep the shipments which furnish the security under his own surveillance, the acceptor of the bills will send the documents to his agent in the centre to which they have been dispatched, and he, in turn, will surrender them to the importer only when the latter furnishes him with a sterling draft on London, for the same amount as that of the bills accepted in London or, alternatively, when the importer signs a Letter of Hypothecation.

These three types of credits, confirmed, unconfirmed, and London acceptance credits, together with those varieties of them, such as revolving credits, are the principal ones creating a supply of bills for the London discount market, since such drafts are always those known as D/A bills, that is to say, bills from which the documents are detached by the drawees, the accepted bills being returned to the holders who are then in a position to turn them into cash.

But a great part of the business of an accepting house is in respect of bills that can never find a way into the market—the D/P or “Documents against Payment” bills that arise from so-called documentary credits.

Some houses, indeed, prefer not to regard these as credits in the strict sense of the word, since they do not themselves accept the bills, but describe them as mere agreements on the part of their customers.

The essential difference between the documentary credit and those already treated is that the house opening a documentary credit does not have to honour the bills drawn under it; they are almost invariably drawn by the exporter upon the importer. If one of this type is opened for the purpose of financing an import of goods into this country the procedure is as follows: The importer will approach an accepting house here to open a documentary credit in favour of the exporter, and this credit will be advised to the accepting house's agent in the exporter's centre, authorizing him to negotiate the

exporter's drafts upon the importer. This credit is in no sense a mandate, for it leaves the negotiation or refusal of the drafts at the absolute discretion of the foreign agent, trusting to the local knowledge of the latter to protect the principal from entering into a transaction of an undesirable character or upon inadequate security.

The agent, if agreeable to undertake the business, will make an advance against the drafts completed with the documents of title and, as a further precaution, will usually have the consignments hypothecated to him. The drafts and documents will then be forwarded to the accepting house which has opened the credit, and this house will obtain the importer's acceptance of the bills, but without surrender of the documents. These will be given up only on the due payment of the bills, and as it is usually desirable for the importer to obtain possession of them before the maturity of his acceptances he is always granted the privilege of taking these up under rebate, that is to say, he pays the accepting house the face value of the bills less discount for the unexpired period of their tenour at a rate of discount of $\frac{1}{2}$ per cent above the clearing banks' published rate for deposits.

The documentary credit operates equally well in financing the movements of goods out of this country as well as the movements of those in, and a vast amount of our trade is facilitated by this method.

The foregoing description of the use of commercial credits shows that, provided that adequate care is taken in their issue and scrupulous attention is paid to the documents of title, little risk is run, and an accepting house may safely lend its name to a large aggregate of bills. Indeed, since the commissions are charged at so low a rate, and the work entailed by each transaction so heavy, it must be done upon a vast scale to be profitable. However, the very fact that there are goods that may be realized in time of need to guarantee funds in the hands of the acceptor to meet their bills does in itself put a large temptation in the way of such houses to over-trade and to keep their affairs on a sound basis a very careful selection

must always be made of the business offered to them. This especially applies when the goods do not touch this country, and more than ever when their shipment is due less to a legitimate demand for them than to the temptation to place them on a market when artificial conditions have temporarily caused an unhealthy wave of high prices.

A sudden collapse of such a market may easily lead to failure on the part of the weaker importers with consequent loss to the accepting houses involved. Their credit in London is never improved by such an instance of mismanagement on their part, though their financial detriment may be small.

The greatest deterrent to overtrading on the part of the accepting houses is that the nature of the business they are undertaking cannot be concealed by them; their bills come on to the market and so advertise their commitments, with the result that when dealers find an undue proportion of the acceptances of any particular house appearing in the parcels of bills they take, they will immediately place a limit to the quantity of such paper that they are prepared to hold.

The acceptance business undertaken by the banks and the houses whose *raison d'être* it is is the very pivot around which the London discount market revolves, and their system of credits has brought an incalculable amount of prosperity to London.

Necessarily, the organization inaugurated over a century ago and steadily expanded since has been copied in all financial centres abroad, but, in spite of tremendous bids made in recent years, particularly by New York, to capture this business from us, the credit granted in London is still by far the most popular.

The cheapness of the commission and the ease with which such credits are obtained have much to do with this, but much more is due to conditions of the money market peculiar to London.

First, the London bill gives the foreign holder the right to gold whenever he should choose to withdraw it. This does not arise merely because no embargo is placed here upon the export

of bullion, for the same may be said in all normal times of many other financial centres, but chiefly because the machinery of our discount market enables the holders of bills at any moment to turn them into cash at most favourable rates. Owing to the comparative lack of bills on other centres, there is nowhere else a system of discount houses to act as intermediaries between the banks and the sellers of bills, so that the latter are much more favourably placed for obtaining cash, which may be converted into gold at will, when the bills of which they wish to dispose, are payable in London. Finally, the whole of the London money market is so effectively controlled by the Bank of England that there is little fear of violent fluctuations in rates caused by the ebullience or depression of the spirits of any section of it.

The traditions of the market also count for much, for it is common knowledge that its steadiness and careful management have prevented for a generation past the serious embarrassment of any great accepting house, whilst the last failure of one occurred over half a century ago.

CHAPTER V

THE BUSINESS OF THE DISCOUNT HOUSES

THEIR relation to the sellers of bills and to the banks—Influences affecting the market rate of discount—The Hellings case

As demonstrated in a previous chapter, the discount houses borrow to enable them to carry the bills which, under any other system than our own, would be found in the portfolios of the banks themselves.

The Practice of Foreign Banks.

Abroad, banks supply themselves with cash by realizing some of their stock of bills, and this brings them into direct touch with their respective central institutions. The London clearing banks, on the other hand, make it a practice never to rediscount any of their holdings, but instead to call in loans from the discount houses whenever it is necessary for them to make provision to meet calls of a substantial character. Consequently it is the bill brokers who, in time of need, withdraw money from the Bank of England to satisfy the necessities of the banks.

The advantage of our system over that obtaining in other centres is that thus a useful buffer is provided between the Bank of England and the other banks; it effectively prevents, for example, the appearance in London of a state of affairs similar to those observed in New York when considerable embarrassment was caused to the financial world by the action of the banks in obtaining heavy credit from the Federal Reserve Bank in order to take advantage of the extravagant interest rates that the Wall Street dealers were willing to pay for loans during a period of soaring prices. Whatever may be the defects of our system, it does prevent inflation for the advantage of a comparatively small section of the community to the country's general detriment.

The Advantage of Intermediaries.

But the system of intermediaries between the banks and the Bank of England, and also between the banks and the sellers of bills, is occasioned not so much for reasons of the general benefit of the market as for the greater fluidity so attained.

From the international character of the London market, it is more sensitive than any other to sudden and heavy demands for cash, and in the long run it pays the clearing banks much better to sacrifice a turn in favour of the discount houses in order to be in a position to satisfy their immediate needs by calls from the latter. As it is, a bill broker generally replaces his calls by new borrowings from other banks, though sometimes by the sale of short bills, and this process normally occupies the greater part of his working day. Were the banks obliged to sell bills to their contemporaries to provide their cash, not only would a considerable delay ensue, but there would be much more frequent recourse to the Bank of England, with all the disadvantages resulting from the ever-widening ripples this would cast over the pool of the country's finance. In such circumstances the banks would feel it necessary to keep a much higher proportion of idle cash than they do at present, the loss of interest upon which would be considerable; with money at $4\frac{1}{2}$ per cent, for example, they would have to be able to invest in bills to nine times the extent of the addition to their cash holding to be in the same position, as regards profit, as they at present enjoy on this part of their business.

The Discount Houses.

The discount houses, as their name of bill brokers implies, are merely intermediaries, for, in effect, they lend to the sellers of bills for periods of three, four, or six months, the money they have borrowed from the banks on the undertaking to repay it whenever they may be asked to do so. They are not many in number. They comprise three powerful public companies, the combined paid-up capital and reserve of which amounts to £6,215,000, and some twenty private firms whose

annual turnover in bills amounts to a very huge total, for they, like the accepting houses, work upon a narrow margin. From the fact that they not merely turn over bills, but also hold large portfolios, it follows that they must possess a considerable working capital in order to justify the borrowings necessary to their requirements. These borrowings fall under several headings. In the first place they invite deposits from both private customers and the public at rates a trifling degree more favourable to the lender than those offered by the clearing banks. Their rule is not invariable, but they generally offer for seven-day deposits $\frac{1}{4}$ per cent over the clearing banks' rate for a similar term, and for those repayable at call the same rate as the banks pay for seven-day notice money. Except when a fall in bank rate is expected the discount houses will generally be prepared to offer higher rates for deposits for longer periods—broadly speaking, the longer the period the higher the rate.

These deposits may be made—and frequently are made—against a simple deposit receipt issued by the borrowing house, although it is more customary for the lender, at any rate, in the case of a deposit made by a business house for a considerable time, to demand security, and short-dated Government bonds, of which the discount houses are at all times holders, usually furnish this. The banks themselves, in times past, were accustomed also to deposit money with the discount houses, but this has, of recent years, largely fallen into disuse.

The Source of Funds and Bills.

The sheet anchor of the bill broker's business, on the borrowing side, is to be found in his regular loans from the clearing banks both from day to day and for periods of a week. The extreme value of this type of money to the bill broker is apparent when it is realized that, in the course of a normal year, its lowest level is at least two-thirds of its highest; in other words, the bulk of it may be regarded as a permanent and unvarying loan.

For the supply of his bills the discount broker again turns

to various sources. He has, in the first place, his private customers, whose accounts are, very naturally, jealously guarded. Some of these private accounts supply him with trade bills, which he is obliged to lock away, but by far the most valuable and sedulously cultivated of this source of supply are the merchants who draw bills under London acceptance credits. When the drawers are big people who frequently have large lines of their bills to place in the market, they take care to be in touch with several firms of discount houses, each of which will be asked to submit a quotation. Normally, there will not be much variation in the different rates submitted, the competition for this class of business being very keen, but by having several outlets for his bills a seller may frequently place larger quantities by splitting his parcel between the different houses than he might otherwise find easy of disposal. But from time to time he certainly does find the human satisfaction to be derived from a hard bargain. He may use the quotation given by one house as a basis, and offer his bills to another at a fractionally lower quotation. Such an offer would probably be accepted if the second house should happen to be a hungry buyer at the moment, or had his quotations resulted in his being passed over on several preceding occasions.

Foreign Customers.

Discount houses also have much business offered to them by customers abroad, some of whom will merely remit their drafts for the bill broker to deal with at the current market rate, whilst others will cable for rates and haggle as successfully as the sellers who are on the spot. The proceeds of this foreign business are usually paid to an agent in London of the seller of the bills, and, in accordance with the instructions from the principal, the agent will either employ them here or apply them to the purchase of a currency draft.

Discounting Banks.

But by far the major portion of the commercial bills handled by the discount houses are those offered for sale in

London by those banks known either as endorsing, exchange, or discounting banks. This quite numerous class comprises English institutions whose chief centres of activity are abroad and the London offices of both colonial and foreign banks. The class of business conducted by all of these in London is essentially different from that of the clearing, the provincial, or Scottish banks.

True, they all make loans to the discount market, but such loans are comparatively small, and they never compete for current and deposit accounts here. The unvarying ebb and flow of their business is, however, the constant payment of drawings by their foreign branches on account of customers abroad with payments to make in London, and the covering of such payments by the sale of the bills remitted to them by their offices overseas. These are the bills which have been drawn under the confirmed and unconfirmed banker's credits, described in the previous chapter, and most of the parcels offered consist of the finest paper available to the market.

The Running Broker.

Some of the endorsing banks sell direct to the discount houses, though in many cases, and particularly when very heavy totals are being liquidated, they requisition the services of a *running broker*. This individual is one who specializes in the turnover of bills; to this end he keeps in close touch with all the discount houses in the market, and so is particularly well placed to assess every movement in the discount rate.

The endorsing bank will put into his hands an order to sell bills to a given amount at a maximum rate, which will be fixed after consulting his opinion. He will approach the biggest houses first, and if he can fulfil their requirements at a satisfactory price, bargaining as to rate on the part of the other firms is mere futility on their part. Having once made a market, the seller will not break his rate, and the running broker's comment, "I can work at that figure," negatives all further argument. The bill broker may either refuse the business altogether or state the amount he is willing to buy.

Treasury bills complete the bill broker's portfolio, and the method of their issue has already been described. They are, like the bills turned out by the endorsing banks, a fruitful field of profit to the running broker, who busily engages himself, as soon as the results of the weekly tenders are published, in finding which firms may happen to prove short of the following week's bills and which over-provided.

Fixing the Rate.

The question at once arises as to what should determine the rates quoted by the discount houses to the sellers of bills, and this calls for the consideration of a whole variety of factors. The upward limit that could be quoted is bank rate; anything above this would merely send sellers to the Bank of England, and persistence on the part of the market in quoting such a figure would result in the hands of the authorities being forced to raise the bank's official minimum. This is a state of affairs of extremely rare occurrence, and in the ordinary course of things the market rate will attain its highest level when a sixteenth per cent below bank rate, and when this figure is maintained for longer than a very few days in order to relieve an important exchange near to gold export point there will be considerable discussion in the market upon the prospects of a rise in bank rate.

At the other end of the scale the limit is set to the discount broker by the price he has to pay for his money, and the standard rate charged by the clearing banks for their loans to the bill market being 1 per cent below bank rate, a sixteenth above the money rate would be the lowest possible quotation, except when an immediate reduction in the bank rate is a foregone conclusion. So, apart from the occasions when any movement in bank rate is likely, approximately $\frac{3}{4}$ per cent expresses the extreme range possible to the market bill rate. The point at which it will stand between the two extremes is determined, first and foremost, by contraction or expansion of the loanable credit available to the market, and secondly by diminished or increased supplies of bills. The former is

however, by far the more potent influence, for money movements cause waves when bill movements cause ripples, and bill rates react almost immediately to money influences. It is often bad policy for a discount broker to refuse loans offered when money is easy, the lender naturally showing more consideration in times of monetary shortage to the firms that borrow from him on the occasions when he finds difficulty in lending. But, in order to absorb this additional money, the discount broker must buy more bills, and the increased demand will consequently lower the rate. At the risk of giving offence, however, money thus offered must frequently be refused; easy conditions are usually of very temporary duration, and when they give place to those of stringency the broker who has over-bought will be forced to liquidate some of his holding in the new conditions, and will count himself fortunate if he be able to do this without loss.

A demand for bills on the part of the brokers has a similar effect on rates as the offering of fresh loans. The sellers, unless they wish to reduce their books, will immediately come into competition for bills to absorb this new money with a consequent weakening of quotations. But it is to be observed in this connection that the depression, although noticeable is less pronounced when the demand is upon Continental account. The Continental banks do not buy Treasury bills, but they will usually await their allotment and the settlement of the market rate in accordance with this figure before bidding for commercial bills at a figure fractionally below the market price. Should the demand be prolonged, it will be able to dominate the market rate and affect the price of issue of the following week's Treasury bills, but their practice of holding their hands until the rate of allotment is known certainly enables the market to get these on more favourable terms, and the continental banks obtain their bills at a better figure than would otherwise be the case.

The Continental demand is invariably for full-dated three month bills. This is a sharp contrast with the practice of the clearing banks, which only buy bills having so long a currency

from the market in order to fulfil orders given them by their customers. But as a sort of half-way house between their short loans and the purchase of full-dated bills from customers (and the treasuries for which they tender) they are at nearly all times heavy purchasers of bills which have only a month or six weeks left before maturity, and here the discount broker finds his opportunity. With certain notable exceptions, it is the rule for dealings in the shorter bills to be at a rate lower than that obtaining for those which have three months to run; therefore, so far as it is politic for him to do so, the discount broker will sell his short bills and re-invest in long. When he sells a bill having six weeks left to run at a rate an eighth per cent lower than that at which he purchases a three months bill he considers that he has "written up" the rate for the latter by a sixteenth per cent, and since he hopes to make a similar turnover on his new bill when that in turn has run down, business of this character has a considerable effect upon his annual profit. At the same time this policy must be tempered with caution, the general desideratum of the discount broker being to keep the dates of his maturities well spread, so that he may not be badly hit by any unexpected combination of events which may upset monetary conditions.

The most successful broker is he who is best able to appreciate the factors affecting the market and who is, moreover, not merely competent to assess their force, but sufficiently far-seeing or fortunate enough correctly to estimate the time at which their influence will be exerted. But to be able to follow this counsel of perfection is rarely granted, and, lacking omniscience, the best thing to do is to steer a middle course between optimism and pessimism.

The Effect of Bank Rate.

The factor having the most lasting effect on the market is an alteration in the Bank of England's rate. Generally speaking, a movement of this character, being based on internal trade and currency conditions coupled with the position of our stock of gold and the tendency of the principal foreign

exchange rates, should be foreseen without much difficulty. It is not suggested that the week in which the movement takes place can be accurately forecast, but it does not require very considerable astuteness—in the absence of the intervention of quite unforeseen circumstances, that is—to be within a week, one side or the other, of the movement. Consequently when a broker takes the view that the bank rate is shortly to be raised, he will back his opinion by retaining his short bills and avoiding, so far as possible, the purchase of long ones, in order to be in a position to re-invest his maturities at as early a moment as it may be possible to do so at the higher market rate imposed by the action of the Bank of England.

If the maturity of his bills is long delayed after the rise he will then, by having to pay a rate for his money higher than that at which he bought the bills, incur a loss in respect of them.

Precisely the reverse applies, of course, in the event of a lowering of the bank rate, although then, if the general view of the market inclines to a probable fall—and there is usually greater unanimity here, as a fall is in practice more accurately forecast than a rise—the competition for long bills will enable sellers to hold out for better terms until, in anticipation, the market bill rate will approximate to the figure at which it might reasonably be expected to stand after the change in the bank rate has taken place.

It does happen, however, that from time to time the market is caught unawares. For weeks previous to the raising of the bank rate in 1929 from $4\frac{1}{2}$ per cent to $5\frac{1}{2}$ per cent the discount brokers had been anticipating no change whilst a steady drain of gold from the bank had indicated the desirability of an advance in order to stem the outflow. They were lulled into a sense of false security from which they were rudely awakened by unexpected movements of bullion to New York, heavy enough to bring the total stock of gold at the Bank below the total adopted as the minimum required for the safety of the financial structure of the country, with the inevitable result, which was painful to themselves.

But, apart from movements in the bank rate, the policy of buying or selling bills is governed by many other considerations having a direct bearing both on the rates at which bills may be obtainable and those the brokers will have to pay for their money. Important amongst these factors is the condition of the internal trade of the country. When this is active, funds will be withdrawn from London to support the demands of traders in the provinces, and such a shortage is most usually pronounced when a general revival succeeds a period of depression. Bill and money rates will both advance, and the trade revival will bring about the creation of an increased supply of bills.

But it must be borne in mind that this will eventuate at a somewhat later date; the money will first be required to finance the manufacturers during the time they are producing their goods, while the advantage of drawing under credits will only be enjoyed when the commodities are ready for dispatch. If the industrial activity be sufficiently prolonged the bills offered for discount in London will become excessive in proportion to the floating credits there available, with the inevitable result of advancing rates, and this in the past has frequently called forth bitter complaints from traders that activity in their business has been frequently paralysed by an advance in bank rate.

Foreign Trade a Factor.

Foreign trade is another important consideration, and a knowledge of its broader tendencies is most helpful in explaining movements in the foreign exchange rates. Political and more general economic conditions abroad must, of course, be coupled with the trade factor in estimating fluctuations in the exchanges, but, more often than not, this is the deciding factor. The discount broker should be able, for the successful prosecution of his business, to anticipate the more general fluctuations rather than be obliged to study the daily table of exchange rates as a sort of hand-to-mouth guide.

Seasonal Fluctuations.

Temporary periods of both stringency and ease occur periodically when the Government is collecting money from taxation or disbursing it in dividends ; the former phases are prolonged, while the effect of the latter very quickly passes away, but neither is without reflection in the market's quotations. The last month of the year again is peculiar owing to the fact that all the banks take a considerable sum away from the market on the last day to provide an abnormally large cash showing in their annual balance sheets. In addition to their fixing loans to the end of the year they are heavy buyers of bills that mature at this juncture, so that at the end of September the rate for the late December maturity is a very low one. The demand for these dates is very keen, for the members of the market are willing to face additional competition on the part of the banks when they tender for Treasury bills that fall due at the end of the year, in the knowledge that what running profit they are sacrificing they will more than recover on the re-sale of these bills before their maturity to the banks. Consequently there is a considerable difference between the rates for bills that fall due on the last few days of the year and for those maturing in early January ; the banks ignore the latter, and, whilst money is cheap in December until the last week, loans carried over the end of the year are correspondingly expensive, and brokers must then have considerable recourse to the Bank of England for accommodation.

The Influence of Treasury Bills.

There are also considerable variations in the value of day-to-day loans—and these again are reflected in the bill rate—owing to the incidence of the payment for Treasury bills, and this often has to answer for conditions which at first sight are inexplicable.

The issue of, say, forty-five millions of Treasury bills in a given week against a like amount maturing would suggest no disturbance to monetary conditions during that week, but it very frequently happens that on the Monday there are no

treasuries falling due (owing to the corresponding date three months earlier having been a Sunday). Money has to be found to take up new ones, and it by no means follows that the maturities on any given day are equivalent to the payments to be made in respect of the fresh issue. Hence at close sight constant ripples are observed to be passing over what at a more distant view appears to be a placid surface, and there are at all times a constant adjustment and re-adjustment of rates to comply with the rapidly changing conditions from moment to moment.

The Task of Repaying Loans.

It is the daily duty of the discount broker to square his book, and to do this he pays a visit each morning to all the banks with which he has loans falling due, and in addition, to those who may be lenders of new money or either purchasers or sellers of bills.

The banks extract their preliminary figures quite early in the day, and it has become an unwritten rule for all demands for the repayment of their loans to be notified to the bill brokers by mid-day, so that, by that time, they should know the task that awaits them. These loans are in multiples of £25,000, although there are a few instances of small banks making loans of lesser sums. It is quite a normal state of affairs for the members of a discount house to spend the afternoon in borrowing a very substantial total of new money, and at a time when this is difficult of attainment their efforts will be intense to gather in the bulk of their requirements before it is too late for them to apply to the Bank of England, which will not accept bills for discount after two o'clock nor grant loans more than half an hour later. On account of this form of financing being most expensive, recourse to the Bank is taken only when all other sources of supply have proved to be dried up, so that it is essential for the broker to be within measurable distance of his requirements before he allows this emergency door to be shut in his face. What is a measurable distance depends, of course, upon the conditions

of the particular occasion, for there are days when it is less easy to find £100,000 of fresh money than it would be to borrow half a million at other times.

When money is in very short supply there is always speculation as to whether money has been drawn from the central institution, and when it has been the fact is always published in the financial articles of the newspapers on the following morning.

Except at the end of the calendar half-years, when such applications are invariable, it is remarkable to note how very infrequently the Bank of England is approached by the market for assistance, a tribute to the general avoidance of overtrading and to the general conservatism of the outlook of its members.

The loans granted to the discount houses are secured by the bills bought with this borrowed money. Since the loans are in multiples of £25,000, parcels of bills will be similarly made up, the total of each parcel exceeding the loan it secures by an amount at least equivalent to that of the discount on the bills constituting the parcel.

The Banks' Watch on Bills Offered.

When a call of money is made, relative security will be removed against the bill broker's cheque from the bank making the call, the security so becoming available for deposit with other banks which may grant fresh loans. Parcels are also continually being exchanged in order to release from security bills that have been re-discounted, so that there is a constant flowing of the bills held by the market between the various banks. This is of great advantage to the banks; all the bills lodged with them are naturally scrutinized, and the constant interchanging of parcels on the part of all the discount houses enables the banks to keep closely in touch at all times with the nature of the bills finding their way to London for discount, and what is of greater importance, gives them an accurate idea of the extent of the commitments of the various accepting houses. If one of these should be considered to be

incurring liabilities on bills to an excessive degree, a bank will not hesitate to call the attention of the members of the discount market to the fact that too great a proportion of such acceptances is to be found in their securities, and to request their removal.

If such a case should arise, the discount broker will, in turn, be obliged to limit his holding of such a name, and the consequent difficulty in placing the bills will act as a powerful check upon the accepting house in question. It is rarely that this circumstance is encountered—the consequences to an accepting house would be too damaging to its credit—but, at the same time, there is a tendency on the part of some to extend their liability to the extreme lengths that prudence will allow.

The Broker's Guarantee.

Discount brokers do not, as a general rule, make themselves parties by endorsement to the bills they purchase; therefore, when the banks buy from the brokers, they do so under a letter of guarantee in which the broker undertakes to take up any of such bills which may be dishonoured, and to assume the general liability of an endorser. The purpose of this is to safeguard the bank in the extreme circumstances of legal action having to be taken. The broker is a transferor by delivery, and as such would be merely liable to the bank for breach of warranty, but the letter of guarantee facilitates the proof of consideration given by the bank, and further ensures the recovery of the full extent of the liquidated damages to which the bank would be entitled did the bill bear the broker's endorsement.

Certain banks have insisted upon the extension of the broker's guarantee to the bills lodged as security, but with what object is not altogether clear. Whilst a broker is financially sound, the bills he lodges with a bank as security are exchanged for others of like value at their maturity and presented for payment, not by the lending bank, but by the broker himself. The only conceivable occasion on which the bank would have

to collect the bills would be when he had to exercise his right of banker's lien and to realize the security; in other words, on the failure of the broker. When the latter is insolvent any guarantee he may have given would appear to be of doubtful value.

Legal Relation of Banker to Discount Broker.

The exact relationship existing between a banker and a discount broker in respect to the security lodged was never legally raised until the case of *Lloyds Bank, Ltd., v. Swiss Bankverein* was heard by the Courts after the failure of Edward Hellings & Co., a firm of bill brokers, in 1911.

This is so important a judgment affecting the title to securities that the report of the case published by the Institute of Bankers is here quoted.

LLOYDS BANK, LTD., v. SWISS BANKVEREIN

UNION OF LONDON AND SMITHS BANK, LTD., v. SAME

This was an appeal from the judgment of Mr. Justice Hamilton giving judgment for the defendants. The claim was for the return of about £35,000 worth of fully negotiable securities or their value, and raised points of great importance as to the legal relations of bankers and bill brokers in ordinary bill-broking transactions. The case is specially noteworthy for the startling doctrine propounded by the plaintiffs of trusts affecting fully negotiable securities.

The facts as summarized by Hamilton, J., and adopted by the Court of Appeal were as follows—

On 15th September, 1911, there fell due for payment by Edward Hellings & Co., a firm of bill brokers in the City of London, to the plaintiff banks two large sums of short money lent against securities; and on the morning of that day Hellings gave to the two banks cheques for the amounts due—cheques which were subsequently dishonoured—and received back from the banks the securities which had been deposited to secure the loans when they were first made. Later in the same day the defendant bank received from Hellings on two separate occasions, but on each occasion with the assent of Hellings, certain of these securities which that firm had received in the morning from the plaintiffs—namely, at 2 o'clock securities of the nominal value of £22,000,

or thereabouts, and at 3 p.m. securities of the nominal value of about £15,000. The whole of the documents in question in the action were negotiable instruments, and most of them were Indian railway bearer bonds, guaranteed by the Secretary of State for India. The question was: Were the plaintiffs or the defendants entitled to those securities?

There could be no real doubt but that on 15th September, 1911, Hellings had been insolvent for some time, and that the senior partner with whom the case was concerned was tolerably well aware of the fact.

On the morning of 15th September, the plaintiff banks' loans had to be repaid. What was usually done was for the borrower in such a case to deliver his cheque to the lender, take away the securities that had been deposited, and deal with them in the course of the day. Hellings did this on that occasion, that was to say, he took away securities from the two banks in exchange for two cheques. Somewhere about the middle of the day, somehow, someone gave the signal, and Helling's business came to the ground. Various people who had lent money on call to Hellings wanted it back, and thereupon Hellings, senior, thought it was time to consult his solicitor, and it was understood that as the result of that interview he was told that if the margins held by him—which had been obtained from the defendants on the entirely false statement by Hellings that they were required to be deposited with the National Telephone Company, from whom money was to have been borrowed on the joint account—were asked for they were to be given up.

His Lordship could well believe that Hellings, senior, had the idea that if these margins were asked for and were not given up some one might say he was dishonest, and that even if the margins were found in his possession aspersions might be thrown upon his character. Accordingly, Hellings saw Mr. Rueff, of the defendant bank, and the result was that another official of the bank, Mr. Glencross, went to Helling's office to get back these margins. Mr. Glencross thereupon went to Helling's office about 2 o'clock, and was given securities of the value of £20,200.

The defendants had other money out with Hellings. That same morning they had called a short loan for £15,000, and had given out securities to Hellings against their cheque. In point of fact, exactly the same procedure had been gone through with them as had been gone through about the same time with the plaintiff banks. Mr. Glencross was told to go again to Helling's office and get back those securities, taking back Helling's cheque for £15,000.

Hellings, who appeared to be desirous to make restitution in

the matter of the margins, boggled at the idea of returning £15,000 additional securities, which were not margins, but in the end securities of that amount were given up to the defendants' official. The plaintiffs said all these securities were theirs—theirs in the sense that they were still holders of them for value, as they had been in the morning of that day.

The plaintiffs said there was a practice of bankers which either had the effect of a custom, or to which the law attached the significance of a trust, under which Hellings, being still in possession of the securities, and his cheques not having been met, held the securities as custodians for the plaintiffs, no doubt with an authority to negotiate them for value, which authority, however, had not been exercised. As against a *bona fide* holder for value, the plaintiffs conceded that their rights must go, but they said the practice they set up was universal, and its meaning notorious to the defendants, who had themselves acted upon it that day, and must, therefore, have had knowledge of the infirmity of Hellings's title to the securities.

The question, therefore, arose upon the assumption that the practice relied upon by the plaintiffs might be proved. Did the defendants take the securities in question for value and without notice? As to the margins taken back by the defendants at 2 o'clock, his Lordship thought the defendants were holders for value, but the case was otherwise with regard to the £15,000 securities obtained by the defendants at 3 o'clock. As regards both bundles of securities he was further of opinion that the defendants took with notice, not indeed, that they had actual knowledge of any infirmity in Hellings's title, but they had such notice as would put them on inquiry, and would have led to actual knowledge. He did not, however, wish to be understood to be reflecting upon the defendants' conduct in any way; they were endeavouring to get possession of security, a thing not improper in itself, in circumstances which would make them take the risk of litigation afterwards if their action were impugned.

The learned judge then dealt with the question whether the securities were impressed with a trust in the hands of the broker so that there was a right to follow the fruits of the trust property.

He came to the conclusion that that was not the necessary or natural conclusion to put upon the transaction, emphasizing the point that it was not a light matter to burden negotiable instruments with a trust. He also commented on the cheque being a negotiable security and conditional payment, the giving of which, if plaintiffs' theory prevailed, was entirely otiose. He held that, apart from any question of holder for value without notice, as soon as the plaintiffs parted with the securities they ceased to be

able to make any claim to them in this action and gave judgment for the defendants.

The plaintiffs appealed. The Court of Appeal dismissed the appeal.

In giving judgment, the Lord Chief Justice said that he had read the judgment prepared by Lord Justice Farwell, and concurred therein. With regard to the case of *Burra v. Ricardo* (1 Cab. and Ellis, 478) he had no doubt, so far as the actual judgment was concerned, that it proceeded on the fact that the securities had got back into the possession of the original lender before any question arose. But he desired to say that, unless there was something in the Stock Exchange rules when that case was decided which would impose a stereotyped duty, he did not agree with the judgment of Mr. Justice Matthew.

Lord Justice Farwell in a written judgment said that the short-question on this appeal was whether in short money dealings, the delivery of negotiable instruments by a banker to a bill broker in exchange for his cheque was a delivery out-and-out or was a delivery upon trust. It was not and could not be contended that the delivery was to the bill broker as a mere fiduciary agent for the bank to deal with negotiable securities for or on behalf of the bank; it was clear that the securities were delivered to the broker as his property, to be used by him in his own business or otherwise for his own purpose as he thought fit. But it was said by the appellants that the securities were impressed with a trust binding the bill broker and all persons claiming through him, other than purchasers for value without notice, to restore the securities to the bank at or before closing hours on the day of their delivery, unless the broker's cheque had been otherwise provided for. It was not suggested that such a trust had ever been expressed in words or heard of as such, but it was said that its existence was so essential to the business efficacy of the transaction that the Court must infer it.

The question arose out of short money dealings of somewhat recent origin. There were now large quantities of first-class negotiable securities created for so short a period of existence as not to be quoted on the Stock Exchange, which were peculiarly appropriate for use in raising loans for a very short time—and money was now raised for a few hours as well as for a few days only to a very large extent. He would take one case only—night money—because it was the shortest period and the one taken by counsel for the plaintiffs as most favourable for his argument. The course of dealing was this. The Bank of England issued and offered for sale a million (say) of debentures to bearer of an Indian railway company, guaranteed by the Secretary of State

for India, and a bill broker desired to take up (say) £50,000 of this issue. The bank would not issue them on credit or on a cheque, but required a banker's draft or cash.

The bill broker had neither cash nor a balance to his credit at any bank of more than a few hundreds, but he was known as a man of good standing and honour. He obtained, on the strength of the credit of his character, from some bank the necessary draft, which he took to the Bank of England, and obtained from them the securities that he desired to buy, and then took them on to his own bank and left them until the next morning. He then came, on the opening of his bank, and obtained the securities in exchange for his own cheque on that bank for a sum equal to that paid to the Bank of England on the previous day. It was known to both parties that his balance was quite insufficient to meet the cheque then, but the arrangement was that he had until 4 p.m. to pay in cash to meet it. He was at liberty to deal with the securities as owner as he thought fit. It was admitted that he might sell or exchange or charge them, not only for business purposes, but to pay his own private debts, but it was said that if he had not met his cheque by 4 p.m. and the securities were in his hands or in the hands of anyone other than a purchaser for value without notice, these negotiable instruments were impressed with a trust in favour of the bankers.

The bank's claim was first put on custom, but this was abandoned. There was no evidence either of a general custom which had now become part of the law merchant and therefore of the common law, or of any custom of a particular trade; but it was said that all the banks who dealt with bill brokers relied on them as all bill brokers knew, to return the securities or equivalent if their cheques were not met by 4 p.m. In his opinion, the evidence, to be of any use to the plaintiffs, must establish a custom of the trade. If there were such a custom, all persons in the trade knew of it and contracted with reference to it. But if it were only the present ordinary practice of a number of individual firms, this established nothing but the practice of each firm, and had no bearing on the question whether contracting parties in any particular contract had or had not adopted the same practice. It was either a custom of the trade or nothing. These securities were negotiable and passed by delivery, and it appeared to him impossible to imply such a trust, and still more to affect any honest taker (and there was no question of dishonesty here) of such a document with constructive notice of some implied trust.

It had been held in this Court that the equitable doctrine of constructive notice had no application to commercial transactions. In the *Manchester Trust v. Furness*, 1895 (2 Q.B., at

p. 545), Lord Justice Lindley said: "What is wanted in this case is to say that by reason of the reference to the charter party the holder of the bill of lading and the person who takes it in the ordinary course of business are to be treated as having notice of all the contents of the charter party. There is no doctrine that goes to anything like that extent; and as regards the extension of the equitable doctrines of constructive notice to commercial transactions, the Courts have always set their faces resolutely against it. The equitable doctrines of constructive notice are common enough in dealing with land and estates, with which the Court is familiar; but there have been repeated protests against the introduction into commercial transactions of anything like an extension of those doctrines, and the protest is founded on perfect, good sense. In dealing with estates in land title is everything, and it can be leisurely investigated; in commercial transactions possession is everything, and there is no time to investigate title; and if we were to extend the doctrine of constructive notice to commercial transactions we should be doing infinite mischief and paralysing the trade of the country."

That was the case of a charter party containing an unusual clause, and it was contended that the holder of the bill of lading, who, of course, knew of the charter party, had constructive notice of all its contents. In *Curtice v. the London City and Midland Bank*, 1908 (1 K.B. 293), the same result was arrived at in the case of countermanding a cheque. It would be a far stronger thing to imply the existence and notice of a trust affecting negotiable instruments. If Mr. Justice Matthew, in *Burra v. Ricardo (supra)*, meant to find that there was a custom of the Stock Exchange, then that decision had nothing to do with this case; but if he did not, he was unable to agree with his decision which involved the creation of a novel equity and the application of the doctrine of constructive notice to Stock Exchange dealings. But in his opinion the appellants entirely failed to prove the existence of any trust at all.

The transaction was a plain sale or a release of securities, and payment by cheque was accepted in discharge. There was an implied contract that payment of the cheque was not to be demanded before 4 p.m., and that it would then be met by providing cash during the day, but there was no contract as to the manner in which such cash was to be provided; it might be in any way that the broker thought fit, including borrowing the money to meet it from the bank itself, on the security of other securities, or of the actual securities delivered to the broker in the morning, if still in his possession.

The whole dealing in short money by bankers and bill brokers

rested on credit. It had its inception in credit, and arose out of the refusal of the Bank of England to give credit without security. The credit was short, and the banks only gave it to men whom they knew and believed that they could trust. The evidence was to his mind clear, and showed that this was an ordinary business transaction on credit; the bankers gave up their securities and took the broker's cheque, and the risk was theirs on the broker's cheque. The appellants' argument really was founded on a play upon words. They said: "The banker trusted the broker with the securities without getting the money for them; therefore the securities are impressed with a trust." One might as well say that a wholesale dealer who trusted the retail dealer with goods on a month's credit trusted the latter with the goods, and that such goods were therefore impressed with a trust.

To trust a man with goods by delivering them on credit was not to create a trust affecting the goods so delivered. The appellants' contention in fact, although not in terms, set up a vendor's lien on negotiable securities; a Common Law Lien was out of the question, and equity, therefore, was vouched. A vendor's lien was treated in the books as either an equity independent of contract, or as a tacit agreement enforceable only in equity; and the argument of the appellants here was that on which a vendor's lien on real estate was founded, namely, that a person who had gotten the estate of another ought not in conscience as between them to be allowed to keep it and not to pay the full consideration; and a third person who had notice (express or constructive) could not keep the estate without paying the price, for it attached to him also as a matter of conscience and duty—*Mackrell v. Symmons* (15 Vesey, 340).

The application of this equity had hitherto been confined to real estate, and they were now asked to apply it to negotiable instruments used in mercantile and financial transactions in the City of London. So to apply it would be (to use Sir George Jessel's phrase) "Equity gone mad." The very idea of impressing negotiable instruments with a vendor's lien or implied trust was utterly repugnant to their nature.

Mr. Justice Hamilton, at pages 306 and 307 of the report of this case in *Commercial Cases*, says this: "I am loth to hold that a negotiable instrument which is already attended with perils enough is impressed with a trust of this kind unless it is necessary, and I cannot see the necessity. I am quite clear that in a small market if this practice were established, where everybody must know the practice and everybody must appreciate that everybody else is acting on the practice, the risk of someone else being affected, I might almost say infected, with notice of the

infirmity of the borrower's title would be most seriously increased, because although he is safe enough as long as he merely takes the security and asks no questions, a very small amount of information tending to show that the borrower—the bill broker—was not going to pay in a new loan to meet the old cheque would be notice that he was dealing with the security in contravention of his trust, and would, therefore, affect the second lender with a risk of notice although the actual dealings with the instrument might be entirely regular." The Lord Justice entirely agreed.

So far from the *Moorcock case* (14 P.D. 64) being an authority in the appellants' favour, if it was an authority at all, it was against them, for nothing could be more inconsistent with the business efficacy of mercantile and financial dealings in the city than the application thereto of equitable doctrines of implied trust and constructive notice, admirable although such doctrines might be when applied to real estate and the deliberate dealings therewith in conveyancers' chambers.

It was, therefore, unnecessary to consider the details of the manner in which the Swiss Bank became possessed of these negotiable securities. They got them honestly, and that was enough. Nor was it necessary to consider the details of Mr. Justice Hamilton's judgment as to "purchaser for value" and "notice." He expressed no opinion thereon and must not be taken to assent or dissent. Both appeals failed and should be dismissed with costs.

The President said he had read the judgment and concurred in it.

Appeal dismissed.

Note. This case is particularly valuable as disposing of three fallacies or heresies.

1. The contention that a negotiable instrument such as a bearer bond can be clogged with a trust.

As Farwell, L. J., says, "The very idea of impressing negotiable instruments with a vendor's lien or implied trust is utterly repugnant to their nature."

The negation of this doctrine does not, of course, affect the principle that when the negotiable instrument has been obtained by fraud from, or is parted with in fraud of, the true owner, no one but a holder for value without notice can make a good title thereto. Fraud was not alleged against the brokers; at most breach of contract. The judge in the Court below held that the defendants gave value for one parcel of the securities, but not for the other; with regard to both he held that the defendants had notice, not actual knowledge of any infirmity in the broker's title, but such notice as would put them on inquiry, and would

have led to actual knowledge. But, both in his view, and that of the Court of Appeal, this was immaterial; there was no trust and the defendants took the securities honestly, and were entitled to keep them.

2. The contention that though no such trust had ever been expressed in words or heard of as such, its existence was so essential to the business efficacy of the transaction that the Court must infer it.

This is a form of the often invoked, now discouraged, theory of the Moorcock case to which the Court of Appeal refer with the words: "If it is an authority at all."

As here, that case has been frequently adduced as justifying the introduction into a contractual relation of incidents not embodied therein or annexed thereto by any recognized legal principle, on the plea that without such incidents the contract is of no commercial efficacy and that the parties must have had such incidents in their contemplation. The usual judicial answer nowadays is that it is not the function of the Court to make a contract for the parties or import terms which the parties themselves could have embodied had they wanted to.

3. The attempted extension of the equitable doctrine of constructive notice to dealings with negotiable instruments.

Quoting Lindley, L.J., Farwell, L.J., says: "As regards the extension of the equitable doctrine of constructive notice to commercial transactions, the Courts have always set their faces resolutely against it If we were to extend the doctrine of constructive notice to commercial transactions we should be doing infinite mischief and paralysing the trade of the country."

In the highest possible degree this is true with regard to negotiable instruments. What, with regard to bills, notes, and cheques, constitutes notice debarring the taker from the position of a holder in due course has been amply and finally defined by the Bills of Exchange Act and judgments of the House of Lords. It would be fatal to countenance any variation of, or tampering with, the tests thereby established and universally recognized.

(Legal Decisions affecting Bankers, Vol. III.)

CHAPTER VI

THE BANK OF ENGLAND'S CONTROL OF THE MARKET

ITS relation to the other banks, to the Stock Exchange, to the accepting houses, and to the bill market—Bank rate and the effect of gold movements—Its control of discount rates—Its relation to the Treasury—Its influence over the price level

EVERY financial centre must be subject to a greater or less degree of control on the part of its central bank which is ultimately responsible for, first, a stock of gold adequate to the internal needs of the country both as regards currency and the basis for the credit structure necessary for trade and commerce, and secondly, for ensuring that the gold reserve is also adequate to prevent external depreciation as exemplified by adverse exchanges.

The Importance of a Gold Reserve.

It may seem primitive that there should be any necessity for the maintaining, in the interests of credit, a backing of a mere commodity such as gold bullion. But man himself is primitive in his passions from time to time, as shown by the outbreak of wars and revolutions, and at such periods the refinement of credit must give way to the crudity of a concrete form of value. The fact remains, therefore, that gold is still the only universal medium of exchange, and the experiences first of Russia, and afterwards of Austria, and then Germany have proved the disastrous character of a policy of creating credits manifestly impossible of exchange into the gold value that they nominally represent.

{In the case of a centre whose financial ramifications are international, the central bank has the added duty of taking scrupulous care that each section of its intricate money market is confining its activities to business that in no circumstances would be likely to cause disturbance to the smooth working of the financial machine with damaging consequences to the whole system.}

What is an Adequate Reserve ?

Admitting the necessity of a bullion reserve, the question arises as to the amount that may be deemed a sufficient one. Here at once are seen the advantages to a country of a full gold standard, such as that enjoyed here before the War interrupted its harmony, for its working is almost entirely automatic. As regards internal currency, notes were printed to the value of the gold held by the Bank of England—plus, of course, its almost negligible statutory fiduciary issue—and their total increased or diminished as gold flowed into or out of the bank's coffers.

So far as the ebb and flow were merely due to circumstances of internal circulation, it meant that the currency was adjusting and re-adjusting itself proportionately to the commodities marketed and, hence, the circulating medium had no influence upon the price level of the country, but was its servant.

When gold from abroad reached the Bank of England in considerable quantities credit was multiplied by approximately ten times the value of this addition to the reserve, the currency expanded to the extent of the gold, and if commodities did not increase pro rata, prices would tend to advance whilst money rates were lowered. The higher price level would tend to check foreign purchases of English goods, and the exchanges would consequently re-act against us. Normally this latter process would be hastened by the action of the Bank of England in lowering its rate, thus checking the continental investment demand for London bills.

When gold flowed out of the country the reverse process applied; English exports were fostered, credit became dearer, and the price level tended to fall. As a result there was never any question as to what total of gold should be held, it varied according to the needs of the occasion, and when circumstances suggested the desirability of an addition, such addition could be attracted here by the simple act of raising the bank rate, whilst lowering it would cure a temporary redundancy.

The Gold Bullion Standard.

Now, however, this country is on a gold bullion standard, and although the term is quite generally considered to be synonymous with that of a gold standard, there is a very distinct difference between the two, and that difference is particularly marked at a time when there is a tendency for gold to leave the country in quantities that are likely to jeopardize the backing for the internal currency. For the essence of a gold bullion standard is that gold should always be obtainable for purposes of export, but that it should not circulate internally, in other words, that the currency system should be subject to a certain degree of management, necessitating a large fiduciary issue against which a stock of gold must be held having a minimum, arbitrarily fixed, sufficient to guarantee the country against a further degree of currency inflation.

The "Cunliffe Committee" of August, 1918, after a most searching examination of all the features then apparent, recommended the return to a free gold market at as early a date as compatible with the successful maintenance by the Bank of England of a store of gold of not less than £150,000,000. These circumstances were reviewed before the passing of the Gold Standard Act of 1925, and it was still considered that this figure was the smallest that could be held with safety to form the foundation of the country's system of credit and currency.

In the face of considerable difficulties, which are undoubtedly temporary in spite of their long continuance, opinions have been freely expressed in favour of an abrogation of the adopted minimum of the gold reserve. This entirely mischievous suggestion has been so widespread that it led to the writing to *The Times* of the following letter by the President of the Association of British Chambers of Commerce on the 9th April, 1929—

Sir,

There is at present some ill-advised criticism regarding the return of this country to the gold standard and regarding the Bank of England system. Some critics ask for an inquiry into

our currency system. They seem to have in view the hope of an opportunity for tampering with the work of the Bank of England, and for altering the recently extended limit of the Bank of England's fiduciary issue, subject though it is to permissible variation under the Currency and Bank Notes Act, 1928.

Business men have confidence in the policy and methods of the Bank of England. Our confidence has been strengthened, if that were possible, by the apparent failure of the Federal Reserve Bank system of the United States to function successfully for the purpose for which it was primarily constructed. The Bank of England's system has many advantages over the Federal Reserve system of the United States. No system can be perfect in its working, but the great strength of the Bank of England's system is that it is independent of politics, and it cannot be said that this is the case in the United States. Any fresh inquiry into our currency system would create doubt and uncertainty, and do more harm than good.

As to our return to the gold standard, I am convinced that, on the whole, Britain's return to the gold standard at the earliest favourable moment was the right course to pursue. We cannot be successful as a trading nation without a stable currency, and it should be, as it has been in the past, linked to gold. The return to the gold standard in 1925, notwithstanding temporary inherent difficulties, has been profoundly beneficial to our credit, and consequently to our international trade, and eventually, therefore, will be beneficial to employment. The difficulties were due not so much to the return to the gold standard as to the failure to make the necessary adjustments in wage rates and salaries, especially in sheltered occupations. With such adjustments the cost of living would have been reduced and equilibrium restored. Let me quote the following extracts from the Balfour Report published last month—

We consider that in principle the resumption of the gold standard was unquestionably necessary and ultimately beneficial . . . and it is unthinkable that any appreciable body of opinion would favour a fresh departure from the gold standard. The foregoing view is fully shared by those members of the committee who had been disposed to doubt whether the actual return to the gold standard was not too precipitate.

The Report then goes on to say that postponing the restoration and slightly reducing the gold content of the sovereign would have prolonged the period of uncertainty, and, at the same time, would have dealt a severe blow to our financial prestige. There may have been differences of opinion as to the best date for

returning to the gold standard, but there would have been criticism of any date adopted. It was certainly desirable to make the change as early as possible.

I hope that the public will, in the interests of British industry and employment, brush aside as mischievous and uncalled for the attacks which are from time to time made upon the policy identified with the Bank of England.

I am, Sir,

Your obedient servant,

(Signed) G. A. MITCHELL,

*President of the Association of British
Chambers of Commerce,
14 Queen Anne's Gate,
Westminster, S.W.1.*

9th April.

One not only feels that the extract from the Balfour Report is right in saying that "it is unthinkable that any appreciable body of opinion would favour a fresh departure from the gold standard"; it is also unthinkable that the Bank of England authorities would have been so feeble as to adopt the line of least resistance to the force of circumstances, which, though highly embarrassing, were neither impenetrable nor permanent.

The Bank of England's first duty of control, then, is to maintain this minimum stock of gold unimpaired—except when it may be allowed to fall slightly below this figure as a purely temporary expedient—until such time as the general conditions of the country shall have changed to the extent of rendering a smaller reserve sufficient. This time can arrive only when there has been so substantial a fall in commodity prices, coupled with a corresponding reduction in the cost-of-living figures, that a reduced total of circulating medium is required for the country's requirements provided, of course, that the policy is still pursued of keeping the country on a Gold Bullion Standard, and making no attempt to substitute a full Gold Standard for it. There can be no hope for a considerable permanent fall in the general price of commodities until the Government is able to compass a large permanent

reduction of the floating debt out of the proceeds of taxation or by funding it into a loan subscribed by personal savings and not by the artifice of creating further bank credits.

Gold for New York.

After the passing of the Gold Standard Act of 1925 the Bank of England's stock of gold showed a considerable margin of safety until the latter part of 1928 was reached. Indeed, during the first eight months of that year there was an addition of £20 millions to the Bank's holding. The normal autumn drain from New York unfortunately coincided with a boom in Wall Street that called for ever-increasing loans from the New York banks to finance the stock markets.

The rate for loans—which is always subject to the most rapid fluctuations in New York—rarely dropped below 9 per cent and frequently approached 20 per cent, so that it became immediately profitable for the American banks not only to withdraw their sterling balances from London, but also to borrow money here in order to re-lend it at the much higher rates obtainable in their own centre. The same inducement caused the French banks to convert sterling into dollars, and the New York Exchange steadily moved against Great Britain. Gold began to flow away from London; that available in the open market was bought on American account, and regular withdrawals were made from the Bank of England. The margin of safety dissolved, and when a sudden and somewhat unexpectedly heavy shipment was made in February, 1929, bringing the Bank's stock below the agreed minimum, action was immediately taken by raising the bank rate from its then rather penal figure of $4\frac{1}{2}$ per cent to $5\frac{1}{2}$ per cent.

Building Up the Reserve.

The leeway was slowly but steadily made up, not, unfortunately, by the attraction to London of foreign banking gold by the high interest rates prevalent here, but out of the new production of the Rand mines, and to secure this in the open market, the Bank of England had consistently to pay a figure

higher than its statutory buying price. So necessary to the Bank of England was the accumulation of bullion that it has, on one occasion at least, paid a price for it only one-eighth of a penny per oz. below its own legal selling price. This laborious re-building of the reserve was nearly demolished in the space of three days; approximately eight millions of this hardly accumulated gold going to Germany in this time (25th, 26th, and 27th June, 1929). The United States had granted Germany a dollar credit for an amount rather over ten millions sterling, and much of it was transferred via London, a striking instance of the international character of our market and its sensitiveness to foreign influences.

Regulating the Stock of Gold.

The necessity for so careful a regulation of its stock of gold caused the Bank of England to exercise its control in a fashion that led to conditions of artificiality in the country, and especially in the discount market. In a normal state of affairs the import of twenty millions of gold that reached our shores during the first three-quarters of the year 1928 would have led to a multiplication of credit to, roughly, ten times that amount, and during the last four months of that year there would have been a contraction of some £200,000,000. The effect on the price level due to these violent credit fluctuations would have been too damaging to be contemplated with equanimity. The trade of the country was slowly emerging from the deepest trough of depression experienced for a long period of years, and it was imperative that everything possible should be done to encourage this recovery. To this end an attempt was made to keep the price level at a steady figure and, to avoid dislocations due to shipments of bullion, gold movements had their effect upon credit promptly neutralized by the Bank of England. Each addition to its stock was countered by the selling to the discount market of treasury bills of an amount equivalent to the newly acquired gold, so taking funds away from the market before it could become the basis of fresh credit. Exports were countered by the

purchase of treasury bills, the money so released being in substitution of the metal withdrawn.

The natural re-action upon the market of an import of gold is a weakening of bill rates, that of a withdrawal, their stiffening, but here there was neither the increase nor diminution of funds to bring about these results. At a time when gold is leaving the Bank in considerable quantity, it is most desirable for bill rates to be well maintained, since it is the market rate rather than bank rate that influences the exchanges. The natural corrective being removed—and it has frequently been difficult to maintain rates at such a time, in consequence of ease in money—the Bank of England has had to take steps to ensure that its own rate should remain effective.

The first step taken has been to notify members of the market that the discount rate should not be allowed to fall below a stated figure, and the discount houses have loyally responded.

But, with the best will in the world, they have not always been able to resist the continental competition. When they have refused to quote below the specified rate what has happened has been that they have merely missed the business offered to them, the holders finding ready buyers at a lower figure among the continental banks. In these circumstances the action taken by the central authorities has been to offer treasury bills for sale at the rate they wish to rule in the market. This is doubly effective; in the first place no one will buy bills at a lower rate than that at which he may help himself at the Bank of England; secondly, the money paid for such purchases is not paid out again, so that the market suffers a reduction in loanable credits simultaneously with an increase in bills and equilibrium is again restored.

On the other hand, there have been occasions when the market rate, through a shortage of money, has been so close to the Bank's official minimum that there has been a danger of the bank rate's being forced up. When this happens, the Bank of England will afford relief to the members of the market by buying bills from them at a rate rather lower than that they

are quoting, so increasing the money available and reducing the total of bills held by the market. These purchases are usually of commercial bills, and to ensure that this assistance shall not be given to undeserving quarters in these open market purchases, the Bank is even more exacting with regard to the names it will take than it is on the occasions when bills are presented to it for discount at the official minimum.

(Bank bills, when financing a branch of industry which the Bank authorities consider to be over-assisted, have been rejected; and the paper of certain acceptors, who, although perfectly undoubted, have been granting credits with a remarkable degree of freedom, has also been refused.

Control of this sort is extremely necessary to keep the market in a healthy condition, for the discount broker who ignores these very plain hints given by the Bank is undoubtedly riding for a fall.

It must be emphasized that the Bank of England only intervenes to regulate the market rate of discount at times when it considers it desirable for Bank Rate to be thoroughly effective, for it has no compunction in seeing bill rates slip away to a full 1 per cent below Bank Rate if its own position is not jeopardized by their so doing. This may be well illustrated by reference to the events of the year 1930. The New York boom came to an end during the latter part of 1929. It had for eighteen months proved a source of anxious pre-occupation to London and the continental money markets by causing the transfer of a vast sum of credit to take advantage of the higher interest rates there prevailing, and consequently there had been a steady flow of gold westward across the Atlantic. At the time of its collapse, Bank Rate in London was $6\frac{1}{2}$ per cent. The suddenly changed conditions in New York not only stopped the transfer of balances to America, but caused their return to London and the Continent. Monetary conditions in London accordingly became easy, and bill rates declined.

The Bank of England adapted its policy to meet the change in circumstances and made no attempt to keep its rate

effective, despite the fact that it had previously pursued the bold—and wise—policy of allowing its gold stock to shrink to £130,000,000 before raising its rate to $6\frac{1}{2}$ per cent. The menace to its holding of bullion being removed and new supplies arriving from Australia, it reduced its rate before the recommended minimum of £150,000,000 had been attained. Three successive reductions had brought Bank Rate to 5 per cent by the beginning of 1930, and that rate was as ineffective as the $6\frac{1}{2}$ per cent rate had been a month or two earlier.

Further falls occurred, until, by 1st May, 1930, Bank Rate reached 3 per cent. At the time it almost looked as though the Bank of England, instead of being the leader of a well-disciplined army, was being dragged along at the tail of a disorderly rout.

Actually, this was far from being the case. Although apparently following the line of least resistance, the Bank authorities were showing courage and taking a long view in lowering the rate before its stock of gold had been rebuilt.

During the previous year the shortage of credit in London had rather obscured the importance of the world-wide decline in trade and the steady dropping of wholesale commodity prices. When it was possible to see things in their true perspective, it was appreciated that there was a redundancy of credit. There was ample to finance a substantial trade revival, although one did not come during the year. True, the Bank did not obtain gold from the open market and lost, moreover, considerable quantities to France, but these withdrawals were more than counterbalanced by receipts from Australia and the gold stock crept up to £160,000,000.

The Bank Rate of 3 per cent was consistently ineffective, the bill rate in the market being as low as $2\frac{1}{8}$ per cent to $2\frac{1}{2}$ per cent, but the authorities evidently felt that they could afford not only to lose a substantial amount of gold—perhaps £10,000,000—but could suspend their control by allowing such exports to play their full part in reducing credit. In such circumstances, Bank Rate would again be effective, or could be made so by applying past methods of control. Moreover,

the advantage of abandoning the policy of neutralizing gold movements, when it is possible to do so, is apparent in the response of the foreign exchanges to the bullion shipments. That response, if not entirely lacking, is almost negligible when the influence of such shipments is nullified.

How Crises are Avoided.

The clear duty of the Bank of England is to avoid the possibility of a financial crisis and at all times to ensure that, should one arise through circumstances beyond the limits of its control, the damaging influence of such crisis should be as strictly circumscribed as possible.

The very mention of the word "crisis" suggests scare-mongering, but that one so rarely occurs in London is chiefly due to the fact that the Bank of England takes care that the financial ship is not laden beyond the safety level, no matter how clear the weather may be at the moment. It must always be remembered that whenever it does occur, a crisis arises suddenly; when troubles can be seen approaching an adequate guard can be set against them, and the embarrassment, although it may be severe, does not approach the dreaded state of affairs understood by the term "crisis."

Financial stress is best avoided by the prevention of over-trading on the part of any of the constituents of the money market, and the Bank lays as heavy a hand as possible on any attempt to do business beyond the limits imposed by ordinary prudence.

When the Bank Intervenes.

The affairs of the clearing banks are conducted in accordance with their own traditions of sound management and conservatism, and active intervention on the part of the Bank of England may well be considered unnecessary where they are concerned. But there is, of course, a close liaison between them and the central authority, while apart from that they are subject to its controlling influence whenever it makes any change in bank rate.

During the post-war boom this was raised on account of the clearing banks, not so much, perhaps, to check their activities, as to enable them to co-operate more effectively with the Bank of England for the purpose of reducing the inflation which had been growing to an alarming extent during the early part of that phase. The banks agreed to reduce their advances drastically, and only to grant new ones after they had been satisfied that these were not sought for purposes of speculation in goods. This check, undertaken at the request of the Bank of England, to the unhealthy tendency in commodity markets, coupled with the raising of the bank rate to 7 per cent, enabled the effective imposition of a maximum issue of currency notes which were both the effect and index of inflation.

Apart from this instance, the action of the banks never has had to be compelled by the Bank of England—if, indeed, this occasion can be said to have been one of force.

Only once for many years past, has the Bank of England had to intervene on account of the Stock Exchange. In the ordinary way a boom there soon burns itself out, and the sufferers during the period of adjustment are usually the individual speculators; the incurable optimists amongst the members of the public rather than the members of the "House."

Overtrading by the latter is kept in hand by the clearing banks from whom they borrow money, and their system of control is usually effective. But on one occasion in July, 1923, the Stock Exchange situation was threatening owing to jobbers being caught short of stocks and prices rose alarmingly. The Bank of England promptly countered this by raising its rate from 3 per cent to 4 per cent.

The Control of the Discount Market.

The discount market, however, comes more directly under the eye of the controller, since its members have from time to time to go direct to the Bank for assistance. Each half-year, when the other banks are calling in for balance-sheet purposes,

the whole of the market must of necessity borrow from the Bank of England quite apart from other adventitious occasions. If a discount broker overtrades he will have, in the first instance, to bid up for money in the market, and by so doing, display, to some extent, the weakness of his position. If, even by paying more than the market rate, he is unable to obtain all he requires he will have to make up the deficiency at the Bank of England, a proceeding sufficiently unprofitable to induce him to liquidate his redundant bills as soon as possible. The half-yearly situation, however, puts the whole of the market into the hands of the Bank, and the latter grasps the opportunity for ensuring that the general condition of the market is healthy. It does this by rationing the amount of the loans it will grant for its minimum period of a week; if a broker requires more than this ration he must borrow the addition for eight, nine, or even ten days, thus increasing the loss he sustains by his borrowing from the Bank. When bank rate is $5\frac{1}{2}$ per cent, the rate charged for loans to the bill broker at the central institution will be 6 per cent; assuming the rate for three-months bank bills to be $5\frac{1}{4}$ per cent, the bill broker will lose $\frac{3}{4}$ per cent per annum on his purchases during a ninth of their currency, or 1s. 8d. per cent for the whole period they have to run. In other words, he would be in the same position as though he had kept a portfolio of bills smaller to the extent of his ten day borrowing at the Bank, and bought that amount of bills at the date on which he repaid the loan, at a discount rate of £5 3s. 4d. per cent or, roughly, $5\frac{1}{8}\frac{1}{4}$ per cent.

The greater the margin between the market rate of discount and bank rate, the more severe will be the "writing down" of bills through borrowing from the Bank. If, for example, bills were bought at $2\frac{1}{4}$ per cent a loan for ten days at $3\frac{1}{2}$ per cent would write them down to $2\frac{1}{8}$ per cent.

If the broker will persist in the policy of carrying too heavy a stock of bills his margin of profit will be appreciably lower than he would make on a more modest holding, and each time he found himself forced into the Bank his profit would be yet further bitten into. But more important still, the broker who

consistently finds it difficult to borrow all the money for his requirements is damaging his own credit with the lending banks by being so persistent a borrower at high interest rates.

It is not, of course, in his own interest that the Bank tries to protect him from himself, although he does gain that advantage from the Bank's action, but because a discount house so conducted would inevitably fail in the early days of a crisis, and its failure in such circumstances would most probably have serious results to those with whom it had business relations and to the rest of the market.

Through its careful selection of the bills it will buy and also receive as security the Bank of England also exercises a certain loose degree of control over the accepting houses; as it is by no means to their interest or to the improvement of their credit to have their paper refused, it is incumbent upon them to restrict the scope of their business to the financing of sound trade within prudent limits.

The Bank of England and the Treasury.

Now that the Treasury is a permanent borrower in the market, its relation to the Bank is also important, especially as at times the two different interests, *prima facie*, would appear to clash. For the sake of budgetary economy, a low bank rate, and, consequently, low interest rates are greatly to be desired from the point of view of the Government, and at a period when discount rates made the placing of treasury bills rather an onerous duty, the Treasury tried to solve the difficulty by applying to the Bank of England for "Ways and Means Advances" in place of borrowing all it required by means of bills.

The immediate result of these heavy overdrafts on the part of the Government was to create fresh credit, and so bring about a lowering of both interest and discount rates. The ultimate result was an increased inflation which raised commodity prices, and was unbeneficial to the country at large. Representations were made to the Treasury by the Bank of England, and the strength of the Bank was proved by what might have

developed into a sort of "pull devil, pull baker" contest, resolving itself into the acquiescence by the Treasury to the views of the Bank, and the reaching of an agreement whereby Ways and Means advances should be strictly limited to the occasions on which they were sought in pre-war days, viz., to tide the Treasury over a few days when expenditure temporarily anticipated revenue. Since the occasion of this incident, which emphasizes the value of the central bank's not being a State bank, there has been not only complete harmony between the two, but a close liaison between the Treasury and the Bank of England.

When Bank Rate is Raised.

The most powerful weapon in the hands of the Bank to compel its complete control, not only over the market, but also over the whole of the country's financial system, is that of bank rate. The chief reasons for raising it are always connected with maintaining a sufficient stock of gold. If this is being depleted the higher interest rates, consequent upon the advance in bank rate, bring with them higher discount rates, and these always tend to turn the foreign exchanges in our favour. The foreign exporter who draws a bill on London will get less of his own currency for it in the new set of conditions obtaining and this results in a reduction of our imports and a correspondingly smaller strain on the exchanges arising out of trade requirements. It also tends to prevent the movement of liquid capital from London to foreign financial centres, but this, to be effective, means that the new rates here must be as high, if not higher, than those ruling abroad. If ours be higher the exchanges will further be encouraged to move in our favour as a result of foreign investment in London bills and the transfer here of foreign balances for lending in London.

But the mischief of a high bank rate is to be found in its penal effect upon trade. As already mentioned, it tends to reduce our imports and, unless credit is allowed to be reduced proportionately to our loss of gold, prices will not be lowered sufficiently to encourage foreign buying of our commodities,

so that trade is affected both ways, advances to traders being dearer without the compensation of an increased demand for their commodities. "In such circumstances the task of the Bank of England is a most difficult one; it must keep its rate sufficiently high to prevent undue depletion of its stock of gold, and yet cannot raise it to a point sufficiently high to attract gold from abroad without adding materially to the burdens of the country. A rise would increase the interest charges of the Government in respect of Treasury bills, and correspondingly reduce the amount of money in the sinking fund applicable to the reduction of the national debt; it would also add to the expense of replacing maturing issues of short-dated Government bonds. The stock markets would be accordingly depressed, and trade would suffer both on this account and by reason of the higher rates it would have to pay for its accommodation.

On the other hand, it does not necessarily follow that a low Bank Rate is a panacea for the ills of either the discount market or of the country at large. During the greater part of the year 1920 the Bank Rate was the low one—as judged by modern standards—of 3 per cent. Short term credit being plentiful, there was every assistance for trade available in London on cheap terms, but a world-wide slump in commodity prices caused sufficient stagnation to render negligible the demand for accommodation. The international forces that were depressing the price level were more potent than the Bank of England, which accordingly abandoned the control it had exercised by its neutralization of gold shipments. The consequence of the plethora of credit and of the absence of capital issues on trade account was the encouragement of an intense demand for bills in a market insufficiently supplied with them. The bill rate fell away to the merest fraction above that for money, and the Bank Rate was entirely ineffective. It was suggested that the market was beyond the control of the Bank of England. It would be more truthful, perhaps, to say that the Bank had temporarily ceased to control the market because such supervision was superfluous;

the brake must obviously be applied whilst going down a hill, when the opposite slope is being climbed its release is essential.

{ One cannot help being impressed by the masterly handling by the Bank of England of the extremely difficult circumstances that have arisen from time to time during its long history, and never more so than during the War period when the force of new elements for which there was no precedent, had to be encountered, and during the post-war years, particularly in those since the resumption of a free gold market in London. These have brought with them all the old problems, often in an intensified form, arising from our having in London the most important bullion market of the world and, in addition, the pre-occupations occasioned by the weakness inherent in a system of a gold bullion, instead of a full gold, standard.

CHAPTER VII

PRE-WAR AND POST-WAR CONDITIONS UP TO 1925

THE period of inflation and artificial conditions—The Bank of England's diminished control during that time—The disappearance of the bank bill and its gradual re-appearance—The position of the foreign exchanges during this period

THE recent history of the London market covers four periods divided from each other by events which have drawn extremely marked lines of cleavage.

Before 1914.

The first period was that which had existed from the time of the passing of the Baring crisis of 1891 until the outbreak of the Great War; a time the general tranquility of which was somewhat ruffled by the disturbance caused by the South African War, and still later, by the swift repercussion felt here of the American crisis of 1907, but otherwise it was one of quietude and entire normality. There was, however, during these years one matter of considerable economic importance, namely, the increasing price level due to the development of the gold mines of the Rand.

It was a steady movement, so unhurried as to be hardly noticeable except over a considerable period, but to the regular expansion of the world's stock of gold is attributable, more than to anything else, its diminishing purchasing power during the twenty years that preceded the World War.

Exerting so gradual an influence over prices, the money markets of the world were undisturbed on this account; in London, the expansion of credit and bank deposits kept pace with the slowly changing conditions, and the foreign exchanges followed their normal courses.

It was a time when the bank rate was usually low; it stood at only 2 per cent throughout 1895, while the average annual rate of £3 19s. 3d. per cent in 1900, the first year of the South

African War, was the highest registered between 1882 and 1906. In the latter year exports of gold to the extent of six millions to Egypt and fourteen millions to New York caused an average rate of £4 5s. 4d., while in the year following, one of great banking panic in America, our rate had at one time to be raised to 7 per cent in consequence of heavy movements of bullion to New York, and for the year an average of £4 18s. 6d. was shown.

But, these two occasions of comparatively high bank rates apart, the usual tendency was towards cheap money and lethargy of trade and markets during the summer months, to be followed by an enhanced bank rate in the autumn and winter seasons of activity due chiefly to increased imports of cotton from America and Egypt, wool from Australia, and grain from various parts of the world. Commodity gold, that is, the new production of the mines, came in steadily throughout the year, but as a banking operation, bullion left this country in the autumn and winter as the result of the unfavourable state of the exchanges brought about by trade conditions at those seasons. The money market accordingly proceeded at a very even pace, and the hand of the Bank of England rested very lightly on the reins.

When War Came.

With the outbreak of War came immediate disorganization on account of the feeling of uncertainty that necessarily prevailed. At a stroke we were deprived of our second biggest customer—Germany—and our trade with the Central Empires ceased. Shipments of goods were immediately subject to war risks of a nature impossible to calculate, for there was no precedent as a guide. Gold points accordingly widened from the mint pars, and if it was a risky proceeding to ship ordinary commodities, it was felt to be still less possible to move bullion. Immediately holders of bills became nervous; acceptors whose names had, up till then, been regarded as first class, possibly had heavy commitments on account of the belligerent countries, and people who had bought their paper

were anxious to know how they stood. The accepting houses, too, felt it necessary to reduce their credits, and were concerned to know whether their foreign clients would be able to put them in funds to meet the bills they had accepted for them. The foreign agencies of the enemy countries were a considerable embarrassment, and finally there was the unknown and disturbing factor of the probability of widespread hoarding of gold on the part of the public. A solution to each of these problems had to be found without delay, and the attention of all interested parties was concentrated during the prolonged Bank Holiday on devising the steps to be taken to deal with these matters. To prevent the entire breakdown of our foreign trade, the Government undertook the insurance of war risks at a low premium, and further made arrangements for the receipt of bullion in Canada from the United States, to be considered tantamount to its deposit in the vaults of the Bank of England. This was occasioned by a breakdown in the New York exchange. The calling in by London of credits granted to America, together with the necessity under which Americans laboured of making remittances to London to meet maturing acceptances given on their behalf, forced the New York rate to gold point, and although America had the gold with which to pay, the impossibility of shipment forced the rate, not merely above the bullion point, but to the figure of \$7 to the pound sterling, when, fantastic though the price was, remittances proved impossible to secure. This extreme difficulty of obtaining funds to meet their bills called for relief to be given to the accepting houses, and accordingly they were permitted to re-accept their bills as they fell due, for a period of a further month with interest upon the amount at 5 per cent. At a later date, acceptors who were still unable to obtain their funds were enabled to borrow them from the Government at interest of 2 per cent over bank rate, and repayment of these loans was not enforceable until after the end of the War. This proceeding eliminated fears on account of outstanding bills although it left a feeling of uncertainty regarding the ultimate position of many of the accepting houses by reason

of the unknown total of bills that they may have placed, in the market term of that day, in "cold storage."¹

The Government further authorized the Bank of England to buy up all outstanding acceptances of foreign agencies, and this was a measure of considerable relief to both the banks and the discount houses.

The Issue of Additional Currency.

Additional internal currency was a pressing need, and as a preliminary to the suspension of the Bank Charter Act, the bank rate was rapidly raised to 10 per cent. On occasions of crisis in the past it had been an unwritten law that this rate should be enforced before the letter of indemnity would be granted to the bank for increasing the fiduciary issue of notes.

The method of previous crises was not adopted on this occasion, but instead the Government itself undertook the

¹ An interesting sequel to this arrangement is seen in the following report in *The Times* of 8th July, 1929—

Messrs. Erlangers' Claim

The Anglo-German Mixed Arbitral Tribunal (Division A), consisting of Dr. Helge Klaestad (President), Mr. Heber Hart, K.C. (British Member), and Dr. Robert Wendriner (German Member), sitting in London, gave judgment in favour of the claim of Messrs. Erlangers, of London, against Karl Theodor Christian Friz, a German national, for £11,566 8s. 4d. in respect of bills of exchange drawn by the defendant and accepted by the claimants before the War.

It appeared that certain bills of exchange were accepted by the claimants in June and July, 1914, for the accommodation of the defendant, who engaged to provide funds to repay the claimants. The bills were re-accepted under the Royal Proclamation of August, 1914, and were paid by the claimants in November, 1914. The defendant failed to provide funds, and the claimants claimed an indemnity.

The Tribunal, in their judgment, held that the claimants were entitled to be indemnified by the defendant for the loss incurred by reason of the acceptances. The claimants had produced a certificate from the Bank of England, from which it appeared that the bills were met on maturity by advances made by that bank under the Treasury scheme of 5th September, 1914, and that the bank were repaid by the claimants on 1st September, 1922, together with interest at 2 per cent over bank rate to date of payment. The amount received by the bank was £11,566 8s. 4d., and this sum represented the loss for which the claimants were entitled to be indemnified.

The Tribunal entered judgment for the claimants accordingly for £11,566 8s. 4d., together with interest at 5 per cent per annum from 1st September, 1922, until crediting, with £55 costs.

issue of additional notes. The banks were authorized to encash their balances at the Bank of England in the new treasury notes, or they could, if they wished, obtain them as a loan, subject to interest at 1 per cent above bank rate, up to a maximum of one-fifth of their deposits. This arrangement immediately gave a potential addition to the currency of approximately £250,000,000, but, as always in the past, anxiety was allayed by the knowledge that the money was to be had, if required, and instead of the banks being obliged liberally to avail themselves of this help to meet the cash requirements of their customers, their borrowings did not amount to more than £13,000,000. Of this, all but a most trifling total was rapidly repaid.

The immediate financial troubles that arose when Great Britain's declaration of War had been made being thus met, panic was averted, and the crisis was quickly subdued, leaving the authorities free to deal with the successive difficulties as they appeared. In order to strengthen the position of the Bank of England, the clearing banks at an early date during the War transferred to it the gold reserves which they were in the habit of maintaining in their own vaults, and replaced them with the new currency notes.

It is impossible here to give more than a brief summary of the most important economic changes to which the country was obliged to adapt itself during the War period, but the general trend of events is important on account of the transformation it effected in the London market.

Inflation.

The outstanding influence was the steady withdrawal of men from industry to the fighting services and the organization of the nation for the prosecution of the War; in economic terms, the divergence of the activity of the community from wealth production to its destruction. The ever-mounting costs of a war of the first magnitude necessitated from the outset the creation of credit unjustified by ordinary trade requirements, in other words, a policy of inflation initiated by the flotation

of the first War Loan, and gathering force throughout the four years of hostilities.

As there must always be a close relationship between the internal and external purchasing power of a country's monetary unit, inflation is reflected, with certain qualifications, in the state of the inflating country's foreign exchanges. Between countries having free gold markets, the purchasing power at home and abroad of the monetary units practically coincides; when one inflates to the point at which it is necessary to place an embargo on movements of bullion, the purchasing power parity replaces the mint par as a basis for calculating exchange rates, but the purchasing power parity may often change more rapidly than the exchange rates can adjust themselves to its vagaries, while the action of speculators will also frequently cause a considerable discrepancy between the basic figure and the rate at which business may be done. Again, a system of control may be instituted to keep the exchange between a gold standard country, and one with a depreciated currency at approximately the same level that would be maintained between them were both on a gold standard. This was the case between London and the capitals of the allies, and also between London and New York throughout the period of hostilities.

The Embargo on Gold.

It was soon apparent that an embargo would have to be placed on the export of bullion from this country, and in August, 1916, London sacrificed the proud position she had held for nearly a century of being the only completely free gold market in the world.

The balance of trade between ourselves and the United States swung in favour of America, first, for the reason that our military preoccupations were substantially reducing our power of exporting commodities; and, secondly, because of an ever-increasing need of buying munitions and foodstuffs from the other side of the Atlantic. Our shipping losses not only reduced our "invisible exports" but necessitated further

purchases of necessities from America in order to concentrate our vessels on shorter voyages than those entailed by importing goods from the more distant parts of the globe. Unchecked, the result would have been a severe depreciation of the New York exchange leading to yet higher prices paid for our American imports. It was so vital to avoid this additional burden that efforts had to be made to keep the exchange at a constant level close to the mint par. The initial remedy was to mobilize our vast holding of dollar securities which amounted in 1910 to the total of £1,318,000,000.

Dollar Securities Realized.

Holders were invited, on tempting terms, either to sell them outright to the Treasury, or to lend them, while later on a scheme of compulsory sale to the Government was enforced. These securities were sold on Government account in New York or used as collateral for the raising of loans there, thus providing a fund upon which drawings could be made to preserve the exchange at the requisite level. After the exhaustion of this fund America's entry into the War made the task of borrowing there a simple one, for the American Government was then able to grant the loans required instead of their having to be raised privately. Much of the pledging of our credit was on account of our continental allies, and our loans to them similarly maintained their exchanges which otherwise would have been in much worse case than our own with America.

This "pegging" of the all-important New York exchange was essential, but it entailed a heavy sacrifice on our part, first of all in a permanent loss of income from our holding of dollar securities, and, secondly, in the fact that our borrowing in order to maintain the exchange was a heavy mortgaging of our future income.

The Discount Market and the War.

As in the case of the foreign exchanges, so in every other branch of the money market conditions of artificiality were encountered.

The discount market found the character of its business entirely altered. Its holding of pre-war bills was gradually liquidated, and instead of being replaced by acceptances of similar character at rates largely influenced by the competition between its members, its portfolio had to be filled by treasury bills which were issued at fixed prices. The working of the discount houses became almost automatic; languishing trade and the concentration in the hands of the Government of the output of many industries almost did away with the necessity for the bills accepted on behalf of customers by banks and accepting houses.

The purchase of treasury bills in lieu of commercial bills certainly eliminated risk of loss, but it also meant little or no business of a turnover character, though compensation was found in the wider margin existing between money and bill rates. Supplies of credit were always ample since they were increased by each addition to the total of the national debt, so that loans to the bill brokers were continued from week to week and from day to day with a monotonous regularity, whilst the vast bulk of the bills bought with this money was held until maturity and then replaced.

This state of affairs for the time being weakened the Bank of England's control over both accepting and discount houses. It was fortunate that the need for ordinary control was largely removed, for its most potent weapon—the bank rate—was severely blunted. In the circumstances of those days a rise in the bank rate would have been totally ineffective; it would have been meaningless to check an export of gold, for none might be sent out of the country except under Government licence; it would have been quite powerless to attract gold here for a similar embargo on its movements was enforced in most countries other than the United States, to whom the allies were daily getting deeper into debt. When it was desirable to prevent abnormal monetary ease from depressing the rate for market loans, the Bank did so by offering to borrow any surplus from the clearing banks at a fixed rate, and it also prevailed upon the latter to encourage the deposit here of

continental balances by the offer of a higher rate of interest upon such deposits.

Stock markets were likewise stagnant except in the gilt-edged department which was consistently busy with the successive issues of War Loans and War Bonds.

The Close of the War.

This general condition of quietude throughout the various branches of the London money market continued until the signing of the Armistice which marked the opening of the third phase to be considered; the chequered period between the close of the War and the passing of the Gold Standard Act of 1925.

With the abrupt ending of the demand for munitions and the rapid demobilization of the army, came the cessation of expenditure for war and the earliest step taken to remove the artificial conditions of the market was the "unpegging" of the controlled exchanges.

Immediately the New York exchange dipped and the downward movement continued until February, 1920, when the quotation was as weak as \$3.20 to £1. This movement was a continual source of embarrassment to the market and solicitude was felt, not only on account of the events of the moment, but for the fear that the depreciation of our currency would lead in the future to the loss to London of the wealth to be gathered from its position as the world's banker. New York had the enormous advantage of a full gold standard, and had her Federal Reserve system been of older standing and more fully tested, there is little doubt that the supremacy of our bill market would have had to yield.

Lack of experience, more than anything else, on the part of the New York market made America unable to capture from London the financing of international trade.

Why Sterling Depreciated.

The causes of this severe slump in the value of the pound sterling were several. In the first place, our trade with the United States was still of a very one-sided character. Secondly,

the Continent was also importing heavily from America, and also transferring funds to New York to avert the loss of capital value that would have been sustained by keeping the money in European centres during a period of continuous inflation. These European purchases of dollars were more frequently effected through London than made directly in Paris, Brussels, or Berlin, and had, therefore, a severely depressing effect on the London-New York exchange, whilst making their own exchanges with London move violently upwards. The New York quotation was, in fact, a New York-Continental quotation more than a New York-London rate. Lastly, by this time the British Government had taken up the question of the American debt. Their loans to us had been repayable at call, and not only had they steadily increased since the entry into the war of the United States, but no payment of interest had been made; it had merely been added to the total of our indebtedness. Although no settlement of the debt question had been attempted, it was decided to make a start in that direction by half-yearly interest payments and Government purchases of dollars to that end were the final factor in bringing the rate down to a point at which the purchasing power of £1 of our paper currency was reduced to that of 13s. 3d. of gold.

The steady falling away of the dollar exchange during the period following the Armistice until this lowest marking was registered is important as a measure of the degree of inflation practised in this country during this time, for, quite apart from the influence of continental purchases of dollars, the exchange was naturally affected by the vast growth of banking credit in London, and the consequent growth of paper currency. The inflation gave rise to a quite unhealthy trade boom of a purely artificial character. It was a period of feverish activity in manufacturing circles caused in many industries (as, for example, the motor trade) by the optimistic placing of orders here on continental account that were nominally sufficient to ensure plants working at full capacity for several years; contracts, however, which were consistently to be cancelled or repudiated at a date a little later on. New issues of capital

and debentures, the latter at particularly heavy rates of interest, were made to an alarming extent, subsequently to leave the companies concerned in the position of finding themselves over-capitalized or burdened with crippling interest charges.

Prices Rise Rapidly.

The increase in credit rapidly outstripped the production of commodities, and caused constantly rising prices, which in turn led to a widespread speculation in commodities. The upward trend of wages, as always during a time of inflation, lagged behind the rise in the cost of living and strikes became frequent and, at times, menacing, as in the case of the railway strike of 1921.

At last it was realized that we were moving along the road leading to the precipice down which Austria and Germany, to say nothing of Russia, had already fallen, and the Bank of England, in conjunction with the Treasury, had to take drastic steps to restore our financial sanity. The bank rate which had been kept at the level of 5 per cent throughout the War, was raised in April, 1920, to 7 per cent in order to impose a penal rate upon those who had availed themselves of heavy overdrafts from the banks to further their speculations in commodities. Then an agreement was concluded amongst the banks to reduce their loans to more modest proportions wherever possible, and to grant new ones only when satisfied not only that the security offer was good but that such advances were not sought for the purpose of financing speculation as distinct from legitimate trade. After thus striking at the root of the matter, the authorities were enabled to lop the over-weighted branch represented by the circulation, and it was decided to fix a maximum for the fiduciary issue of Currency Notes. Prior to the War the note issue of the Bank of England was, roughly, 60 millions,¹ and it was estimated that 100 millions of sovereigns were at that time in circulation.

By June, 1920, the bank notes totalled £139,919,785, in addition to £362,276,853 of currency notes.

¹ Notes issued 23rd July, 1914. £57,914,410.

It was decided that the fiduciary issue for the year should not exceed £360,000,000, and that the actual maximum attained in any year should be the legal maximum for the one ensuing.

A few weeks after this regulation was brought into being the legal maximum was almost attained, and in the fear that the scheme might prove abortive a margin was provided by the subterfuge of treating the outstanding issue of the earliest notes—which were no longer legal tender—as no longer forming part of the fiduciary issue.

As things turned out, the total, including the first issues, at no time exceeded the allotted maximum, although it approached it very nearly.

Deflation Begun.

The effects of these drastic actions were rapidly felt, and a feeling of much greater confidence gradually returned to the City, although the immediate result was one of difficulty to the Government. The 5 per cent War Loan had no greater market value than 82; short-dated War Bonds sunk to a point at which they yielded the buyer 7 per cent per annum when the premium on their redemption was taken into account, and a similar yield had to be granted by the Government upon a new issue of Treasury Bonds.

But the severity of the remedy was necessitated by the gravity of the complaint, and the circumstances of that time marked the turning point; not only was inflation permanently stopped, but a definite policy of deflation begun and regularly pursued.

If prices did not descend as rapidly as they had risen, nevertheless they fell steadily and Government credit improved.

Within eighteen months of this action the 5 per cent War Loan was being dealt in at par, and bank rate instead of being 7 per cent was only 3 per cent.

But the improvement of the national credit and restoration of the money market to a condition of health was not accomplished without severe disturbance to the country. Trade

was checked, which was as well, in view of its previous disastrous character, for it furnished the opportunity for industry to adapt itself to actual needs in place of indulging in over-production, although its slowing down led to widespread unemployment. But since our trade lives upon its overseas connections, the improved purchasing power abroad of our monetary unit was a compensation in the long run to the severe dislocation caused by the sudden stop put to our inflation.

The discount houses and accepting houses were now able to take stock of the situation, the latter finding the field of their normal activities again being opened to them, while the former began to note a slow trickle of commercial bills into their portfolios, which then were almost entirely filled with "treasuries."

But while this state of affairs had obtained at home very different conditions had prevailed on the Continent, and these only added to our already difficult problems.

Continental Conditions.

In both Austria and Germany the financial position rapidly became acute. Pending the draft and acceptance of the Peace Treaty, both countries were debarred from raising foreign loans, the burdens that might be imposed upon them making the security they had to offer far too precarious to tempt the private lender abroad to grant them assistance. Their foreign trade, more than that of their enemies, was disorganized, whilst their liabilities were increasing. The degree of inflation enforced upon them during the War was intensified by the problems of peace, and their burdens were made yet more onerous when the Peace Terms were finally forced upon them. The German exchange depreciated to 360 marks to the £1 in the early days after the resumption of business relations, and what was then so phenomenal a fall tempted speculators in their thousands, with neither knowledge of existing conditions nor foresight to read the future, to buy heavily. The mark doubled its value as the result of

their optimism, but the quotation of 180 proved the lowest it could touch until the reorganization of German finance under the Dawes plan. Unceasing inflation steadily pushed it upward until the mark became worthless. As suggested above, inflation was undoubtedly forced upon Germany though whether to the degree of thrusting the country into bankruptcy is problematical.

But the policy was encouraged by powerful financial and trading interests in Germany on account of benefits it brought to them even though it was detrimental to the country at large. Manufacturers profited inasmuch as the increase in their costs of production in the shape of both wages and overhead charges could not keep pace with the rise in the selling prices of their goods. Merchants in Great Britain accordingly found their trade in foreign markets undercut not only by Germans but also by their competitors in all other countries where inflation granted a bounty to the exporters of goods.

Again, the extreme lengths to which inflation was pursued conferred upon German trading concerns the benefit of having the value of their existing debentures and liabilities of a similar character entirely wiped out, thus giving them a further advantage in the world's markets over their competitors in countries following the more thorny path of financial rectitude. Both the German and Austrian currencies became valueless, and at the same time those of France, Belgium, and Italy became depreciated to the extent of roughly one-tenth of their gold value.

The Effect on the London Market.

The result of this violent depreciation of the currencies of all those countries which had, in the past, been most important financial centres reacted on the London market. In the first place contracts for British goods for which payment was to be in sterling were constantly being repudiated, and the time honoured custom used by the British exporter of drawing his bills in sterling with the phrase "exchange as per

endorsement" incorporated in the body of the bill had to be abandoned as banks were obliged to refuse negotiation of such drafts on the grounds of the uncertainty of their being honoured at maturity. Accepting houses were similarly chary of granting credit facilities.

During all this period of inflation, continental money was busy seeking employment in London to avoid the loss of capital which would have been the inevitable consequence of retaining it at home.

Whatever lessons taught by an inflationary policy may have been lost, the one that was most effectively learnt was that a constant depreciation of currency from its gold value is a very far-reaching form of Capital Levy.

It is a tribute to the confidence retained in London by the Continent that although vast sums were transferred for safety to New York, a yet greater aggregate sought employment in London despite the fact that America was on a full gold basis, and Great Britain was not. This transfer of funds brought the exchanges of the countries buying sterling and dollars to a point yet less favourable to themselves, but the process was continued despite the most rigid regulations imposed to forbid the export of capital. Germany, with characteristic thoroughness, concentrated exchange business into the hands of a few big banks and appointed inspectors to examine every application for foreign remittances. Foreign exchange business was certainly hampered thereby, but the restrictive efforts only proved the futility of any attempt to keep money from leaving the country.

Forward Exchanges.

In London the breakdown of foreign trade that would have resulted from the use of sterling bills was averted by the introduction of an entirely new feature into the foreign exchange market: that of buying and selling currencies "forward." The exporter could sell his foreign currency to a bank at a rate fixed at the time of the contract, for delivery at a specified future date. The rate the bank would quote would

depend, in turn, on that at which it would cover the deal, thereby shifting the risk of loss from its own shoulders on to those of whoever was willing to assume the responsibility, and in this respect the speculator in foreign exchange proved of real value to both the merchant and the money market.

Gold Goes to New York.

The wave of financial lunacy that swept over the world became so menacing that remedial measures became imperative if general national bankruptcy was to be averted. Even in New York financial trouble was threatened as a result of European indebtedness causing a steady stream of bullion to flow into the United States. True, there was a general embargo on gold movements, but the Treasury in London found it expedient to grant licences for the export of new gold arriving from the Cape, in addition to which that held as reserve against our currency note issue crossed the Atlantic and was replaced by Bank of England notes. Consequently, half the world's stock of gold became concentrated in New York, and to avoid a "gold inflation" (or a general increase in prices) and the general dislocation thereby caused to trade, the authorities were obliged to prevent these accretions of bullion from becoming the basis of fresh credit. The curious situation arose of an acute shortage of gold in Europe, whilst in America it was so redundant as to require immobilizing.

The phenomenal position was observed of gold being dug out of the bowels of the earth in South Africa in order to be uselessly reinterred in the vaults of the Treasury in New York.

The stumbling block to an earlier solution of the problems of that time was the necessity for official recognition on the part of debtor countries of their outstanding debts in order that they might obtain foreign credits.

Such recognition and the arrangement for a satisfactory settlement was impossible until there had been a general stocktaking to determine the extent of these liabilities, and this involved the allocation of war indemnities and agreement

between the various allies with regard to their debts to one another.

The Austrian Loan.

After the signing of the peace treaties Austria was the first country to be rehabilitated. After she had given her bond in connection with her liabilities towards the victorious countries, the League of Nations undertook to set her on her feet to assist her in carrying out her obligations. Her currency was valueless, and accordingly a new system was instituted, with safeguards against the repetition of a policy of inflation. The reserve to be held against the note issue was divided into two parts, respectively 40 per cent and 60 per cent of the total issue. The portion of 40 per cent was to consist of gold and gold exchange, and the proportion of gold was never to be in a less proportion to the foreign balances and bills than 3 to 1, whilst the second portion represents the fiduciary issue. The scheme of holding gold exchange as the equivalent of gold was merely an extension of the old principle of holding London bills as part of the backing for her note issue. To ensure the position for the time being of the newly organized Central Bank and to prevent depreciation of the exchange, a loan was floated simultaneously in New York, London, and one or two continental centres on behalf of the Austrian Government, thus leaving funds abroad which could be drawn upon in order to support the exchange whenever it should prove necessary to do so.

Reorganization of the Reichsbank.

German finances were the next to be taken in hand under the Dawes scheme. This scheme was tentative as regards payments of reparations, but its provisions for the reorganization of the Reichsbank were of a permanent character.

The exclusive right of note-issue has been granted for a period of fifty years to the reconstructed bank, and the reichsmarks it issues are to be the only unlimited legal tender in the country.

The reserve held against the issue is regulated on similar lines to those drawn for Austria, that is to say, a minimum of 30 per cent of the total issue must be in gold, although this gold may be held in part by foreign banks of issue provided that it is at the free disposal of the Reichsbank. The difference between the total of gold and the amount represented by 40 per cent of the total issue may consist of deposits with foreign banks, foreign bank notes or cheques or short bills of exchange, while the remaining 60 per cent of the issue may be backed by approved domestic cheques and bills of exchange.

The Reichsbank is obliged to buy all gold offered to it at the rate of 1,392 Reichsmarks to the metric pound, but it is not obliged to sell gold. However, this does not mean that the export of bullion is forbidden, for on several occasions gold has left the Reichsbank for London since the acceptance of this scheme in 1924.

As in the case of Austria, the inauguration of the new regime was assisted by the flotation of a foreign loan.

In the case of both these countries the depreciation of the old currency was so great that it was self-repudiated; the old German marks were exchangeable at the figure of one trillion for each new Reichsmark, so that there was no question of a stabilization of the existing currency, but the setting up of an entirely new one, which, in the case of Germany, had the same gold value as that of pre-war days.

Reorganization—Belgium, Italy, and France.

The conditions in Belgium, Italy, and France, to take them in the order in which their currencies were reorganized, were considerably different. They had inflated to a degree which would have appeared disastrous to the eyes of the economists of pre-war days, but they were far removed from the insolvency of their late enemies.

There was no question of repudiation of their currencies, but to deflate to the extent necessary to restore them to their pre-war parity was not only impossible, but would have been disastrous to their trade had it been attempted. At the same

time they recognized that it was as vital to themselves as it had been in the examples of their late enemies to restore their finances to a gold basis. The preliminary step, namely, that of checking fresh inflation, can be taken only when a country is in the position to balance its budgets. A small deficit in one or two years may be covered by borrowings without detriment to the country's exchanges, but a consistent expenditure in excess of revenue is bound to cause a revival of the evils of inflation.

It was the difficulty of making ends meet that caused the long delay on the part of these countries in restoring the gold standard, but so soon as their expenditure on reconditioning the areas devastated during the War had ceased, and production once more started to grow, the problem of stabilization of their currencies was immediately tackled.

Belgium.

From the time that Belgium was first enabled to balance her national budget until the moment appeared to be ripe for the official revalorization of her monetary unit, the rate of exchange between Brussels and London remained steadily in the neighbourhood of 175 francs to £1, and on this basis stabilization was accomplished.

In place of the pre-war gold franc a new theoretical gold coin was introduced, called the Belga, having a pure gold content a thirty-fifth of that of the sovereign. For purposes of internal circulation the franc notes were to be retained, the value of the francs being fixed at one-fifth of the Belga, and are linked to gold by being payable either in gold or its equivalent in foreign currency. A foreign loan was necessary in the case of Belgium to prevent the new arrangements from proving abortive as the result of a depreciation in her exchanges, following her re-adoption of a gold standard. This was raised in New York, London, Switzerland, Holland, and Sweden to a total value of \$100,000,000, and further to support the exchanges private credits in favour of the National Bank of Belgium were arranged not only in the five centres in which

the loan was floated, but also in Germany, Austria, Hungary, and Japan.

The scheme proved thoroughly effective, for at all times since its inception the Belgian exchanges have remained within the gold points without the necessity of seeking further foreign assistance.

Italy.

The Italian currency was the next to be stabilized; the par value of the new unit was fixed at lire 92·46 to the £, but a foreign loan was not a necessity thanks to the large amount of Italian capital that had sought employment abroad during the inflationary period.

France.

The return of France to a gold basis was much belated; it was not accomplished until three years after England had unlocked the gates of her bullion market in 1925. The delay was occasioned more by her domestic political differences than by difficulties inherent in a scheme of financial reorganization, for her exchange maintained itself at a steady level of fcs. 124 to £1 for some eighteen months before the Act of Stabilization became law. As in the case of Italy, no foreign loan was necessary, and for the same reason: that adequate funds stood to the credit of France in other financial centres resulting from the steady transfer of capital into those countries whose currencies had been stable.

The chief enactments of the law of June, 1928, were as follows—

1. The abandonment of bi-metallism.
2. The setting up of a gold bullion standard. Under this heading the Bank of France is bound to similar conditions to those governing the Bank of England, for the French notes, although legally encashable in gold, may be paid only in bullion, and then may be encashed only at the head office of the Bank of France for minima quantities.
3. France to be a free gold country. This is an advance

beyond the state of either Germany, Belgium, or Italy, which are not free gold markets, although the export from them of bullion is not entirely interdicted.

4. The new gold franc (to be minted in 100 franc gold pieces) is to weigh 65.5 milligrams and is to be $\frac{9}{10}$ ths fine. This gives a Mint Par with Great Britain of fcs. 124.21 to £1, while gold points are about 40 centimes on each side of the parity.

This is provided that fine gold is available for export. If the Bank of England releases standard gold, the bullion must be refined before being acceptable to the Bank of France, and hence the cost of refining has to be added to the costs of transporting the gold. Consequently, the export gold points from London are 123.65 if standard gold be taken and 123.80 if pure gold should be available.

5. The arbitrary limitation of the French note circulation is abolished, but a legal minimum reserve of gold cover for notes and deposits combined is fixed at 35 per cent of the total issue. This provision is based upon those governing the Federal Reserve Bank of New York, and is a distinct departure from the form of the reserve to be held by the Central Banks against the note issue of other European countries.

6. The Bank of France is obliged to buy all gold offered to it.

Other Countries Return to Gold.

The restoration of the gold standard was not confined to the more important centres whose efforts have been described above. It was also undertaken by Poland, the new Baltic States, and the Balkans, for each one had learnt from bitter necessity the painful results of enforced inflation, and that the only hope of sustaining their trade was in wedding their paper values to bullion.

The result to this country of this general continental action has been, in the main, enormously beneficial. True, certain industries that found advantages in the shelter of artificiality, suffered from the fierceness of the competition to which they were subjected by the restoration of more normal conditions, but this should prove only a temporary set-back, and they

should gain in the long run. But these measures of steady values have enabled our trade with the Continent to grow without restriction, and the disturbances that arose from speculation in the exchanges are now no more. An immediate result was the demand on a large scale for foreign trade credits, and it is a matter of congratulation that borrowings were sought in London rather than in New York.

An increase in commercial bills had been noticeable for some time before these efforts at stabilization had been made, but subsequently there was a steady growth in the issue of commercial credits in addition to the flotation of foreign loans, and the bill portfolios of the banks and the discount houses showed an increase in the proportion of bank acceptances to Treasury bills.

Conditions Not Yet Normal.

Normality was by no means entirely restored; indeed, the settlement of war debts will alone be sufficient to prevent so happy a condition in the money markets of the world for many years to come. The remarkable situation of New York—to be considered in a later chapter—has also been a most potent factor in retarding the smooth working of the world's money markets, and it is the dislocation caused by the problems in connection with the United States that has given rise to most of the criticisms directed against the general financial policy pursued by European countries, and against ourselves in particular.

Details of the various schemes are, no doubt, open to objection, but the wisdom of the general principle is unassailable; currencies can be permanently preserved from depreciation only by having an adequate gold backing, and that gold reserve can be kept at the requisite level without detriment to a country's trade only by having a free gold market, and attracting bullion to it, when more is required, by the lure of higher interest rates. Placing an embargo on its export is a desperate remedy disorganizing trade for the temporary benefit of the money market, which, after all, is but the servant of trade.

CHAPTER VIII

THE RETURN TO THE GOLD STANDARD

THE sacrifice involved—The long and the short view—Provisions of the Gold Standard Act—The effect of the return upon trade, finance, and the money market—The present world position of gold

THE fourth phase of our post-war financial evolution dates from the decision of the Government in the year 1925 to make London once again a free gold market. Although a momentous undertaking, it was the natural sequel to the policy of deflation which had been consistently the aim of the authorities during the three preceding years, a policy, however, which has been subjected to considerable, and often weighty, criticism of an adverse nature. But it is necessary to discriminate between the objections raised to the rapid steps taken by the Government to deflate and to the expressions of disapproval of the removal of the restrictions upon bullion movements. Continental countries have, in the jargon of the market, "gone back to the gold standard," but they have not necessarily re-opened their bullion markets. France has done both, it is true, but on lines very different from our own, inasmuch as her system entailed a revalorization of her currency, whereas we forced the pound sterling back to the pre-war parity of the sovereign in terms of undepreciated foreign currencies, such as the dollar and the Swiss franc.

The Sacrifice of Inflation.

It is upon this line of conduct that criticism has been most cogent, a school of thought, led by Professor J. M. Keynes, maintaining that the advantages to be gained by pursuing this policy would be more than offset by the damage inflicted upon trade by a too rapid system of deflation. A further argument advanced by the adherents to this line of reasoning was that, since the national debt was brought to its stupendous magnitude at a time of inflation, its service and reduction would be

of a permanently crippling character when they were obliged to be met out of a deflated currency. The remedy suggested by Professor Keynes was that, instead of continuing the deflation that had been actively pursued since 1922 until the pound sterling was back to parity, our currency should be stabilized at its then existing gold value in terms of dollars.

To attempt to criticize this body of opinion led by so weighty an authority is to tread a very thorny path, but since several years have passed since the advice of this party was rejected, and five have elapsed since the passing of the Gold Standard Act, a survey of the events of those years may justify some slight analysis of the relative merits of the two opposing policies.

The financial advisers of the Government were undoubtedly taking a longer view than their opponents. They felt, and rightly, as subsequent events have proved, that the restoration of the sovereign would ensure to London its previous eminence as the banking centre of the world; that, if we were to maintain our position amongst the creditor nations, and once more to garner the wealth resulting from the flotation of foreign loans here, and from the granting of world-wide acceptance credits, confidence abroad in the sovereign must not be shaken. Tradition and precedent count for much in such matters, and had an alteration in the value of our currency been made by means of stabilization, there would have been present a sense of uncertainty as to whether, in the future, expediency would dictate further changes to the detriment of foreign borrowers.

Against this was the view of the exponents of stabilization that the falling values would deal such a blow to trade as would prevent its reaping the benefits that should naturally accrue from the normal functioning of our money market, and would nullify the impetus it would receive from a general seeking and granting of credits in London. That trade was seriously hampered as an initial result of the restoration of the currency was undoubted, its development was clogged by the increased burden of taxation imposed by the new conditions in spite of abatements in the rate of a direct character, and exporters

found it difficult, if not impossible, to compete against their foreign rivals in the countries whose depreciated currencies furnished a powerful bounty to their own trade. It has been urged that in 1926 the stoppage of work in the coal industry, developing into the General Strike that proved so disastrous a factor in the struggle industry was making to raise itself from a very tenacious slough, was the direct outcome of the financial policy of the previous years. More lately, however, the wisdom of the step was justified as regards trade, which, if it did not enjoy a season of considerable prosperity, became active to a degree which would have been very problematical under a system of stabilization, while, as the remarks, previously quoted, of the Chairman of Hambros Bank show, our acceptance business regained its pre-war level, instead of having been transferred to the other side of the Atlantic, as would most probably have occurred had not international confidence in the sovereign been restored.

The Gold Standard Act of 1925, at the moment of its passing, appeared to be a very bold step to take, for the New York exchange was below the export gold point, and there was every indication of an outflow of gold to the United States upon the Act becoming operative.

The Gold Standard in Force.

In order to prevent an undue loss of bullion a credit was arranged in New York in favour of the Bank of England, but the exchange promptly rose above the gold point, and the period of two years for which the credit was available passed without the necessity for recourse to it. This was a matter that gave rise to a good deal of congratulation and a certain degree of surprise, but a parallel in the past history of the money market suggests that what did occur is exactly what might have been expected. In the year 1866, one of acute crisis in London, the Paris rate fell to the lowest possible figure, and remained there despite the fact that, thanks to a high bank rate here, investment in London bills would have yielded continental bankers no less than 6 per cent more than their

money could earn in their own centres. In the words of Clare, "the very magnitude of the inducement held out to attract foreign capital had the opposite effect of scaring it away." But by taking its courage in its hands and reducing its rate the Bank of England immediately caused the exchange to improve.

As in 1866, so in 1925. With restrictions upon gold exports, the New York rate was below gold point; by lifting the embargo and thereby spreading the knowledge that gold was to be had for the asking, the tendency to demand it vanished; confidence was restored and the exchange improved.

The lesson is that between a gold standard country and one that is either divorced from such a standard or which, although a free gold market, is in an abnormal condition due to internal embarrassment, exchanges are always considerably more favourable to the former, and in order to rectify the position the less fortunately placed country must reverse the policy normally to be adopted to cure an important adverse exchange.

The Gold Standard Act of 1925 was designed to enable gold to be obtained without let or hindrance for the purpose of settling international debts whilst prohibiting its use as an internal currency. To this end the provisions of the Bank Charter Act, directed towards ensuring the convertibility of the note-issue, have been suspended "unless and until His Majesty by Proclamation otherwise directs," and the Bank of England is relieved from the necessity of encashing its notes in legal coin, while the right of any person to the free mintage of gold bullion by virtue of Sect. 8 of the Coinage Act of 1870 is also suspended.

Since sovereigns are now seen only in negligible quantities, the practical effect of the first sub-section of Sect. 1 of the Act is to make Bank of England notes (including those of small denominations which have replaced the now obsolete currency notes) the sole form of unlimited legal tender in the country.

Gold Sales at the Bank of England.

The second sub-section reads as follows—

So long as the preceding subsection remains in force, the Bank

of England shall be bound to sell to any person who makes a demand in that behalf at the head office of the bank during the office hours of the bank, and pays the purchase price in any legal tender, gold bullion at the price of three pounds seventeen shillings and tenpence halfpenny per ounce troy of gold of the standard of fineness prescribed for gold coin by the Coinage Act, 1870, but only in the form of bars containing approximately four hundred ounces troy of fine gold.

Sect. 4 of the Act of 1844 not being repealed, the Bank of England is still obliged to buy all gold offered to it at the rate of £3 17s. 9d. per ounce, eleven-twelfths fine, but the subsection above quoted is entirely new law. Previously the Bank of England was under no legal obligation to sell gold, but in pre-war days it always did so, since sovereigns could be obtained for notes, and their disposal was always possible by weight, if not always by tale. Now, however, it is anybody's right to obtain bullion in excess of the minimum quantity prescribed, and whenever the state of an exchange makes the shipment of gold to the foreign creditor the cheapest form of satisfying a debt the gold will be withdrawn.

Gold Prices Fixed.

The fixing of a buying and a selling price for bullion at the Bank of England naturally has the effect of establishing the limits for its price in the open market, namely, 84s. 10d. and 84s. 11½d. per fine ounce, these figures being the equivalents of 77s. 9d. and 77s. 10½d. for standard gold.¹

A lower price than 84s. 10d. no seller will accept; he can obtain that for it at the Bank of England, while a buyer will not pay more in the open market than he would have to give to the central institution.

Foreign Loans.

The re-opening of our bullion market led to an immediate flood of new colonial and foreign issues in London, and although

¹ The refusal of the Bank of France to accept British standard gold has made it possible for gold to be bought in the open market on French account at a price in excess of 85s. per oz. The cost of refining standard gold being 1½d. per oz., this amount must be added to the upward limit of 84s. 11½d.

the impetus gathered in the first few months could not be entirely maintained, ever since there has been a very regular demand for accommodation here. The satisfying of the early host of hungry borrowers gave rise to the fear that the London market was overlending with the obvious sequel of falling exchanges and an outflow of gold. But, in this instance, the prophets were falsified. Loans have been sought from all parts of the world with the notable exception of the United States, and New York has been, after all, the principal centre to which a loss of gold has been experienced to an alarming degree. True, some has been lost to the Continent, but quantities have also been received thence, and our exports on Dutch and German account—the latter more particularly—have attracted an attention that would have been almost entirely lacking had not such withdrawals been coincident with a heavy American drain.

The somewhat heavy withdrawals on French account have been the natural sequel to her reversion to the gold standard. Paris is now again able to function as a centre in which credits may be freely obtained, and her sterling balances are being re-converted into francs to that end.

In addition, sterling balances held on French account in London are subject to withdrawal when ordinary banking factors would not suggest their removal. Much of this money found its way to London during the "flight from the franc"; it was money lodged here, not to take advantage of higher interest rates in this country, but to avoid capital depreciation during the period of inflation in France. Being placed here for a special purpose, and not as an ordinary banking transaction, it is liable to recall at any time, and during 1930 much of it was withdrawn.

Gold accordingly left the Bank of England for Paris in considerable amounts, and much of the gold available in the open market was also bought on French account. This accumulation of gold by France caused its neutralization by the French authorities. Necessary though such action may have been, the advantage of such artificial conditions was

emphasized by the entire unresponsiveness of the French exchange to the bullion shipments.

Since the proceeds of a foreign loan may be withdrawn only in the shape of the export of goods, the rendering of services and the dispatch of bullion, our trifling loss of gold to the borrowing countries clearly indicates that our lending has proved to be a powerful stimulus to trade and a helpful adjunct to our invisible exports. The restoration of the gold standard has hence gone a long way towards rebuilding the fabric of our national prosperity, and the recrudescence of commercial bills in the London market is an index of the re-birth of our overseas trade. It is noteworthy, too, that, although present-day difficulties have led to the suggestion in various quarters that the gold standard should be again abandoned (see Chapter VI, page 85, letter of reply of the Associated Chambers of Commerce), the authorities who condemned the drastic deflation that was the forerunner of its re-institution, have never uttered a word in support of its abandonment, while the Treasury and the Bank of England are both extremely unlikely to contemplate checking the life stream of our banking and commercial body save in time of the direst national need.

The American Debt.

The causes of our present-day difficulties are all the outcome of war conditions. The close of hostilities found the United States the only one amongst the great nations that was not in a state of economic exhaustion. She, on the contrary, was the creditor and the chief source of supply of the allies, and this condition had the effect during the war years, of hastening enormously the process that had been noticeable during the preceding decade, namely, that of her change from a country exchanging raw materials for manufactures into one of advanced industrial development. As a consequence her demand for foreign goods has considerably diminished, whilst there is still a strong request for both her wheat and her cotton. Her exports of the latter, however, are diminished both by

the reduction in the Oriental demand for British cotton goods and the tapping, within the British Empire, of new sources of the raw material.

Since the general restoration of the gold standard in Europe and the diminished American demand for foreign manufactured goods, the United States have considerably increased their tariffs to preserve their growing industries from undercutting by their older established rivals in other countries. Further, America holds Europe in fee on account of War Debts.

The Times of July, 1929, gave the following synopsis of the official estimates of the balance of America's international payments during the year 1928—

Estimates prepared by the United States Department of Commerce, at Washington, of the balance of international payments of the United States last year show very clearly why the dollar opened the year at a discount in many currencies and closed it generally at a premium. As Mr. Lamont, the Secretary of Commerce, points out, in the second half of the year America thrust a billion dollar transfer problem upon the outside world by increasing her favourable trade balance by \$452,000,000, and reducing the underwriting of foreign securities by about \$610,000,000. The international turnover of America last year was \$22,000,000,000 (£4,400,000,000), or about \$4,000,000,000 more than in 1927. The visible trade balance was favourable to the extent of \$837,000,000 (against \$583,000,000 in 1927).

Increase in Foreign Investments

After deducting miscellaneous invisible items—such as freights, war debt payments, tourist traffic expenditure, emigrant remittances—the favourable balance was reduced to \$730,000,000 net (as against \$588,000,000 in 1927). America's foreign investments were, however, increased by a larger sum than this, the figure being \$962,000,000 net (as against \$695,000,000 in 1927). Roughly, the American position in 1928 can be summarized as follows: The world paid to America, \$1,109,000,000 for commodities and bullion, \$882,000,000 for interest on private investments and deposits abroad, \$210,000,000 for war debt payments, and \$67,000,000 for miscellaneous items, making a total of \$2,268,000,000. On the other hand, America paid to the world in the shape of new loans and investments abroad \$962,000,000, for tourist expenditure \$525,000,000, in payment of interest to

foreign investors and depositors \$359,000,000, in respect of immigrant and missionary remittances \$241,000,000, for freight payments to foreign carriers \$84,000,000, and foreign payments by the United States Government \$57,000,000, making a total of \$2,228,000,000. The relatively small difference between the two totals is attributed to errors in some of the estimates.

United States as a Creditor Nation

Mr. Lamont points out that the increase in the American export trade in the last seven years has been the result of an increased foreign demand for her manufactures. This is the more notable since it has been accompanied by a marked decline in exports of crude foodstuffs. Last year the excess of exports over imports was \$1,038,000,000, being the largest excess since 1921. This is a real increase, for the quantity of exports was about 47 per cent larger than in the earlier period. In 1928 the average price of export commodities showed little change, but the average price of imports was less. Because of the large amount of foreign capital invested in the United States, Mr. Lamont is of the opinion that America is a creditor nation to a much smaller extent than many people suppose. Excluding war debts, he estimates the net credit at less than \$9,000,000,000 (£1,800,000,000). Long-term foreign capital invested in the United States is estimated at over \$4,999,000,000 (£800,000,000). The favourable balance of payments from Great Britain last year was estimated by the Board of Trade at £149,000,000, which roughly corresponded to the amount of our foreign investments, as against £114,000,000 in 1927. The American balance available for foreign investment was £146,000,000, but the net increase in America's foreign investments was about £50,000,000 larger.

All these factors have combined to turn the European exchange rates in favour of America, and the effect upon the London rate has been particularly adverse, as London has been the favourite market for the Continental purchase of dollars, this, in turn, being partly the actual sequel to the amassing of sterling balances during the era of general currency depreciation, and partly due to the fact that Great Britain is also a substantial lender to the Continent.

The American Boom.

A fully developed industrial country is usually both a heavy investor in foreign securities and a substantial lender of new

money to foreign borrowers. In the case of New York, however, the development of her money market by no means kept pace with her growth as an industrial nation. True, sound European bonds and shares have always found a market, though a somewhat limited one, in Wall Street, and true it is, also, that the list of foreign securities, particularly British, there dealt in has recently been extended considerably, but her foreign investments and her lending of new money have fallen far short of the amount that her national prosperity would lead one to expect, and the net result of this reluctance to lend, added to her favourable balance of trade, was steadily to draw gold from Europe in general and from London in particular.

The buoyancy of America's industries led to a natural enhancement of the Wall Street values of industrial shares and, as always at a time of steadily expanding trade, to a Stock Exchange boom. In the ordinary course of events such a boom is of an ephemeral character, but, owing to the continued expansion of American production, and more especially owing to the loss of control of the money market in New York, due to circumstances to be discussed later, it continued unabated for a period of three years. The financing of New York's colossal Stock Exchange business occasioned the withdrawal of American balances from London, and since money finds its own level with a rapidity akin to that of water, the high interest rates prevalent in New York induced bankers freely to borrow in European centres where accommodation was cheaper, in order to take advantage of the more remunerative rates they could obtain at home. This accentuated the tendency to ship gold across the Atlantic, and caused the Bank of England considerable pre-occupation in the conservation in its own vaults of the amount of gold requisite for our needs.

Gold Leaves London.

From the restoration of the gold standard in April, 1925, until the August of the same year, gold came into this country

on balance, the Bank of England during those four months being able to increase its stocks by approximately £7,000,000, but by the October the pendulum was swinging the other way. Exports of rubber from the Dutch East Indies drew gold away from London, and this was coincident with an outflow to New York. So heavy was this drain that by the end of the year the Bank of England found itself poorer by 11½ millions than it had been on the re-opening of the bullion market. The movements of the two following years showed on balance comparatively little variation in the Bank's stock of gold; 1926 showed a net inflow of £6,000,000, and 1927 an efflux of a trifle under £2,000,000. Since in April, 1925, the Bank started with a stock of £155,000,000 the movements during the intervening years showed it to have a stock of £152,000,000 at the beginning of 1928, which was to prove a year of heavy shipments both in and out. The accretions to the Bank's stock were continuous until September, when the record holding of £176½ millions was attained. Then the New York drain began in earnest, and by the end of the year the previously acquired £20,000,000 had disappeared, and a further million with them. Throughout the period of these constant withdrawals the bank rate was maintained at 4½ per cent, and in the early days of 1929 the critical period seemed, for the moment, to have passed. At the latter end of January, however, the New York exchange again fell away to bullion point, and a further withdrawal of £4,000,000 in one week reduced the stock below the minimum reserve required to be held, and to check further loss the bank rate was raised to 5½ per cent. This severe measure was sufficient, for a time, to check further loss; it was ineffective in attracting gold to London as a banking operation, but it did enable the Bank laboriously to repair the ravages by securing the commodity gold from South Africa. Soon, however, the magnetism of New York for the metal re-asserted itself, and the Bank of England was obliged, in order to obtain the gold in the open market, to pay a rate for it only one-eighth of a penny per ounce below its own statutory selling price. Still the New

York exchange continued adverse, and whilst it hovered a trifle above and below gold point—causing fresh withdrawals each time it dipped below that figure—the French and German exchanges also fell away, and bullion went from the Bank to the Continent.

This brief synopsis of the history of specie movements from the time of our reversion to the gold standard until the middle of the year 1929 has been presented in order to give some idea of the difficulties that have been experienced in maintaining that standard and in preserving an adequate base for the structure of credit in the country. In the interests of trade and the price level of commodities, the effects of these gold movements had to be neutralized, and so an unhealthiness was caused in the money market by the artificiality of such conditions. In order to keep the bank rate effective and to avoid giving further stimulus to the downward tendency of the exchanges, the market rate of discount had to be maintained at a level often incompatible with the unnatural ease of money after the withdrawal of gold from the Bank. The lack, too, of a natural sympathetic response to bullion movements sometimes occasioned a sense of false security that was not in the best interests of the money market. This was the case to a marked degree during the closing months of the year 1928, and such a state of affairs might easily develop a serious weakness of our general credit system by encouraging growth at a time when a discreet pruning should be the wiser plan to adopt.

Gold Famine in Europe.

The chief obstacle in the way of an increase of our stock of gold since 1925 was the gravitation of the metal during that time towards New York, and the American situation was the dominating factor of our difficulties throughout. The British Government were obliged to use gold freely in settlement of payments to America before the passing of the Gold Standard Act, and hence nearly the whole of the production of the Rand mines was transhipped to New York

in addition to the £28 millions which had been set aside in the early days of the War as a gold backing for the currency note issue.

Considerable proportions of the reserves of the other allies also found their way across the Atlantic, and the curious situation arose of a virtual gold famine in Europe, whilst in the United States the redundancy of the metal gave rise to fears of what has been described as a "gold inflation," and, in order to prevent a continuous upward tendency in commodity prices in the United States as a sequel to the constant importation of bullion, the United States Treasury officials consistently "sterilized" the gold by allowing it idly to lie in their vaults and not to form the basis of additional credit. Indeed, the acquisition of gold by New York proved almost as embarrassing to the United States as its loss was to London and the Continent. The anomaly of the position was the more marked inasmuch as there was in New York an unprecedented pressure for loans, the rates paid for call money frequently reaching 15 per cent and over, whilst when they dropped temporarily to 7 per cent or 6 per cent such figures were considered phenomenally low.

This range of rates was paid while the New York Federal Reserve rate was standing at the figure of 5 per cent, and this clearly argues one inherent weakness in the American financial system when the central bank is unable to exercise control over the market if a pedestrian rate of progress is accelerated to one of considerable velocity.

Although the continuous accumulation of gold by New York has been so remarkable a feature of international finance, it is unsafe to blame the older countries for causing their own difficulties by worshipping an ancient fetish in their anxiety in returning to a gold standard. At the close of the War the dollar was the only international standard of value, and it was measured in terms of gold. Hence it at once became necessary, in order to conform to that standard, for a return to gold on the part of countries the currencies of which had a variable purchasing power. Otherwise their industries could not

emerge from the slough into which they had been forced by the events of the War, nor could their money markets retain importance among international financial centres.

But the effect of this general return to gold has certainly, so far, been very one-sided; it must, however, be admitted that some of the circumstances are not of a permanent character, although their effect has been unusually prolonged.

American Development.

The United States of America, prior to the War, had been essentially a "young" country, hungrily seeking financial assistance from Europe to help in its development, and relying, in the main, upon its exports of raw materials to pay for the mass of manufactures it was obliged to purchase abroad. Its own industries had been, however, steadily growing for many years, and in 1914 its development was far in advance of its neighbour Canada.

Its industrial expansion was enormously accelerated by the War, and, as its trade returns for 1928 show, it has now an extensive exportable surplus of manufactures and a considerably smaller one of raw materials. This tendency is more likely to be continued than to die away, and will spread the autumn and winter demand for dollars more evenly over the year so that the seasonal fluctuations in the New York exchange will be considerably lessened. An industrial country is invariably a creditor country, but America's experience in the latter connection is a very unusual and somewhat limited one.

Normal foreign lending for purposes of trade is in its infancy in New York; and the huge national loans she was able to grant during the War period are being steadily repaid. Her lendings since 1918, apart from stabilization loans and others of similar character, have been negligible in comparison to the totals that have been the common feature of the older creditor countries, but this type of business is increasing in America, and will inevitably develop greatly with the further growth of her industries.

Why New York is Behind London in the Money Market.

Up till now there have been two potent influences at work to check the attainment by New York of the position of a financial centre akin to that of London. The other countries have long since learnt that the surest way of securing repayment of previous loans is by being willing freely to grant new ones—not necessarily to the same borrowers—and a consistent policy of lending is desirable. True, this experience was gained from loans granted on trade and commercial account, but the lesson holds good in the case of those made on Government account, and by a greater freedom in granting commercial credits New York will not only hasten the development of her money market, but will also find the repayment of her War Loans greatly facilitated with an accompanying amelioration in the condition of the exchanges and the gold situation. Such a betterment is as much in the interest of the New World as of the Old.

The second influence that has retarded foreign borrowers from satisfying their requirements in New York is to be found in the interest rates that have prevailed there. To be a successful lender an international market must charge reasonable rates; to borrow in America has been, until now, too expensive.

The cause of this is not reluctance on the part of American bankers to grant credit facilities, nor was it, in the main, lack of confidence in the stability of borrowers, but simply that the power of granting credit has not been increased proportionately to the additions to the gold stock. The prolonged boom in Wall Street very heavily taxed the capabilities of the American banks to finance it, and the rates offered were sufficiently attractive to divert funds from the channels of foreign lending.

Flourishing though American trade might be, it could not possibly justify the market quotations for industrial securities, and sooner or later they were bound to drop to a figure consistent with the profits made by the various concerns. An adequate control of the market would have probably

achieved this earlier, and such an easing of the situation in New York would have brought considerable relief to the financial centres of Europe. But the moment arrived when the superstructure of credit in New York became so top-heavy that only a very slight push was necessary to send it crashing. This "push" was given, indirectly, by the Bank of England.

The unceasing flow of gold from London to America as the result of the fantastic money rates current in New York led to the raising of the Bank of England's rate to $6\frac{1}{2}$ per cent. This forced the Federal Reserve Bank of New York to advance its rate in turn.

Holders of stocks became nervous, particularly those who had bought "on margin," and selling consequently began. The feeling of disquietude rapidly spread, and vast blocks of stocks were placed on the market with the result that many of the leading industrials in the new conditions could not command a quotation better than a third of the figure they had reached when the boom was at its height. Here and there a slight rally might have been noticeable, but it was never long maintained, and the boom entirely ceased. The persistent liquidation of their position by speculators deprived the banks of a most profitable field for short loans, and their money was diverted to its more usual channels. American balances once more sought employment in London and on the Continent; the New York/London and the New York/Paris exchanges moved up to the bullion export point, and gold left America for both England and France. The easing of the tension in London made it unnecessary for the Bank Rate to be maintained at the figure to which it had been advanced. After it had remained at $6\frac{1}{2}$ per cent for a period of more than a month it was reduced to 6 per cent and a little later by two successive steps to 5 per cent.

Would a Lower Gold Holding Suffice ?

In the meantime the comments of Professor Gustav Cassel on the position in regard to gold contain the valuable enlightenment always to be derived from dicta of that eminent authority.

He says—

It may be asked: Cannot the world rely on the annual gold production to supply sufficient quantities of gold to meet the growing needs, and can it not be hoped that in this way a practically sufficient stability of gold may be attained without the adoption of any deliberate policy to that end? The answer is decidedly in the negative. The experience of the period from the middle of the nineteenth century to the outbreak of the War shows that during that period an annual gold production of 3 per cent of the total amount already accumulated in the world was required to ensure the stability of the general level of commodity prices. There is hardly any valid ground for believing that economic progress should become much slower henceforth, or that the annual supply of gold required for this progress should automatically fall below the pre-War standard. According to this standard the annual production of gold ought now to reach a figure of about £120,000,000. The actual production, however, stands at about £80,000,000, and this does not cover more than two-thirds of the need. In such circumstances it is obvious that we have to face a growing scarcity of gold. *A deliberate reduction in the world's monetary demand for gold is the only means by which the scarcity can be met.*

To bring about this "deliberate reduction" Professor Cassel suggests a general recognition of a lower percentage of gold cover, but he is careful to lay stress on the point that such lower percentage should be accepted by all the leading countries. He says: "As soon as a country has accepted the gold standard it has thereby made itself dependent upon the value of gold, and therefore, to a certain degree on the monetary policy of all other countries."

These remarks would appear to furnish a sufficient answer to those who have favoured a change in policy by the Bank of England in substituting a permanently lower figure for its minimum gold holding than the £150,000,000 proposed by the Cunliffe Committee. As the Professor points out, only a general agreement between the principal central banks of the world to reduce the proportion of their gold stocks to their demand liabilities, would adequately ensure a real economy in the use of the metal. Such a co-operation may be possible, or, indeed,

dictated by force of circumstances in the future, but at present there are no signs that the time is ripe for such a convention. Action in this direction by the Bank of England alone would be a futility; after all, whatever limit is to be laid down must be a figure arbitrarily imposed, and there is not the slightest guarantee that a reduction of our reserve from £150 millions to, say, £100 millions, would afford more than a temporary relief.

Our present difficulties might well be repeated when our stock approached the new minimum, and in a more acute form, since the lack of a similar policy abroad would merely prove that we had resumed a policy of inflation.

Unless and until the general arrangement suggested by Professor Cassel is made by the various central banks, relief from the present situation of an inequitable distribution of bullion can be afforded only by America, and it would seem that it is only a question of patience in awaiting the change in conditions there which economic factors will inexorably bring about, to find a considerable simplification of the problem of the world's gold for some years to come.

Professor Cassel's opinions have since been confirmed by the findings of the Gold Delegation of the Financial Committee of the League of Nations. The interim report of this body, after an exhaustive and painstaking research, suggests a general world shortage of gold by the year 1940.

CHAPTER IX

THE PRESENT BANK OF ENGLAND RETURN

ANALYSIS of the items in the return—Its use as a guide to the money market—Contrast between pre-War fluctuations and present-day fluctuations in the figures

SINCE the Bank of England is the hub of our financial system both as regards our domestic currency and our affairs as an international market, it follows that the statements it publishes each Thursday are studied with avidity. They not only are a reflection of the affairs of the moment, but read in conjunction with other known factors furnish a guide to the immediate future. This is particularly the case when a Return is considered in relation to those issued during the previous weeks, as the tendency towards future movements in a given direction is indicated by the events just revealed, and the items the fluctuations of which are of the most value in this connection are "Gold Coin and Bullion" in the Issue Department, and the "Other Deposits" and "Notes" of the Banking Department.

It must be borne in mind that the Returns are often cryptic; movements are frequently difficult to follow, and explanation of their causes is mainly speculative, but they are the principal key we have to the policy of the Bank of England, and the slightly more detailed form of their presentation since the fusion of the currency note issue with that of the Bank has made them more informative than they were previously, although in pre-war times there were considerably fewer unexpected factors to complicate the disentanglement of the ravel the figures presented.

The Issue Department.

The first part of the Return, namely, the figures of the Issue Department, present no difficulty, and call for little explanation, the debit side merely showing the liability of the

Bank in respect of its note issue. It now publishes separately the amount "In circulation" and that held as its reserve in the Banking Department, and although the ratio between the two varies considerably the change in the total is governed entirely by gold movements into or out of the Bank. When gold is bought by the Bank additional notes are printed to the value of the purchase, the amount of "Notes issued" on the one side and "Gold Coin and Bullion" on the other being equally increased. If it be withdrawn the "Other Deposits" in the Banking Department will be reduced by the draft made on them by the purchasers of the bullion, and a corresponding amount of notes held in the Reserve of the Banking Department will be presented for encashment to the Issue Department, so that the balance sheet of the latter will show a similar reduction on either side.

If the effects of the gold export are to be nullified, the total of the "Other Deposits" will immediately be restored to its previous level by a purchase of securities by the Bank, the reduction in the "Notes in Reserve" being offset by an increase either in the "Government Securities" or "Other Securities" on the same side of the Balance Sheet.

In illustration of this reference to actual movements is pertinent.

On the 30th January, 1929, "Notes Issued" totalled £412,714,393, representing an active circulation of £355,644,424 and £57,069,969 held in the Banking Department. During the ensuing week the Bank lost gold to the amount of £3,088,216 and the figures published in its Return for the 6th February showed "Notes Issued" £409,626,177 (- £3,088,216) consisting of an active circulation of £357,519,235 (+ £1,874,811) and a reserve of £52,106,942 (- £4,963,027). This loss to the reserve exactly balances the withdrawal of gold plus the expansion in the domestic demand for currency. The figures for 6th February, the next Return after these movements of gold, show an increase of approximately £5 millions in the Government Securities which is in part due to the counteracting of the outflow of bullion.

The Fiduciary Issue.

As the cover for its note issue the Bank of England is permitted, since its absorption of the currency notes, to hold securities and silver coin to a total of £260 millions.

The fiduciary issue is limited to this figure except at times "that it is expedient" that the amount should be increased. Then the Bank may apply to the Treasury for permission to exceed it for a period of not more than six months. The Treasury has power to renew this authority, until two years have elapsed from the time when it was first granted, but should the Bank still desire an increased fiduciary issue it is no longer within the discretion of the Treasury to grant it; Parliamentary sanction must be obtained.

The securities held against the fiduciary issue fall under four headings. The first, a Government debt of £11,015,100 is a permanent figure; it was a loan granted by the Bank of England when first established, to the Government of that day, and has been part of the fiduciary issue ever since. The "Other Government Securities" of the second item were those transferred in November, 1928, from the old Currency Note Redemption Account and their total has shown little change since.

The "Other Securities" represent, first of all, those which the Bank is entitled to hold in respect of the lapsed note issues of other banks, since the passing of the Bank Charter Act, and in addition securities other than those of the Government which the Bank may hold at its discretion.

This marks a considerable advance towards attaining the elasticity that was considered desirable many years ago by the critics of our rigid gold standard. They frequently insisted on the advantages of a currency based upon commercial bills of exchange that were self-liquidating, urging that under such a system our currency could expand and contract automatically with the increased or lessened demand for it. Now, at long last, the Bank is empowered to hold a small proportion of such bills in its cover for notes, and it is highly probable that, with the march of time, they will largely supersede the

Government Securities, as the floating debt shrinks from its present high figure.

Whether the fiduciary issue will then be allowed to vary to meet currency demands of the moment or whether a rigid limit will still be imposed will be, of course, a question for the financial rulers of that day, but if the methods suggested by past critics should be approved, the necessary machinery will already be there.

The Banking Department.

On turning to a consideration of the balance sheet of the Banking Department, three of the items on the Liabilities side may be dismissed in a few words. The "Proprietors' Capital" is self-explanatory, and the "Rest" to the extent of £3 millions is equivalent to the "Reserve Fund" of the other banks. The amount in excess of this figure represents the balances of the Bank's sundry accounts, including the Profit and Loss Account. The maximum of this item is attained shortly before the payment of dividends on the Bank's stock, and its lowest level is shown immediately afterwards.

In years past "Seven Day and Other Bills" reached a comparatively substantial figure, for it rarely dropped below £1 million. Now, however, it is negligible, the Return for 18th July, 1929, showing that the liability for Bank Post Bills outstanding was only £2,058.

Public Deposits.

"Public Deposits," i.e. deposits of public money are the Government balances at the Bank, and their level varies in accordance with a variety of influences affecting the income and expenditure of the Treasury. In the first three months of the year, and to a less degree, in each July, the tax collector is exceedingly busy, and the tendency of his activities is to reduce the "Other Deposits" and to swell the "Public Deposits" as the result of the payment into the Bank of the drafts on account of revenue payments. Taxes are not,

however, collected for the purpose of showing a heavy bank balance, so the opportunity is taken to issue a smaller amount of treasury bills than those maturing during the weeks when the national revenue is in excess of expenditure. These repayments of treasury bills and the excess of revenue cannot synchronize exactly although they do balance over a period, so that the fluctuation in the level of the Government balances may be considerable during those periods. Treasury bills, again, may be responsible for alterations which at first sight are mysterious, in the level of the "Public Deposits."

The maturities during two successive weeks may balance the issue of new bills, but it by no means follows that the daily receipts and payments on this account are in a state of equilibrium. Therefore, should the market, in order to obtain a favourable maturity, elect to pay for its "treasuries" during the latter part of the first week, and the early days of that following, the Bank Return of the second week will show, other things being equal, an increase in the "Public Deposits."

A marked influence upon the level of the Government balance is the payment of dividends upon Government stocks, the most important of these distributions being those of the 5 per cent War Loan on the first of each June and December. In preparation for these disbursements the issue of treasury bills during the previous two or three weeks is invariably in excess of the maturities, and the difference is allowed to remain on deposit with the Bank.

In illustration of these remarks a reference to the published figures may be useful. On the 9th January, 1929, the level of the "Public Deposits" was £11 millions, on the 16th January it was £15 millions, by the following week £17 millions, and it had reached £19 millions by the end of the month. The payment of interest on a maturing series of treasury bonds on the first of the new month reduced the balance, and on the 6th February it had shrunk to £8 millions.

A low figure (£9 millions) was reached in the middle of May after the distribution of interest on treasury bonds, and from then until the end of the month, it was steadily increased until

£24 millions stood to the Government's credit on the 29th, only to be diminished to £8½ millions the following week after the satisfaction of the claims of the holders of 5 per cent War Loan.

Other Deposits.

Since November, 1928, the figures representing the " Other Deposits " have been divided into the two items of " Bankers " and " Other Accounts." This is, in fact, a reversion to the form in which the Bank Return was presented many years ago, and the re-adoption of the old method has been very welcome to the market as the separate publication of the bankers' deposits is a more valuable index to the amount of loanable credit available than the combined total of the two items. It is on account of the practice of the banks in preserving an almost constant ratio between their cash and their other assets that the level of deposits with the Bank of England is so informative; the variations in the amount of credit available are proportionate, with two important exceptions, to the fluctuations of the weekly totals of their cash at the central institution.

The first of these exceptions is the occasion of the half-yearly balance of the banks, when they withdraw money from the discount houses and increase their holding of cash. The last Bank Return issued in 1928 showed the Bankers' Deposits to be £69,489,708 whilst that issued after the close of business on 2nd January, 1929, disclosed a level of £84,916,042. In the Return dated 27th June, 1929, their total was £67,420,265, while in that for the following week it was £75,558,462. The figures for the two periods are not comparable; on the 31st December they would naturally exceed the £84 millions published three days later, and those for the end of June would similarly be heavier than the £75½ millions shown on the 4th July, but the two periods have this in common: loans were greatly restricted at the time when bankers' deposits were attaining their peak, while the opening of each new half year found the plethora of credit which the next returns suggested should exist.

The other exception to the rule that increased bankers' deposits connote "easy money" is on the occasion—mercifully rare—of financial crises. In the past, at such times, it has been the practice of the banks to restrict the credit facilities they have been granting, and to increase their cash holding, so that money is in strong demand when the "Other Deposits" would suggest the reverse.

The payment of dividends on Government stocks has the reverse effect upon "Bankers' Deposits" to that upon the "Public Deposits." The coupons and dividend warrants are paid into the banks, their deposits with the Bank of England are increased, and money is temporarily plentiful.

The first Bank Return after the dividend on the 1st December, 1928, in respect of the 5 per cent War Loan was published on 6th December, and showed an increase of £16 millions from the previous week in the bankers' deposits in spite of the market having had five days in which to make use of the increased credits. During this week money could be borrowed by the discount houses at the rates of $2\frac{1}{2}$ per cent and 3 per cent as opposed to the clearing bankers' figure of $3\frac{1}{2}$ per cent.

On the 6th June, 1929, after the next distribution of interest on the War Loan, the bankers' balances had increased by £14 millions, and money was lent at $3\frac{1}{2}$ per cent against the clearing bankers' $4\frac{1}{2}$ per cent.

During a period of neutralization of the effect of gold movements, the bankers' deposits show few variations apart from those caused by the disbursement of Government dividends, and except for the weeks when their influence is felt, the average figure of the bankers' balances has been £60 millions. Broadly speaking, the greater the excess of "Other Deposits" over "Other Securities," the greater the ease in money.

Government Securities.

This heading on the assets side of the balance sheet comprises, as its name implies, the Bank's investments in Government securities of various descriptions, but it should be noted that this holding of securities excludes treasury bills which

the Bank may, from time to time, buy from discount houses. Purchases of this description go to swell the "Discount and Advances" subdivision of "Other Securities." "Government Securities" are swollen on the occasions when the Treasury seeks an overdraft from the bank to anticipate revenue shortly due to come in. The best example of this, again, is when the big Government dividends are paid.

Preparation for these, as already pointed out, is made by an increase in the amount of treasury bills issued, so augmenting the Public Deposits, but in addition to this extra borrowing from the money market, the Treasury is obliged to seek assistance from its bankers under the guise of Ways and Means advances. So we find that on the 29th November, 1928, the Bank of England's holding of Government securities amounted to £52 millions, but by the week following had risen to £64 millions.

The Bank of England, in common with the other banks and the discount houses, applies for treasury bills on their issue, and payments in excess of maturities will, therefore, swell the total of "Government securities." During the first week of August, 1929, there were issued treasury bills for £5 millions in excess of those falling due, and the natural inference was that stringent monetary conditions would prevail as the result of the taking up of this additional amount. But, on the contrary, money proved unexpectedly easy during that time, and the explanation was furnished when the Bank of England published its return on the Thursday, showing that its holding of Government securities had increased by £12 millions, principally as the result of the Bank's buying the new bills, and the bankers' deposits had also risen from £60 millions to £67 millions.

Again, the "Government Securities" will generally show an increase when exports of gold have been heavy, in order to neutralize the effect of the outflow. Between the 25th July and the 1st August, 1929, gold was being withdrawn by France and the Bank lost £8 millions during that week. The "Government Securities" rose by £11½ millions in the same period, the balance of £3½ millions representing purchases of treasury bills.

"Government Securities" is an item which is naturally liable to considerable variations, that, with the exception of an increase to be expected immediately before the payment of big Government dividends, cannot well be anticipated. The lowest level it has reached in the first half of 1929 was £36,211,855 on 13th June, but on 27th of the previous December it was £67,296,855, and on the 8th August, 1929, the high total of £74,266,855 was attained.

Other Securities.

The "Other Securities" are now divided into "Discounts and Advances" and "Securities," the latter representing the Bank's investments other than those of the British Government.

Although bank rate is the official minimum rate of discount for approved bills, yet the Bank of England will, in common with the other banks, buy bills from its own customers at the rates current in the discount market, and purchases of this description are the foundation of "Discounts and Advances."

When, however, monetary conditions are sufficiently stringent to force the discount brokers "into the Bank," both the loans they obtain and the bills they discount will swell this total.

Recourse to the Bank of England by the discount market has been necessary far less frequently since the raising of the embargo on gold exports than formerly was the case; indeed, it is now only at the end of each half year that the assistance of the Bank has to be invoked to any marked degree. While the margin between the market rate of discount and bank rate is so narrow, there is always the danger of considerable applications to the Bank of England having the effect of forcing the bank rate to rise when it is not desirable for it to do so. Consequently, when the discount market is "near the Bank"—and this stringency in money is usually caused by the incidence of payments for treasury bills—the Bank of England will often afford relief by an indirect purchase of bills, sometimes treasury bills, but more frequently commercial bills,

at the market rate of discount. When buying such commercial bills the Bank will take only the best; it is even more rigid in its selection of names than when it discounts them directly for the market at bank rate.

Either of these operations, i.e. a direct or an indirect purchase from the discount market will swell the total of "Discounts and Advances."

When the banks are compiling their half-yearly balance sheets and calling in loans heavily in order to augment their cash holdings, the discount houses are perforce sent to the Bank of England to satisfy the demands made upon them by the other banks, and accordingly a considerable increase is to be expected, both at the end of June and the end of December, in the Bank of England's "Discounts and Advances." On the 13th December, 1928, its figure was £11,185,832, rising to £15,667,010 the following week, and to £25,931,966 by the 27th. The increase during the first of these two weeks was obviously accounted for by a precautionary sale of early January bills by the discount houses; the ten million rise during the second week was due more to weekly loans granted by the Bank. That the applications during the last few days of the year were of an extremely heavy character is revealed by the figures published on the 3rd January, 1929. "Discounts and Advances" then totalled £47,745,162, more than four times its total three weeks earlier, after the loans due on the 1st and 2nd January had been repaid, and those may be estimated to have amounted to £10 millions. These figures indicate that between the 12th December and the end of the year, the assistance sought by the discount houses amounted to approximately £47 millions.

The return of the 10th January shows a drop from £47,745,162 to £14,686,357, and this covers the period during which loans were repaid. The bills discounted had not, however, all run off by this time, but their maturity between the 11th January and the end of the month reduced the total to £9,657,227.

A very similar state of affairs is revealed by the returns

covering the latter weeks of June and the month of July, 1929. A total of £5½ millions on the 13th June increased to £27 millions by the 27th and £52 millions by the 4th July, and this figure gradually shrunk as the result of repayment of the loans and the maturity of the bills until on the 25th July "Discounts and Advances" were a trifle under £9½ millions.

Loans are never granted by the Bank of England to the discount houses for a shorter period than seven days, but the amount the Bank will lend for a week on any given day is strictly limited, so that the unfortunate bill broker who is in need of more than his allotted share will have to borrow the excess for eight or sometimes nine, and in extreme circumstances, even for ten days. The rate charged for these loans is invariably $\frac{1}{2}$ per cent over bank rate, and, consequently, being forced into the Bank for so long a period is a decidedly unprofitable experience, and the wider the margin between bank rate and the rate at which the broker has bought his bills, the more expensive his borrowing from the Bank will prove to be.

When discounting bills for the discount houses, the most usual practice is for the Bank to insist that no bills they buy shall have a shorter currency than fourteen days, or a longer than twenty-eight, and every parcel must have an average length of three weeks. This rule, however, is not invariable, and the Bank will alter it in accordance with the exigencies of the moment; for example, should a rise in bank rate be imminent a shorter average currency would be demanded.

Reserve.

The two final entries on the "Assets" side of the bank return together represent the final banking reserve of the country. They are, firstly, the notes which are not in active circulation, and the "Gold and Silver Coin" which is the "till money" of the Bank, and the fluctuations in its level are naturally of the utmost importance to the banking community and, indeed, to the country in general.

The total of the Reserve is subject to the acquisition or loss

of gold and, in addition, is affected by the variations in the demand for internal currency. Both these factors must be studied before determining whether the state of the Reserve forebodes any alteration in the bank rate, for its total, regarded by itself, may convey a false impression. A demand for increased currency may coincide with an outflow of gold and the combined effect of the two movements may reduce the Reserve to a point at which the proportion it bears to the Bank's liabilities is a very low one, and yet the bank rate may not be advanced. It is well known that increased demands for internal currency are usually seasonal and, therefore, temporary. Hence, the additional notes withdrawn from the Bank may be expected shortly to return and again to swell the Reserve. On the other hand, currency returning from circulation at a time when gold is flowing abroad may prevent a depletion of the Reserve, but should the outflow of gold happen at a time when the Bank's stock of bullion is dangerously low, and the exchange rates do not respond to the exports, then a rise in the bank rate may well be expected.

Figures recently published by the Bank will illustrate this statement. In the latter part of 1928 the Bank had suffered severe encroachments upon its stock of bullion. On the 3rd January, 1929, it stood at £153 millions, the active circulation, still swollen by notes withdrawn for the Christmas demand, was £378 millions and the Reserve only £35 millions. On the 30th January the stock of gold was practically the same as it had been three weeks earlier, but the trickling back of notes from the country had reduced the circulation from £378 millions to £356 millions, and the Reserve had consequently improved to £57 millions, and showed a proportion of 49.75 per cent of the liabilities. By the following week a further £2 millions of notes had returned from circulation, but a loss of further gold reduced the "Gold Coin and Bullion" in the Issue Department to £149½ millions, and the bank rate was advanced from 4½ to 5½ per cent despite the fact that the Reserve stood at £52 millions and was 46 per cent of the liabilities.

The figures for July, 1929, illustrate the reverse case. Throughout this month the Bank suffered a steady loss of gold and was subjected, at the end of the month, to the usual demand for currency that is a feature of the holiday period, with a consequent severe depletion of the Reserve. "Gold Coin and Bullion" shrank from £154 millions on 3rd July to £140 millions on 7th August, while the note circulation crept up from £369 millions to £376 millions. The Reserve was accordingly reduced from £46½ millions to £25 millions when its proportion to liabilities was as low as 22·4 per cent, and yet the bank rate remained unchanged. It is only fair to state, in quoting these figures published on the 8th August, that considerable surprise was felt when they were made public, that no increase had been made in the official minimum, particularly in view of the fact that the stock of gold had fallen £10 millions below the prescribed minimum of £150 millions. Indeed, there was such general trepidation that on the Friday morning inquiries were made at the Bank as to whether any change was being made on that day, and the Governor of the Bank took the unusual course of issuing a re-assuring statement to the effect that he contemplated making no alteration in the immediate future unless his hand were forced by circumstances that could not be foreseen at the moment.

Certain movements in the Reserve are purely of a seasonal character, and may be anticipated every year with unfailing regularity, the chief of these being in its depletion before each Christmas and at the end of each July by reason of the withdrawal of notes for expenses incidental to the holiday season. A similar decrease is experienced at Easter and an almost negligible one at Whitsuntide. The notes withdrawn at these periods, however, rapidly drift back to London, those drawn before the August holidays being slower in their return, so that in January and September the Reserve is either definitely increased by this movement, or its depletion, should there have been an outflow of gold at these times, diminished. The notes in circulation on 27th December, 1928, were £388 millions, their

total was reduced by £10 millions in the next week, and by a further £17 millions during the following fortnight.

Aside from the holiday influence, the Reserve is little affected by matters concerning the note circulation except when trade conditions in the country cause a variation in the demand for currency. At a time of a growing prosperity brought about by buoyancy of industry, employment will increase, and for satisfaction of the wages bill more notes will be withdrawn from the Bank of England. A depletion in the Reserve occasioned by a trade boom will be accompanied by a corresponding reduction in the "Other Deposits," and since the accommodation the industrialists require in the shape of loans and overdrafts will be furnished by the banks at the expense of the discount houses, at such a time money will be "tight" in the discount market. The stringency will later be accentuated by the increase, consequent upon expanding trade, of the bills of exchange offered for discount in London, and the discount market may be forced "into the Bank"; a state of affairs that will be reflected in the bank return by an increase in the "Discounts and Advances" on the one side and "Bankers' Deposits" on the other. To sum up, a trade boom will increase the note circulation and deplete the Reserve. The drop in the Reserve will be compensated by a rise in the "Discount and Advances" if the requirements of trade be sufficiently large to force the discount market to borrow from the Bank of England or by a fall in the "Bankers' Deposits" should the bill brokers be able to find sufficient funds outside the central institution.

Conversely, general trade depression leads to "easy money" in the market and, somewhat paradoxically, to strength in the Stock Exchange prices for Government securities. The explanation is that traders repay their borrowings from the banks, and a steady stream of money comes from the provincial branches to head offices for employment in London. Consequently, the discount market encounters a plethora of funds and the bankers' deposits with the Bank of England are increased. Manufacturing business being slack, industrialists

will use funds, which ordinarily they employ in their business, to purchase gilt-edged stocks, to be liquidated again when their trade revives.

In the past certain bullion movements—which affect the Reserve—have also been seasonal. As previously mentioned, our trade with U.S.A. resulted in an adverse rate of exchange, from the English point of view, in the Autumn, and an improving one in the Spring. The movements usually went as far as the bullion points with a consequent loss of gold by the Bank of England during the latter part of the year, to be compensated later by an influx from New York. A change has come over our trading conditions with America during the last few years, but the diminution in the autumn drain on account of trade requirements is countered by the British Government's demand for dollars in preparation for the payments made each December in New York in connection with our War debt to America. Similar preparations during the spring for the June payment of interest check the buoyancy of the New York rate that might otherwise be expected, and preclude a gain to the "Reserve" from gold shipments across the Atlantic in an easterly direction.

Our free gold market, coupled with the facility with which credit may be obtained in London, makes our foreign exchanges very sensitive, and since our "return to gold" in 1925 the "Reserve" has been constantly denuded by foreign demands for our bullion, and the ravages have been laboriously repaired by purchases of the output of the South African mines. The state of the Reserve and that of the bullion are a constant pre-occupation of the authorities of the Bank of England, whose most potent weapon in their defence is the official rate of discount. At times this weapon is rather blunted; for six months in 1929 the Bank Rate was maintained at the highly penal figure of $5\frac{1}{2}$ per cent, and yet the stock of gold was £12½ millions below its level when the bank rate was raised from $4\frac{1}{2}$ per cent. Although £10 millions below the prescribed minimum, it was felt that the amount of bullion would not be augmented by shipments from other money markets were the

bank rate yet further advanced, and such an action would only be damaging to the country's trade. This confession of failure was due to circumstances to be discussed in the next chapter, but it is a serious matter when the most delicately-organized money market of the world should fail to respond to the movement of the governing lever.

Proportion.

The actual size of the Bank of England's reserve is not so important as the relation it bears to the Bank's liabilities to the public, i.e. the total of Public Deposits, Other Deposits, and Bills.

The strength or weakness of this ratio was, in the past, the chief guide of the student of the bank return to the policy of the authorities in regard to the bank rate. When the proportion rose to nearly 50 per cent, a reduction in the bank rate was usually foreshadowed, while, on the other hand, if it sank to the neighbourhood of 30 per cent of the liabilities, a rise might confidently be expected. There was an exception to this course when the reduction was due to a purely temporary circumstance, such as heavy borrowings by the discount market at the end of the year. This would increase the liabilities in respect of "Other Deposits" and the Reserve, *ceteris paribus*, remaining the same, the proportion would be reduced.

Again, if the Reserve shrank as a result of the holiday demand for currency, the proportion would again be lowered, and no change would occur in bank rate even though this reduction in the Reserve brought the proportion to so low a figure as 30 per cent. The proportion is not now so sure a guide as in years gone by. That it is still a factor of importance goes without saying, and the Reserve is the final banking reserve of the country, but since our return to gold in 1925 the aggregate of the Bank's stock of the metal is the more decisive factor, although the total of the Reserve is very closely linked with that of the "Coin and Bullion."

From 1925 to 1929 the Bank Rate was perforce maintained at high levels, and nobody would have been more inclined in

the interests of trade—and of the taxpayer—to reduce it than the Bank authorities themselves. Unfortunately, circumstances did not prove propitious to movements in a downward direction. Owing to the proximity of the gold store to the "poverty line" of £150 millions, and despite a Reserve of £59 millions at the end of February, 1929, bearing a proportion to the liabilities of 54·7 per cent, no reduction could be made, nor, on the other hand, was the rate raised when the Reserve shrank to £25 millions on 7th August with a proportion of only 22·4 per cent.

The gold situation is now paramount; a reduction of the bank rate when the Reserve and proportion were high in the early days of 1929 was not only impossible on account of the state of the foreign exchanges, but the rate had to be advanced in order to conserve the stock of gold.

The continuance of the 5½ per cent rate enabled the gold to be increased to £163 millions by the 13th June, and the wisdom of its maintenance while the holding was slowly being augmented is manifest in the light of the events of the period between the middle of June and the 7th August. Despite the high bank rate gold disappeared from the coffers of the Bank, and by the latter date was at the low figure of £140 millions. Then every factor seemed to imply a further increase in the rate—a dangerously low stock of gold and important exchange rates either at export gold point, or at only a slight fraction above it; a very low Reserve and a small proportion to the liabilities. But at this time the Paris exchange at last grew responsive to the exports of bullion and the French demand ceased. The bank rate was allowed to remain where it stood; the opinion of the authorities being that by raising it, internal burdens would be increased without the prospect of their early reduction by the attraction of foreign gold to London as a result of the higher rate.

In studying the bank return it must be borne in mind that a new set of factors is operative; the principal being that the artificiality of credit conditions occasioned by the War still persists for the reason that the credit-fund of the

country cannot always be allowed to vary in proportion to bullion movements.

When the time is ripe for completely abandoning the policy of neutralizing gold imports and exports, the old principles familiar to students of economics will again be in operation, and although there is at present no indication of the approach of that moment, its arrival will be extremely welcome. It will indicate a healthier condition of trade when it no longer should require to be sheltered from the effects of gold movements, but that shelter will probably be needed so long as the intermittent movements of bullion in and out of the country are on so large a scale as they are at present. The London money market as a whole, and the discount section of it in particular, will greatly benefit when no longer working in the artificial atmosphere that the neutralization of gold shipments causes.

For purposes of comparison, the last representative bank return published before the War is given on page 158 with the one for the corresponding week in 1929 on page 159.

The points of difference between the Returns of the Issue Department are, first, the increase in the gold stock now held by the Bank and, secondly, the reduction of its proportion to the note issue. The total of gold in circulation in 1914 has been variously estimated, the most conservative figure being £100 millions.

Apart from a quite negligible quantity that has been hoarded this was replaced by currency notes and returned to the Bank of England, the coffers of which were further replenished by the exchange for notes of the bullion that other banks were then in the habit of keeping in their own vaults. On balance the gold in the country is, therefore, below its pre-war level, although the fact must be emphasized that it is now concentrated in the Bank of England, and hence always available, whereas then three-quarters of it was scattered, and its mobilization was a matter of considerable time. The note circulation in those days was more than covered by gold. In July, 1929, the proportion of gold to the circulation was only 40·6 per cent, and liable to reduction with every fresh export of bullion.

In the Banking Department the outstanding change is in the Other Deposits, and is symptomatic of the inflation the country has endured since 1914. Bank deposits having been increased during the inflationary period, the amount of "Cash at Bank of England" maintained by the banks has been proportionately greater. It is now approximately £10 millions below the figure it reached before a policy of deflation was instituted.

In the days before the War the "Other Deposits" indicated the necessity for the discount houses to resort to the Bank of England for assistance when the amount of this item fell below £40 millions. When inflation reached its peak the market's "poverty line" was £105 millions, while now it is unusual to find the discount houses "in the bank" when the "Other Deposits" are as low as £95 millions.

On the other side of the balance sheet it is in the "Government Securities" that the chief compensation for the rise in the "Other Deposits" is to be found. Of the intimate details of this item one can only conjecture, but it is highly probable

BANK OF ENGLAND

AN ACCOUNT FOR THE WEEK ENDED ON WEDNESDAY,
THE 22ND DAY OF JULY, 1914

ISSUE DEPARTMENT

Notes issued	£ 57,914,410	Government debt	£ 11,015,100
		Other securities	7,434,900
		Gold coin and bullion	39,464,410
	<u>£57,914,410</u>		<u>£57,914,410</u>

BANKING DEPARTMENT

Proprietors' capital	£ 14,553,000	Government securities	£ 11,005,126
Rest	3,456,453	Other securities	33,632,762
Public deposits	13,735,393	Notes	27,697,120
Other deposits	42,185,297	Gold coin and bullion	1,609,931
Bills	14,796		
	<u>£73,944,939</u>		<u>£73,944,939</u>
		Proportion	£52 7s. 6d.

Dated the 23rd day of July, 1914.

that the Bank's investment in War Loan, War Bonds, and other modern issues of the Government are higher than their pre-war holding of Consols and kindred securities. There is no doubt, however, that the great bulk of the increase under this heading consists of the holding of treasury bills.

The Reserve again is considerably higher in the more recent return, as is only natural in view of the changes in the other items in the account, and although, in the two returns cited, the proportion of the Reserve to liabilities is much lower in 1929 than in 1914 (39·7 per cent against 52·375), it is still at a figure that would have caused little or no perturbation at the earlier date.

As previously stated the Bank returns furnish a valuable guide to the money market, but, somewhat paradoxically, although the modern method is more informative than the old the market was able to learn more from the older ones than it can from the newer.

BANK OF ENGLAND
AN ACCOUNT FOR THE WEEK ENDED ON WEDNESDAY,
THE 24TH DAY OF JULY, 1929

ISSUE DEPARTMENT

	£		£
Notes issued—		Government debt	11,015,100
In circulation	367,332,145	Other Government securities	234,993,474
In banking department	42,134,485	Other securities	9,148,573
		Silver coin	4,842,851
		Amount of fiduciary issue	260,000,000
		Gold coin and bullion	149,466,630
	<u>£409,466,630</u>		<u>£409,466,630</u>

BANKING DEPARTMENT

	£		£
Proprietors' capital	14,553,000	Government securities	50,781,855
Rest	3,516,450	Other securities—	
Public deposits (including Ex-		Discounts and ad-	
chequer, savings banks, com-		vances	£9,426,937
missioners of national debt and		Securities	£23,672,822
dividend accounts	11,684,787		33,099,759
Other deposits—		Notes	42,134,485
Bankers	£61,009,441	Gold and silver coin	1,233,528
Other accounts	£36,483,919		
	97,493,360		
7 day and other bills	2,030		
	<u>£127,249,627</u>		<u>£127,249,627</u>

Dated the 25th day of July, 1929.

The disturbances of which the various monetary centres have been the victims latterly have been more violent and sudden than any experienced in pre-war days, except in times of crisis. The movements of those harmonious days were not only smaller but could be forecast, exchange rates were not so liable to the violent oscillation that is their modern characteristic, and the present bugbear of the Bank of England—unexpected withdrawals of gold to the extent of several millions—was non-existent.

Exchanges then responded to bullion shipments, and raising the bank rate was an effective corrective of a diminishing reserve, by attracting gold from abroad. Moreover, such an attraction of gold was necessary only in the interests of the banking reserve; now, however, it is desirable also to maintain an adequate margin between the total of the note issue and the fiduciary portion of it.

Since a rise in the Bank Rate is not always now a certain expedient either to attract gold, or to prevent its loss, the published figures do not give the same indication of its probable movement, and the market has, in consequence, to tread warily. The discount houses have done so in difficult times, such as those that prevailed in 1929, by keeping their quotation for bills a mere fraction below Bank Rate, and hence, to prevent their hands from being forced, the authorities have then found it necessary to keep the discount market out of the Bank.

The "Other Deposits" accordingly furnish little indication of the market's resources, for when their total suggests a tightness of funds sufficient to make the discount brokers apply for its assistance, the Bank of England will promptly restore the level by the purchase of bills.

It is only to be expected, however, that difficulties of this nature must survive until the world gets farther away from the centre of the eddy caused by the War in the financial pool; it is already reaching the outer ripples, and will eventually attain the placidity to which it was previously accustomed.

CHAPTER X

THE INFLUENCE UPON LONDON OF FOREIGN MONEY MARKETS

THE financial rehabilitation of the Continent—The Federal Reserve system of America—The influence on London of foreign borrowings—The effect upon the exchanges and the gold position of the results of stabilization

IN the history of the past it has always been the experience of any one of the great financial centres to find its general policy largely dictated by the conditions obtaining in foreign money markets. London, by reason of its pre-eminence and particularly on account of its having been the only completely free gold market, has always been the most sensitive to happenings abroad.

Post-war Sensitiveness.

Now, however, the influence of other markets on London is more marked than ever before, as the War has increased to an astonishing degree the financial interdependence of nations. This close relationship is still particularly noticeable on account of the fact that the financial world is even yet in a period of transition between the completely abnormal conditions of the War years and those of ordinary working, and is still engaged in a process of "clearing up." The re-linking of currencies to gold is now almost complete, and only a very few of the relatively unimportant centres have yet to take that highly necessary step, and the methods adopted by the principal countries have already been discussed.

Great Britain, America, France, Belgium, Switzerland, and the Scandinavian countries all can boast of being free gold markets, but much yet remains to be done before a state of normality can be said to prevail, and in the interim these centres, and London more than the others, are affected by the artificiality that still prevails.

The return to the gold standard of the belligerents and those

neutral countries which had been divorced from it by the War was primarily undertaken for the domestic advantage of each, but in the case of those which took part in the hostilities this policy was closely related to the settlement of the obligations which arose from war conditions. Credit is the lubricant of the wheels of trade, and credit was realized to be unobtainable unless a satisfactory settlement could be arranged for the immense international indebtedness that had been incurred whilst the Powers were at grips with one another. London, too, realized that, until she returned to a gold standard, she could not hope again to become the international market for loans and credits that she had always been before the War broke out.

The continental allies were in debt to Great Britain, she, in turn, to America, for after her power of lending to her associates had been exhausted, she "backed the bills" which they gave to America in return for further assistance. The end of the War, therefore, found Europe in fee to America, and the question still to be decided as to how much would be recoverable from the defeated countries.

Reparations and Indemnities.

Although twelve years have passed since the nations were first able to take stock of the situation and to adopt measures to deal with it, many of the agreements made were tentative, and some, indeed, proved abortive and required amendment. The payments enforced from Germany have proved onerous to that country to the point at which—in the latter part of 1930, when Germany was suffering, in common with the rest of the world, from acute trade depression—it was rumoured that she would have to seek a moratorium in respect of her reparation payments. As a palliative, a credit was raised in New York to the extent of \$125,000,000 on German account in October, 1930. It was noticeable that, immediately after the grant of this credit the New York Exchange on London recovered, while the Berlin rate, which until that time had been moving strongly in favour of this country, fell rapidly

away. The inference is, of course, that Germany availed herself of the credit via London, and the incident is an illustration of the influence upon London of foreign money markets in respect of transactions in which we have no direct interest.

The position as it now stands in respect of obligations that are the direct outcome of the War is that the Allies are receiving reparation payments from Germany; Italy and France are making half-yearly payments to Great Britain and America, whilst Great Britain has bound herself to payments to America which, up to date, have cost her some £200 millions more than she has received from the Continent. The agreements that have already been made and their regular fulfilment have done much towards restoring the trade of the world.

The importance of such arrangements is emphasized by the absence of a similar recovery of the trade of Russia, a country in default of her outstanding obligations. She, of course, is in urgent need of foreign credits for her national development, but her repudiation of her foreign pre-war debts has caused a natural reluctance on the part of foreign lenders to grant her accommodation with the result that she is negligible as a trading nation, and is forced into a dependence upon her own resources, as the power of exchanging surpluses of her own production for those of other countries is almost non-existent.

Britain's Changing Trade.

The trade of Great Britain has very naturally undergone a considerable change from its former state. In the days of depreciating currencies it suffered a severe, though passing, handicap from the competition engendered in the world's markets by the "bounty" its foreign rivals derived from their monetary conditions. Business with Russia, which, before the War, was considerable, is practically at a standstill; trade with Germany is far below its magnitude in the days when she was our second largest customer. Again, political disturbances in the Far East have had a serious effect upon our production and export of cotton goods, and our foreign sales of coal—the only raw material we export—have been diminished by

the growth of the use of other forms of fuel, and further crippled by German coal forming part of her payment of reparations in kind.

Our foreign trade, therefore, has had to seek new channels as compensation for the decreasing flow through many of the old, but its expansion is of paramount importance in view of our debt settlement with America. The service of this debt demands payment in goods and services either directly to the United States or to other countries which, in turn, are entitled to dollars.

The New York Exchange.

Payment to America in goods has been made increasingly difficult by the tariffs imposed by that country for the protection of her own growing industries, and her lending to Europe and investments in foreign securities are much below the figure that her prosperity would seem to justify. Added to this, during the years 1928 and 1929, the prolonged boom on Wall Street attracted foreign money there in addition to causing the withdrawal of American balances from abroad.

This being so the foreign exchanges all moved heavily in favour of America, with the consequence that London and the continental money markets fell under her domination, and the settlement by means of goods and services had to be supplemented by payments in gold to the mutual embarrassment of both debtor and recipient.

The question may well be asked: "If the constant gold movements were as unwelcome to America as to Europe, why did not the authorities in New York modify their policy for the mutual benefit of themselves and foreign financial centres, particularly since there is a continuous interchange of views between the governors of the principal central banks and their relations are completely harmonious?" The answer is that the New York money market is so constituted that the central bank cannot exercise the same degree of rigid control that the Bank of England can make felt in London, and the market in America became out of hand.

Further, the relief that would be afforded by the American

granting of commercial credits is lacking owing to the fact that foreign merchants generally prefer the facilities obtainable in London to those in New York—in other words, the American market for acceptance credits is by no means fully developed. Finally, the preference of American investors for dollar securities is always too strong to encourage hope for relief from considerable purchases of European stocks and bonds, and the popularity of their own is markedly great at such times as their stock markets are buoyant and general optimism prevails in regard to prospects for the immediate future.

That war debts should give to New York the power to dominate foreign markets is understandable, but that American Stock Exchange speculations should be able to exert so harmful an influence on other countries suggests that steps might be taken to remedy a situation that does no good to America, while it damages her friends abroad. The very fact that stock market speculation persisted for three years with little or no check to its growth leads to criticism of the imperfect functioning of the Federal Reserve system, and it certainly must be admitted that, side by side with the undoubted strength of that system, there are certain inherent weaknesses.

America's Federal Reserve System.

The banking system of America differs from ours at the outset by consisting of a multiplicity of banks instead of a few with ramifications throughout the country, although recently there has been a considerable movement in the direction of amalgamation among the bigger establishments. To overcome the drawbacks of scattered reserves independently held, the Federal Reserve system enables them to be concentrated into a series of separate pools which, in turn, are connected one with another.

The country is divided into twelve Federal Reserve districts in each of which is established a central bank, the capital of which is provided by the subscription on the part of each member bank in the district of 6 per cent of its own capital and reserve. One half of this subscription is paid up, while the

Federal Reserve authorities have the right to call up the remainder at any time.

It is compulsory for all national banks and optional for state banks and trust companies to be members of the system.

The minimum reserve which each American bank is obliged by law to maintain must be deposited, in the case of member banks, with the Federal Reserve bank of its district. The latter is obliged, in turn, to keep 35 per cent at least of its deposits in cash, but may invest the remainder. In order to remove the incentive to employ their funds to the limit the Federal Reserve banks are restricted to a profit of 6 per cent upon the stock owned by the member banks; any margin in excess of this goes to the Government. Consequently, their cash reserves are nearly always well in excess of the legal minimum of 35 per cent of their deposits.

The reserves of the different districts are not concentrated in one centre, such as New York, but their separation is not complete, since one Federal Reserve bank may discount the bills held by another thereby preventing the districts from becoming so many watertight compartments. Indeed, the Federal Reserve Board may "require federal reserve banks to re-discount the discounted paper of other federal reserve banks at rates of interest to be fixed by the federal reserve board."

A Federal Reserve bank may, when necessary, make its rate effective by the sale of bills and Government or municipal securities, and, on the other hand, the reserve of one district may be, in part, transferred to another by the Federal Reserve bank of the first purchasing bills or bonds in the second.

In short, therefore, there are twelve centres in the country in which short loanable funds are concentrated, with provision for the transfer from one experiencing small demands to another whose need is more urgent. Theoretically, each district is independent of the others in the matter of the re-discount rate of its Federal Reserve bank, though, as a matter of practice one rate generally rules throughout the country.

From time to time, however, one Federal Reserve bank will

raise its rate without a corresponding adjustment on the part of the others following immediately. They are not, as a rule, long in coming into line because the higher rate of one district indicates a shortage of funds there, and its Federal Reserve bank is able to relieve its necessity by re-discounting the bills it has bought from its member banks with the Federal Reserve bank of a district where the rate is lower. The result is that there is in America a mobility of loanable credit which is comparable with that to be found in this country, but the essential difference between the two banking systems is that, in the United States, banks can help themselves at the central bank by presenting their bills to it for re-discount; moreover, they can "create" finance bills and discount them with the Federal Reserve Bank, whereas in London there is a useful buffer between the banks and the Bank of England in the shape of the discount market. The American banks look upon their re-discount facilities with the Federal Reserve Bank as their source of supply of cash in much the same way as London banks regard their loans to the discount houses, but with the important difference that bills may be "melted" at the Federal Reserve Bank to a considerably greater total than English banks would deem prudent to call in from the discount market. This facility for obtaining vast sums of liquid cash might appear a point in favour of the American system, but when such funds are applied to the financing of pure speculation, a strain is thrown upon the central bank, and no useful purpose is attained. The American banks have financed a boom in Wall Street to the extent of \$6,020,000,000, the figure published as the total of "brokers' loans" on the 8th August, 1929.

This gigantic total has been made possible by the banks supplying themselves with cash at the Federal Reserve bank in New York,¹ although it must be pointed out that another factor, foreign to English banking traditions, also comes into

¹ According to the circular of July, 1929, of the National City Bank of New York, re-discounts fluctuated between \$900,000,000 and \$1,000,000,000 for several months.

play. This feature is that American banks are willing to act as brokers to individuals or corporations desirous of lending money to the Stock Exchange, by passing such accommodation on to borrowers at a rate fractionally higher than they themselves pay for it, and when doing so they stipulate that the lender shall have no right of recourse against the bank in the event of the borrower's failure. No doubt money is often lent privately to the Stock Exchange in London, but the banks do not act as intermediaries for such transactions, and so, by the relative paucity of the money lent in such a manner, the restraining influence of the Bank of England is not weakened in the same way that the control of the Federal Reserve bank of New York suffers as a result of these operations.

The persistence of the Wall Street boom was a most powerful magnet for drawing money to New York. Had other influences been normal, this could have been disregarded, but the constant demand in other centres for dollars in settlement of war debt payments, coupled with an increasing American export trade and a diminishing—or, at least, non-expansive—granting of foreign loans by New York focused attention upon the effects of this speculation on the world's money markets. American authorities felt its influence to be baneful there as well as damaging to Europe, and the weakness it has revealed in the Federal Reserve system calls for remedial measures.

Tentative efforts, within the existing scope of that system, were taken. The official re-discount rate in New York was raised to 6 per cent without alteration of the rate at which trade bills would be discounted; the object of the step being to check the speculative elements without imposing a handicap upon the trade of the country.

The immediate result was a sudden drop in the quoted prices of securities, but the subsequent realization that the advance was insufficient to restrict the amount of the loans demanded by Wall Street led to a general recovery, and the action of the central bank proved largely nugatory. The New York exchange rate hovered round about gold point, and

the Bank of England was still liable at any time to lose more gold to America where the redundancy of the metal made further additions to its stock as undesirable as its loss would have been to this country.

As all other booms of a like character, the one that raged in New York finally burnt itself out. Although eventually to the general benefit, other centres were bound to be adversely affected at first by its sudden cessation. The possibilities of profit-making from this boom prompted European speculators to participate in it, and losses that arose from its failure accentuated the difficulties experienced both in London and continental markets. But such losses proved small so far as London was concerned; since the difficulties they created constituted a Stock Exchange problem the money market as a whole was little affected.

The Weakness of the Federal Reserve System.

The weakness of the Federal Reserve system seems to lie in the fact that it is unable to contract credit with the same ease that it may expand it, and the effort made to check the demand for accommodation by raising the rate of re-discount to member banks whilst retaining a low discount rate in the interests of trade, seems a hopeless proceeding when considered in the light of the treatment that would be accorded to a similar state of affairs in this country.

Were a Stock Exchange boom in London to attain considerable magnitude and to cause high rates to be offered for loans to finance it, the banks could satisfy it in part at the expense of the discount houses. It is highly improbable that they would assist an unhealthy growth, but on the unlikely assumption that the rates the Stock Exchange was willing to pay tempted them to call in a large proportion of their loans to the discount houses, the latter would be forced to borrow heavily from the Bank of England, and considerably to restrict their purchases of bills. The result would be a rise in discount rates to a point that would force an advance in bank rate. Indeed, to suppose the situation analogous to that which

existed in New York, the hands of the Bank authorities would be forced to a succession of increases in the rate. Each increase would, however, impose a further burden upon traders and manufacturers, and the brake being thus applied to their progress the speculative bubble would be pricked by the market value of their shares adjusting itself to the new conditions.

The raising of the New York Federal Reserve rate did not penalize American industries, and the supply of credit to Wall Street being so little reduced by it, the speculation still continued.

As, too, it is a popular method for profits to be distributed in the shape of bonus shares rather than in dividends, it is obvious that share values were being progressively overrated, and such a policy must always bring the time of collapse nearer to hand. "Watering" of capital during a period of unusual prosperity is nearly always dangerous in the long run.

France.

While the London market suffered from the unfortunate events in America, it was subjected to considerable difficulties that arose from the financial re-habilitation of France. She, as already pointed out, underwent a long period of currency inflation during the years immediately following the War. But this creation of credit was undertaken for the very practical purpose of enabling her to repair the devastated areas, and to re-establish her ruined industries. That it was successful in this was shown by the general expansion of her trade and the almost complete disappearance of unemployment amongst the ranks of her workers. But a very natural result of the continuous depreciation of the purchasing power of the franc was for capital to be transferred to London and New York—and to the former most particularly—to ensure the retention of its original purchasing power at any time when it should be desirable for it to be re-transferred to Paris. Vast sums accordingly lay in London on French account not merely until the time when inflation ceased after the national budgets could be made to balance without the assistance of fresh Government borrowings, but until the future was assured by the official re-valuation

of the French currency by the law of June, 1928. After that it was only to be expected that sterling would be translated into francs on a considerable scale, but higher interest rates were current in London than in Paris, and the French demand for London bills continued—in the colloquial phrase, French money remained in London. But rather unexpectedly heavy transfers were made from London to Paris during July, 1929; the French exchange rate dipped below the export bullion point, and gold flowed from London to Paris in considerable quantities. At the time of this loss the rate for money in Paris was only $3\frac{1}{2}$ per cent, while London had a bank rate of $5\frac{1}{2}$ per cent, an open market discount rate only a fraction below the official minimum and call money commanded from $4\frac{1}{4}$ to $4\frac{1}{2}$ per cent.

The explanation immediately forthcoming was that the drawing of gold from London was for political reasons. The level of money rates in the two centres clearly indicates that neither ordinary banking nor normal economic reasons supplied the cause, but there is also no ground for suggesting that the reason is political in the sense of being required by the Government. What is a reasonable supposition is that France, having once more a healthy trade, a stable currency, and a free gold market, felt herself once again able to resume her place amongst the creditor nations of the world. The withdrawal of her funds, temporarily employed in London, was an obvious step to be taken by French bankers to place themselves in a position to satisfy foreign borrowers, although it was an unfortunate circumstance for the Bank of England and the London money market that our stock of gold should have to be depleted in order to assist the quite legitimate aspirations of France.

Moreover, since such funds were placed in London, not as an ordinary banking transfer in order to take advantage of a higher interest rate, but to avoid capital depreciation, it follows that the owners of the money privately placed in London would be prone to withdraw it whenever they saw fit to employ it at home, irrespective of the comparative level of interest rates

current on floating balances in the two capitals. Throughout 1930 there was a steady transfer of balances from London to Paris, with the consequence that large quantities of gold left the Bank of England for France. France, in addition, was the chief buyer of bullion in the open market in London. The Bank of France accordingly received so much of the metal that it was forced to take steps to prevent its becoming the basis for fresh credit, and so causing a "gold inflation" within the country. Although a step forced upon the French authorities, it is no doubt one that was taken with some reluctance, for the neutralization of gold imports prevents their exercising their normal influence upon the exchange and the Paris rate consequently remaining low, the flow of gold was unchecked by its own momentum.

The French market is now in an exceedingly strong position. The return of the Banque de France dated 23rd October, 1930, shows a gold stock of Fcs. 50,642,645,000, equivalent to £408,408,000 against a note issue of Fcs. 72,867,560,000. This store of metal is nearly two and a half times that held by the Bank of England, and the proportion it bears to the French note issue is 69·51 per cent, while our gold backing for our note issue is no higher than 38·02 per cent. In addition, the position of the Banque de France is strengthened by having "available at sight abroad" Fcs. 6,504,524,000 (£54,068,742), and the portion of this held in London can, of course, be converted at any time into gold at the wish of the central bank in Paris.

Berlin.

The influence of the Berlin market upon London is by no means so pronounced as that of either New York or Paris, but Germany has had to avail herself of foreign credits in order to maintain her indemnity payments, and her borrowings abroad have, on several occasions, moved the exchanges to such an extent that she has been able also to withdraw gold from London. Trade credits in London on German account have been freely sought, and it is somewhat curious that while

there was such a hunger for facilities to draw in sterling, the rate of acceptance commissions should have been cut to the very fine figure of $\frac{1}{8}$ per cent on the three months bill.

The events in other parts of the world having had an effect neither sufficiently adverse nor favourable to London to provoke comment, have been disregarded in the main, although these happenings mark profound changes since the War.

India.

The Indian market is an outstanding example. In the times which are now past, the balance of trade was always strongly in her favour, and she was, consequently, an importer of both gold and silver on a large scale, while the demand in London for the weekly issues of India Council drafts payable in Bombay, Madras, and Calcutta, was usually keen. Her exports now are so greatly diminished that no tenders are invited in London for Council drafts, and the demands in the open bullion market for gold on Indian account are of a very moderate character indeed. Needless to say, the withdrawal of sovereigns from the Bank of England to India is now quite a thing of the past, although it used to be both frequent and of some magnitude.

The exchange business is now almost entirely in the hands of the Indian banks, although from time to time "Reverse Councils" have to be issued in India.

The attempt was made to abolish the Gold Exchange Standard which had worked so satisfactorily for many years until its breakdown under the stress of war conditions. The proposal was to make India a Gold Standard country by establishing there a central bank under the obligation both to buy and sell gold bullion for rupees without limit at rates based on the prescribed parity of the rupee with the sovereign (i.e. 13.33 to £1), the rupee to be the sole legal tender in the country. Indian opinion was, however, averse to the suggestion of a central bank, and the duty of maintaining the rupee close to its parity with the sovereign still rests upon the Indian Government.

As before it is obliged to buy bar gold for rupees, but the

option is placed in its hands of selling either gold or gold exchange. The rejection of the proposal to set up a central bank which would take over control of the currency and exchange was emphatic in India, but since native opinion has, in recent years, been partially weaned from its excessive tendency to hoard the precious metals and coaxed into using the facilities offered by savings banks, and is being gradually enlightened with regard to the advantages of investment, it is by no means improbable that it will be eventually educated to the point of acceptance of the system of a central bank controlling a full gold standard.

Australia.

Conditions in the financial relations between England and Australia are also different from what they were before 1914, and the smoother working of the exchange between the Mother country and the Dominions is largely the result of the establishment of the Commonwealth Bank. Australia, being a pastoral and agricultural country, has a seasonal foreign trade. The wool clip, her staple export, added to her products of fruit and grain, cause the exchange to move in her favour in the autumn and remain adverse to London throughout the winter months. The London offices of the Australian banks are then collecting the proceeds of the bills drawn against the goods shipped, and this used to result in a plentiful offering of Australian money to the discount houses during this period, to be followed by a corresponding poverty in the summer on the part of the Australian banks in London. Concurrent with the accumulation of Australian funds in London there was experienced a severe shortage of currency in the Commonwealth. From the point of view of the Australian banks this was unfortunate; their branches in London were inundated with money difficult to remit to their home offices which were in urgent need of funds to meet domestic requirements. Consequently, the exchange rate moved against London; the Australian banks here were naturally reluctant to sell drafts on their offices at home, and equally eager to purchase drafts

on Australia that would help to replenish the depleted coffers on the other side.

These conditions are now a thing of the past, and the change has been effected by the simple method of authorizing the Commonwealth Bank of Australia to issue notes in Australia against funds held by it in London. All that the other Australian banks need do now is, after collecting their bills in London, to deposit the proceeds with the Government bank here and their Australian offices will be able to obtain the notes they require from the Commonwealth Bank in Australia. After this method came into operation, exchange operations between London and Australia were considerably simplified, and for a considerable time the quotations of the associated Australian banks in London, for both buying and selling drafts on Australia, remained remarkably stable, and the movements of gold between the two countries was as unusual as it once was frequent.

But during the year 1929 things went badly for Australia and became worse during 1930. In common with the rest of the world, she suffered from the general trade depression and falling commodity prices. The lowering of the value of wool made a considerable difference to the value of Australia's exports and the payment of her debt service to this country accordingly became more onerous. The value of her imports did not diminish comparably with that of her exports, and these factors, coupled with others, partly of an economic and partly of a political character, provoked in Australia a financial crisis. Relief was sought in London to alleviate her adverse exchange, but since the general condition of Australia was unfavourable to the floating of a long term loan, advantage was taken of the plethora of short term credit in London to make a series of emissions of Commonwealth Treasury bills.

Although a remedial measure from the point of view of the exchange, it was merely a palliative and by no means a cure for the malady of which the state of exchange was a symptom.

Strenuous efforts were made by Australia to deal with the situation, and its gravity is illustrated by the desperate

attempt on the part of the authorities to restore equilibrium by placing an arbitrary limitation upon imports of "luxury articles." Naturally, gold had to be exported, and the recovery of the gold stock of the Bank of England, from the level of £130,000,000 left to it at the end of the American drain, was due to the receipt of £20,000,000 in sovereigns from Australia, during the latter part of 1929 and the early months of 1930. Huge as these bullion exports were to a country such as Australia, they proved to be insufficient for the purpose.

The gold held by the Australian banks was therefore mobilized and transferred to the coffers of the Commonwealth Bank and shipments were resumed in the latter months of 1930.

Japan.

Japan found the readjustment made necessary by her war experiences greatly retarded by a disastrous earthquake, and this delayed her return to the gold standard; a step which was eventually taken in 1930. The exchange value of the yen is not far below parity, and indeed, after its recovery from a very sharp drop in value following the earthquake, was not less than 1s. 10d. for over two years, and it subsequently passed the 2s. level.

South America.

The South American countries have had chequered fortunes since the War. The Argentine was in a position to absorb gold during the years 1927 and 1928, although little reached her directly from London. She did, however, draw it to a considerable extent from New York, and also affected the London bullion market by causing a diminution in its supply from the Cape. Purchases on Argentine account were arranged at prices for shipment "ex Durban," freight charges obviously being less for cargoes direct from South Africa to Buenos Aires than for those that first come to this country. The pendulum later swung the other way. New York received gold from the Argentine, and shipments were also made to London.

In 1930, the Argentine, also a sufferer from the economic ills of the world, found it necessary, in addition to the export of gold to America and London, to borrow short term credits in London on yearling Treasury bills, which were well received. In September, the financial world was startled by the news of a revolution in the Argentine and anxiety was, for the time being, felt in London. However, the term revolution proved to be a grandiloquent description of what was, after all, nothing more nor less than a sudden and spectacular change of Government. Since the rulers who were deprived of their power had been discredited, and those who took their place had the general confidence of the people of the Argentine, the change was for the better. The new Government immediately announced its intention of honouring all outstanding foreign obligations, and consequently the rate of exchange improved to a figure better than it had shown for some time previously, and Argentine securities were "marked up" on the London Stock Exchange.

More than once in history revolutions have proved to be epidemic, and almost before the Argentine had found the opportunity for settling down after her domestic upheaval, a revolution of much more serious character broke out in the territory of her neighbour, Brazil. Brazil has been unfortunate. Before the War, Germany was the chief consumer of her coffee and therefore, from 1914 to 1918, Brazil was severely victimized by the European upheaval and her currency accordingly depreciated. The post-War reaction caused a considerable over-production of her chief commodity and a series of actions had to be taken in the interests of the industry. To prevent a ruinous fall in the price, stocks of coffee were warehoused under Government supervision, and a regular quota released from such stocks to maintain a steady flow into the world's markets.

Moreover, State loans were raised in London upon the security of the coffee. For a time these arrangements were adequate and the currency was stabilized. But, the reduction in purchasing power due to the world-wide decline of trade

caused an undue accumulation of the coffee in Brazil, with the natural result of severe economic difficulties imposed upon the authorities and a threat to the stability of the currency. Affairs were in this condition in October, 1930, when the revolution broke out. Instead of its being of the bloodless character of its forerunner in the Argentine, considerable fighting took place between the revolutionaries and the Government forces.

Fortunately, what threatened to become a prolonged guerilla warfare—with, presumably, much damage to property—came to a sudden end by the overthrow of the Government. The revolutionary party, however, had not the same general sympathy within the country that was gained by those who revolted in the Argentine, and consequently the recovery, economic and financial, must be a far more prolonged process in Brazil.

Progress can be Hastened.

The financial world, all this time after the close of the War, is not yet out of a transitionary stage between the chaotic conditions of the period of hostilities and those belonging to a time of complete normality. The progress made towards recovery from the upheaval of the War years has necessarily been slow, though it should be accelerated by a final settlement of the question of reparations and war debts.

The political difficulties which have clogged the machinery of the money markets being out of the way, the financial centres will then have to face only the problems that arise out of trade conditions.

The machinery, however, is of a pre-war pattern, and it is the urgent duty of the authorities to ensure that any portion shall be renovated that does not function satisfactorily in the altered circumstances. Little fault can be found with the Bank of England authorities on the grounds of an unyielding conservatism, and criticism cannot be levelled against the continental centres which have yet to be fully proved, but it is a matter for regret—and also of some astonishment—that

America should be slow to remove the weaknesses of her system. America has a large stock of gold lying idle ; it is not only useless, but is a positive embarrassment to her. At the same time the continental countries are scrambling for the supplies adequate to their needs. France has acquired a stock, too, which seems unnecessarily large in proportion to her requirements as laid down by her Act of Stabilization, and the excess has had to be neutralized. The release of the unwanted hoards in America and France would not only go far to alleviate the difficulties present elsewhere, but would be of considerable help to the development of the world's trade, and the smooth running of the financial markets necessary to finance it.

CHAPTER XI

THE OUTLOOK FOR THE FUTURE

Now that so much has been accomplished since the War to resuscitate the trade of the world by re-establishing sound currencies and preventing widely fluctuating exchanges, it is interesting to take stock of what yet remains to be done to restore the normal working of the money markets—which are, after all, merely the handmaidens of trade—and to observe the lines that future progress is likely to follow.

The Questions which Arise.

Some few difficulties still centre around the final settlement of the questions of war debts and reparations, and when these are arranged satisfactorily from the political standpoint, the problems arising from them which affect the monetary centres still remain to be assessed in their true proportions.

In looking to the future the observer is faced with several questions. Will the heavy internal national debts be capable of sufficient reduction within a reasonable time to allow of further deflation and a fall in price levels? Or will the fall in price levels noticeable in 1929 and 1930 continue to the extent of increasing the burden of the service of national debts to the point at which it will become unbearable? If not, will the gold stock of the world be an adequate base for the increased size of the credit structure that growing trade will demand?

Will the onerous external war debts prove of a crippling character to the debtors or at least, a disturbing element to the peace of the money market in their settlement? Touching ourselves more immediately, will London continue to be the favourite market for the continental purchase of dollars, so that European settlements with New York will be a permanently depressing factor in the London-New York exchange

while tending to move the continental exchanges in our favour? Finally, how far will our trade be affected by the continental competition engendered by the European payments of war debts to ourselves and America?

Deflation.

The answer to the first question is that any general deflation on a substantial scale is highly unlikely. The British Government, it is true, has adopted the policy of creating a fund out of which interest on the floating debt is to be paid, and any excess after satisfying this charge is to be devoted to extinction of debt. This sinking fund, however, is necessarily slow in attaining an appreciable reduction, and its action was impeded until the end of 1929 by a series of high bank rates which made the service of the floating debt a very expensive one.

An immediate step would be to diminish the burden of the service of National Debt by a reduction in the rate of interest payable on it.

The easy monetary conditions that prevailed in London throughout 1930 enabled the Treasury to effect an economy of £18,000,000 in respect of the floating debt, and this saving was automatically applied to debt extinction. But the lowering of interest rates on the longer dated obligations is a pressing need. The plethora of money that characterized the London money market after the collapse of the boom in Wall Street at first blush suggested that a conversion operation on a large scale might be practicable. It was soon realized, however, that this was not the case, for the abundance of money was only seeking short term investment. There were many reasons for this.

Trade had been bad for a long time, profits were considerably reduced, and company after company had either passed its dividends entirely or had greatly reduced them. In such circumstances it is not surprising that a genuine investment demand should be lacking and the success of a new issue would therefore be dependent on particularly favourable terms being offered to the investor. The poor trade, moreover, had

affected all classes, and the considerable total of small applications that had been so pronounced a feature when the War Loans were raised, could not be expected to be attained by a conversion operation.

A tentative experiment was made by the Treasury in October of 1930 by issuing a seven year bond, bearing interest at 4 per cent at a slight premium to extinguish the Tax Compounded 4 per cent War Loan. Such an issue was purely a money market security and £105,000,000 was raised by this method. So far as it went it must be counted a success, but it was hardly encouraging to any attempt to deal with the mass of the 5 per cent War Loan. If the Government credit was thus proved to stand on a 4 per cent basis for a short term money market security, it is obvious that a considerably higher rate of interest would have to be paid to attract subscriptions to a long dated issue that could only appeal to a very limited extent to the dealers in short credit.

Continental countries are worse placed than ourselves in respect of deflation, and the vital question of gold reserves consequently comes into prominence. As previously stated, a shortage has been predicted by Professor Cassel, and this will prove a matter of considerable consequence to the financial centres unless they come to a mutual arrangement amongst themselves to reduce the metallic backing of their note issues. It certainly seems possible that the solution of this question will be found in the establishment of an International Central Bank, and the constitution of the "Bank of International Settlement," with headquarters at Basle, to assist Germany in meeting inter-allied debt payments may, in all probability, develop into a controlling bank of the various monetary centres. The fact that this new bank is to be so organized as to be outside the field of political influence is one that gives rise to hope of its ultimate development in this direction.

An International Central Bank.

Although essentially it is to act as trustee for the various nations interested, and is to be regarded as a supplement to

the machinery of existing money markets, it is to be in a position to give credit to any central bank and so contribute to the stability of the exchanges. This, in itself, should result in a considerable economy of gold movements, particularly if, as suggested, other central banks should be able to obtain re-discount facilities from it.

It is proposed that the control of the bank be placed "in the hands of the central banks, since these are the organizations responsible in each market for the convertibility of the national currencies and the control of credit."

Presumably by the term "central banks" the Committee whose report is quoted, meant those of the countries to whom their proposals were submitted. The capital suggested for the new bank is the equivalent of £20 millions, although only 25 per cent of this amount is to be called up at the time of its formation, but the whole of this first issue is to be guaranteed by the central banks of the seven countries represented on the Experts Committee. The Governor of each of these central banks will be entitled to become a director, *ex officio*, in the new bank.

Two submissions of the Committee of Reparations experts touching the International Bank show an appreciation of the needs of the future. The first is: "As a stabilizing factor in the foreign exchanges its advantages are obvious; and if, in due time, the arrangements provided for an international settlement fund are put into effective operation, the bank should go far to eliminate the costs and risks now incurred in the shipping and re-shipping of gold," and secondly, "In the natural course of development, it is to be expected that the bank will, in time, become an organization, not simply, or even predominately, concerned with the handling of Reparations, but also with furnishing to the world of international commerce and finance, important facilities hitherto lacking.

Especially, it is to be hoped that it will become an increasingly close and valuable link in the co-operation of central banking institutions generally—a co-operation essential to the continuing stability of the world's credit structure."

The proposals give hints of the wishes, not distinctly expressed, of the experts, and it is obvious that not all of their recommendations will be accepted without a certain amount of opposition.

The scheme shows considerable breadth of vision in creating a bank that shall stand in relation to the existing central banks in much the same way as they stand towards the other banks in their own countries. How far the central banks will be willing to come under the domination of a controller remains to be seen, but a natural reluctance should not be hard to overcome since the present inter-relation of the various money markets often entails submission to the conditions obtaining in one of them by the central banks of the others. Independence on their part is already more theoretical than practical.

A possibility that the report seems to visualize, although it is not expressed, is that the new bank may become the repository of the world's gold. If this could be attained, it would be of incalculable benefit. It would, incidentally be going beyond the materialization of the dreams of the far-seeing economists who have found each central bank's providing the gold reserve for its own country too parochial a system for their approval.

Soon after the War, a distinguished banker (Mr. J. F. Darling of the Midland Bank) propounded a scheme to the Institute of Bankers in London for the formation of one central bank for the British Empire. The reception his proposals received indicated that his views were considered visionary rather than practical, but less than ten years later, a bank of much wider-spreading influence has been established.

If, in the course of time, the note issues of each country represented on the International Bank could be backed by the gold held in the vaults of that bank instead of by reserves of bullion held by themselves, the relation of the world's prices to the international stock of gold could be regulated with ease on the lines suggested by Professor Cassel as being desirable.

The question arises as to whether the establishment of the new bank and its development in this way would interfere

with London's supremacy as the world's banker. There seems little or no necessity for its suffering severely so far as the granting of acceptance credits is concerned; this form of business is one for which a central bank is less suited than the accepting houses or the other banks, and, indeed, in granting this type of facility for traders the Bank of England does not participate.

Foreign exchange business would certainly experience changes in the method of effecting settlements, but it is doubtful if the drawing of bills under credits would be materially affected.

The discount market would function in the same manner as hitherto, but with greater freedom, as it would gain enormously by the removal of the fears engendered by heavy bullion shipments.

Whether the flotation of foreign loans in London would be gravely affected is another question. It need not be, although it must be admitted that, the International Bank having been set up abroad, the centre in which it is established should gain in time a considerable prestige. But borrowers will naturally seek the market offering them the greatest facilities, and London is still the chief lender. The International Bank should be a potent factor in stabilizing interest rates so far as they may be affected through the foreign exchange market, and domestic conditions should, therefore, be the dominant influence over them in the future.

In other words, if our war indebtedness to the United States is to be offset by our receipts on like account from our continental debtors, without derangement of the foreign exchanges, our capacity for foreign lending will be determined by the profits of a buoyant trade. Trade, in turn, will find encouragement from lower charges in respect of banking facilities when the Bank Rate no longer need be maintained so often at penal levels in order to guard a stock of gold against severe inroads. A low Bank Rate, again, causes foreign borrowers to turn their eyes towards London when they are seeking accommodation, and our national income from foreign investments would, as a consequence, be increased rather than diminished.

True, much of what may happen in the future must be in the nature of speculation, for the Bank of International Settlement has been in operation for too short a time, so far, to exercise any potent influence over the existing central banks. Its ultimate position as their banker would suggest that it should become the repository of their stocks of gold. The stumbling block to this is the fact that such a prize would be an irresistible temptation to a combatant nation to invade the neutrality of Switzerland in the event of another Continental War of magnitude.

Even without such a bank it seems that some centralization of gold is inevitable sooner or later, but with it this desideratum should be attained much earlier than it would be had no such institution been suggested.

One very great advantage to be derived from an international bank with powers of control over the various money markets would be that they would become so closely inter-related as to be different portions of one whole.

It is not suggested that they would no longer be competitive, but they would simply experience the application, on a vast scale, of the principle of "rationalization" that is already taking place in industry.

With the outbreak of the Great War ended one period of our financial history, a period which is still generally regarded as representing "normal times." But the "normal time" of the future is bound to differ greatly from that of the past, although basic principles will remain. Money markets must be as adaptable to varying conditions as manufacturers must be to changes in the demand for commodities. Just as the manufacturer, to be successful, must be able to anticipate the popular change in tastes, so should those engaged in the financial world be able to foresee the effects of the economic changes that the world is experiencing, in order that they may be able adequately to assist the development of the prosperity that should be the fruit of a world peace.

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