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THE RESTORATION OF EUROPEAN
CURRENCIES

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THE RESTORATION OF EUROPEAN CURRENCIES

BY

D. T. JACK, M.A.

DEPARTMENT OF POLITICAL ECONOMY
UNIVERSITY OF GLASGOW

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PREFACE

THE following pages were prepared and intended for completion for the autumn of 1926. This was rendered impossible by uncontrollable circumstances. Since that time, important changes have occurred in the general monetary situation in Europe, and the original draft has been completely rewritten with a view to bringing the narrative as far as possible up to date. The final stabilisation of the French franc and the Italian lire remain to be achieved, but except for political considerations that end might already have been accomplished.

As in other cases, a proper understanding of post-war monetary problems as these have developed in Europe requires the adoption of a true sense of perspective. It is to that end that emphasis has been laid in the concluding chapter of this volume upon the successive phases of the general problem of monetary reorganisation which have occurred. It would be misleading to conclude that, with the general reorganisation of European currencies on a gold basis, the monetary difficulties of the present generation had been brought to an end. The problem remains as to the future trend of gold prices and the possibility of preventing extensive movements in either direction which might occur in the value of gold in years to come. The fact that the form of the problem depends upon so many uncertain factors should not be allowed to justify an attitude of neglect. It is perhaps significant of recent developments in economic ideas that schemes for stabilising the value of gold should no longer be relegated to academic treatises. The principles outlined in the Genoa Resolutions in 1922 represent an important advance in the direction

of "managing" this problem. The long-period problem of the future value of gold is not, however, examined in detail in the present volume, but is deferred to a later occasion. The recognition of its existence is nevertheless important.

Finally, I desire to express my indebtedness to all those unnamed persons who have assisted in any way towards the writing of these pages.

D. T. JACK.

*The University, Glasgow,
September 1927.*

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26 MAY 1923

THE RESTORATION OF EUROPEAN CURRENCIES

CHAPTER I

INTRODUCTION

IN the following pages an attempt will be made to discuss certain of the methods which have been employed within recent years to reform the disorganised currency systems of Europe. Up to the time of writing these reforms have not been completed, but the significant feature has been the general tendency to effect some reorganisation on a gold basis, either directly or indirectly. In several instances the new reforms have yet to be tested, and there are several reasons why that testing-period is likely to be protracted. Both politically and economically, post-war Europe remains in a state of infancy. Independent states have been multiplied, and out of former economic unities have sprung a number of secession states which lack that degree of cohesion which is required for their proper development. In both respects, experience in the management of affairs has had to be acquired, and the new knowledge has been drawn for the most part from the bitter realities of post-war dislocations. This result has both its advantages and its drawbacks. On the one hand the practical consequences of unsound finance have been directly experienced; but on the other there has been a certain disregard for long-period considerations. In this connection the inevitable instability of political and economic conditions has added to the difficulties of financial recon-

struction. New governments, and more especially those which have arisen out of political upheavals, cannot readily give effect to those financial measures which are demanded by the nature of the situation. Public expenditures have to be increased both on account of the devastation occasioned by previous events and on account of the insecurity of the new régimes, but it is seldom that finance ministers display sufficient strength of purpose to impose the necessary taxation. Popular support more often demands the lightening of existing fiscal burdens than the imposition of fresh ones, and there is a general reluctance to accept the price which must be paid for political experiments. The position which emerges is of the nature of a dilemma. Fresh taxation must either reduce the consumption of the community or reduce its saving capacity, and it may be that neither of these alternatives can be willingly endured. Foreign loans which would relieve the position will be difficult if not impossible to secure in view of the political instability which prevails. Under such conditions, continued inflation appears for the time being to afford a simpler means of escape. But, paradoxically, this apparent escape only leads to greater difficulty and greater insecurity. In these respects history in the main repeats itself, though always with differences, so that past experiences possess only a qualified significance for present problems. And in a state of flux the lessons of the past are even more difficult to apply than to learn.

In the subsequent chapters it has been found convenient to examine the position of each country separately in order to simplify the treatment. But some more general discussion is essential at the outset, and that must concern itself with the nature of the problem itself. Currency inflation, which for the present may be defined as an excessive expansion of the supply of money in relation to the work which that money has to do, has been common to all countries since 1914, though in varying degrees. This inflation is reflected in a general rise in prices, or, what is the same thing, a general fall

in the value or purchasing power of the unit of money. But the increase in the quantity of money is not alone important, and in many of the cases now under review, changes in the rapidity of circulation are particularly significant. Thus in the extreme instances of inflation prices may rise more than in proportion to the increase in the quantity of money, owing to an increased velocity of circulation proceeding from and reflecting a diminished level of public confidence. As in other things, the general willingness to retain or hold money will be governed by the expectation which prevails as to its future value. If that expectation infers that the value of money will fall through further inflation, the velocity of circulation may increase and prices will rise before the expected inflation has in fact occurred. Similarly, if there is an expectation that under deflation prices will fall, the willingness to hold money will increase, the velocity of circulation will diminish, and prices will fall more than in proportion to the contraction in the quantity of the circulating medium.

There are, however, numerous difficulties which emerge in the attempt to correlate these phenomena by reference to actual data. The volume of trade, or the work which the supply of money has to do, may be greater or less than before, but no accurate index of the change can be obtained. On general grounds, supplemented by more particular evidence, there is reason to suppose that after the war the volume of trade was diminished, and to that extent the rise in prices would be expected to be somewhat more than in proportion to the increase in the supply of money, and apart from changes in the velocity factor. But in view of the magnitude of the increased supply of money during the period under review, no particular emphasis need be placed on the diminished volume of trade.

Other difficulties arise with the attempt to measure the actual increase in the supply of money in the different countries. Before the war, that supply consisted of metallic coins and notes issued by the note-issuing banks,

but whereas the note circulation was known with sufficient accuracy, the metallic circulation remained a matter of estimation. After 1914, much of the gold circulation in the several countries was withdrawn, but some unknown part remained in private hands. Moreover, in certain countries there occurred a considerable but indeterminate hoarding of new paper money, and to that extent the increase in the effective circulation might be less than the apparent increase. A further difficulty emerges in those countries where an initial hoarding of notes occurred and where also subsequent inflation was on a large scale. In such cases the futility of hoarding notes, the value of which was rapidly diminishing, would become evident, and the hoarded stocks would be disbanded, whereupon they would begin to exercise their real but belated influence upon the price level.

Further allowance must be made for changes in the area over which the increased supply of money circulates. More especially since 1918, these changes have become more important. The post-war territories of Germany, Russia and Austria have been greatly reduced, while those of France and Denmark have been increased. Here again it is necessary to rely on estimates upon which to compare the present circulations of these countries with the pre-war circulations for the same areas. Thus in the case of Austria, the pre-war circulation of the Austro-Hungarian Empire was estimated at about 2500 million gold crowns, but the pre-war circulation of the new Austria was only about one-fifth of that amount. In April 1926 the circulation of the U.S.S.R. was 1200 million gold roubles, but this must be compared not with the pre-war circulation of the Russian Empire given as 2400 millions, but with an estimate of 1700 millions, for what now constitutes the Soviet Republic. In the same way, the present circulation of Germany must be compared with a figure smaller than the 6000 million gold marks which constituted the circulation of the former German Empire.

Nor do these exhaust the qualifications which have to

be applied in the examination of the available data. In countries where currency depreciation became rapid, use was frequently made of more stable currencies either in actual circulation or for purposes of investment. This consideration has special reference to the cases of Switzerland, Holland and Sweden, where depreciation was less marked. Under the same head might be placed the large volume of German marks purchased on speculative account by the nationals of other countries. Such purchases would help to maintain the value of the mark at a level higher than it would otherwise have reached, while later the realisation of these holdings would reinforce the further depreciation of that currency. Then again, in both Russia and Germany, where there developed a literal shortage of money in spite of apparent profusion, notes were frequently issued by institutions without legal authority.

In the following table, average index-numbers of wholesale prices in the several countries are enumerated for the years 1918, 1922 and 1926 (1913 = 100).

	1918.	1922.	1926.
United States (<i>Bureau of Labour</i>)	194	149	151
United Kingdom (<i>Statist</i>)	226	154	148
Holland	273	160	145
Sweden	339	162	149
Switzerland (1914 = 100)	—	167	147
Denmark (1912-14 = 100)	292	179	141
Norway (1914 = 100)	345	233	198
France	334	327	703
Belgium (1914 = 100)	—	367	744
Italy	409	562	708
Czechoslovakia (1914 = 100)	—	1,334	954
Germany	—	34,182	137

Thus the upward movement in prices during the war period varied in magnitude as between the different countries and was not confined to the belligerent states. The rise in prices in France was approximately equal to

that in Sweden and much in excess of the increase in British or American prices. By 1922, on the other hand, a rearrangement had occurred and the indices for the group of neutral states were far below those for the Latin countries, where in turn the indices were low relatively to those for Germany, Austria and the secession states of Europe. From 1920 a certain deflation had occurred in most countries, but in some this only led to a temporary fall in prices and inflation was continued. The causes of inflation, therefore, are not to be found exclusively in the methods of war finance adopted prior to 1918.

Certain of these causes may be examined in more detail. In the first instance they must be related to the methods of war finance. Public expenditure was of necessity increased for war purposes, and in no case was the tax increase made to respond to the augmented outlay of the state. In some countries war finance was governed by the conception that the cost of the war would ultimately be recovered from the defeated Powers, but even where this policy was not openly avowed, the bulk of the additional expenditure was financed by loans. Thus, in France, ordinary and extraordinary state expenditure for the period 1914-18 was only covered to the extent of 15 per cent. from sources other than loans. In the United Kingdom the corresponding proportion was 29 per cent., while in Russia, during the years 1914-17, budget deficits amounted to 75 per cent. of the total public expenditure. Even in the United States the governing principle was to cover the new war expenditure out of loans to the extent of two-thirds.

Within certain limits, loans raised for war purposes need not have involved inflation provided they were drawn from the genuine savings of the community. But not all the loans actually raised can be brought under this condition. In America, in the United Kingdom and in Germany, subscriptions to war loans were frequently made out of bank advances specially granted for the purpose. In addition, in certain countries, the

central bank granted loans to the Government by the creation of new money. The general result was a rise in prices brought about by the increase in the supply of means of payment thus effected.

This general process was made possible by the more or less complete removal of the restrictions on banking methods permitted during the war. Before the war, when the gold standard in some form was generally operative, note issues were directly related to the gold reserves of the issuing banks, which were obliged to maintain the convertibility of these notes on demand. Moreover, the necessity of maintaining adequate cash reserves placed an effective limit to the lending capacity of the banking systems. Excessive lending led to a rise in prices, and that was followed by a drain on the gold reserves of the central banks both in respect of the internal circulation and for export owing to the fall in the exchanges. Once the danger-point had been reached, precautionary and restrictive measures became necessary. The demand for loans could be checked by raising the rate of discount and ensuring that the rise was effective. The volume of credit was contracted and prices tended to fall. The drain of gold was checked and an inflow might be initiated.

The foregoing description has been brief and perhaps insufficient, but it may serve to summarise the nature of the checks and limitations which were at work. With the abandonment of the gold standard and the free use which was made of the printing-press for the provision of cash, these limitations were removed, and the banks were then in a position to grant advances directly or indirectly in favour of the borrowing Governments, and on a large scale. They could still maintain adequate cash reserves, but these reserves were now mainly composed of inconvertible paper. In Germany, where, under the law of 1875, one-third of the Reichsbank's note issue had to be covered by gold and two-thirds by discounted bills suitably guaranteed and with not more than three months to run, legislation was passed on the

outbreak of war enabling Treasury bills to be grouped together with trade bills as security for note issues of the central bank; bonds issued by the special loan banks were accepted as equally suitable security. In France the limits to the note issue of the central bank and its advances to the State were raised by a series of successive decrees, while convertibility was also abandoned. In the United Kingdom, while convertibility remained legally possible, it was practically unimportant, and a new issue of currency notes was sanctioned unhampered by restrictive regulations as to volume or gold security. And in the other countries of Europe the convertibility of note issues was suspended, and gold movements no longer remained free.

The effects of inflation may be worked out in terms of the reactions brought about by the general rise in prices. Thus inflation, by reducing the effective value of the monetary unit, operated as a concealed form of taxation which enabled the Government in question to obtain a command over resources which they were either unable or unwilling to derive by the imposition of additional taxation in the usual sense. For that reason the process has sometimes been described as a "depreciation tax." The process may be represented algebraically as follows:— Let R represent the value of the real resources of the community over which it chooses to keep command in the form of money, and for convenience it may be supposed that the real value remains unchanged. If then, at the outset, there are N units of money, one unit of money will be equal to $\frac{R}{N}$ real resources. Suppose now that N is increased to N^1 , the purchasing power of the unit of money will then be reduced to $\frac{R}{N^1}$ by the creation of $(N^1 - N)$ new money units. The general result, therefore, is that the Government directly or indirectly obtains a command over $\frac{(N^1 - N)R}{N^1}$ real resources without the use of the normal tax machinery, while the real

resources of the community are reduced to $\frac{NR}{NI}$. This example, of course, assumes the inflation to have occurred suddenly, whereas in fact it is a process involving time. To that extent the Government's gain will be even greater than that indicated in the formula. In the case of Germany, Mr. Keynes has estimated that up to the middle of 1922 the German Government had been obtaining for some time the equivalent of £75-100 million per annum by this means,¹ while the Soviet Government estimated² that in their own case, for the period 1918-21, the State had secured the equivalent of 1234 million gold roubles, or fully £123 million by the same method. In Poland, again, inflation was estimated to have yielded \$549 million, or fully £112 million up to the beginning of 1924.³

But war-time inflation may proceed from more indirect causes. The imposition of heavy additional taxation may itself be a factor if it leads to a demand for credit advances at the banks, and Cassel cites the case of Sweden, where this factor operated. Neutral countries, moreover, in so far as they normally traded with the belligerent countries, found themselves in a peculiar position. Imports from abroad became difficult to obtain, but the foreign demand for their exportable products was greatly increased. The initial difficulty was, in fact, to obtain payment for their exports, and it became necessary either to suffer a restriction of their exports and inflict hardship on the industries concerned, or to grant advances to the belligerent states which were eager to absorb their products. This second alternative was generally accepted by the countries in question. In the case of Sweden the visible trade balance showed a considerable and abnormal excess of exports during the war years. Similarly as regards Switzerland, the normal excess of imports greatly declined and in 1916 was converted into an excess of exports. For these reasons the neutral states tended more and more

¹ Keynes, *Monetary Reform*, p. 58.

² *Ibid.*, p. 57 n.

³ Zdziechowski, *The Finances of Poland*, p. 5.

to become creditors of the belligerent countries, and in the course of that process there occurred a gold movement from the latter to the former, partly as payment for goods received and partly as the basis for loans to be raised in the neutral countries. These several changes were not without their effect on the value of gold itself. In most countries, save the United States, the gold standard was abandoned, and gold which had formerly been in public circulation was withdrawn and replaced by inconvertible paper.¹ In addition, the distribution of the world's monetary gold stock was greatly altered by the special concentration of supplies in the neutral states, which also found their stocks augmented by new gold production. The general result was a marked fall in the value of the metal—a phenomenon which has sometimes been referred to as "gold inflation"—and the dollar, which remained on a gold basis, depreciated in purchasing power to 40 per cent. of its pre-war value. Thus even the stability in value which is normally associated with the use of gold was seriously impaired, and in certain neutral states, led by Sweden, further gold imports were prohibited in the hope of maintaining the value of the currencies of these countries at a relatively higher level than that of gold, which had also depreciated.

It is reasonable to inquire why greater efforts were not made to finance the additional war expenditure by imposing fresh taxation on an even greater scale. That is to raise a number of psychological considerations, many of which are of a highly speculative order. In that connection it is necessary to ignore a number of facts which are now known, but which were unknown during the early stages of the war. The duration of the war and its cost were indeterminate factors. Estimates which were regarded as extravagant when made proved ultimately to under-estimate the true position. Under these conditions it was impossible to budget accurately

¹ In the United Kingdom this was virtually the *de facto* if not the *de jure* position. It will be unnecessary in this discussion to enter into the legal refinements of the British position as regards convertibility.

for the actual expenditure to be incurred. In addition, there were in certain cases the political considerations of recovering the cost of the war from the defeated Powers, while the psychological effects of heavy taxation in impeding industrial changes which were essential would also prove a potent argument in favour of the method of borrowing. To many, the course of events was obscured by a war mentality which, as in the United Kingdom, was satisfied by the legal fiction that both Bank of England notes and currency notes were convertible into gold on demand, and which, as in Germany, derived mysterious confidence from the magnitude of the gold reserves of the country. A detailed examination of these factors is not essential to the present purpose. Heavier taxation might, in fact, have been imposed, but the actual position is alone important as regards subsequent analysis.

In the post-war period these inflationary movements were continued, though from different causes. The cessation of hostilities did not bring relief to the national exchequers, and the impoverishment which resulted from the war became strikingly apparent. In many countries there was extensive devastation to be repaired, and the political instability of the period led to the maintenance of armed forces on a more than normal scale. In the case of certain of the newly established states, this last item of expenditure was particularly great, and in Poland and the Baltic States the war with Russia placed a serious burden on the national finances. Under the same head, account must be taken of the extension of State activities, many of which were of an essentially unproductive nature. Public undertakings as a whole were conducted at severe losses. In Italy the deficit on the State railways aggregated 2963 million lire for the three years 1919-20 to 1921-2, and similar deficiencies were important in the cases of Germany, Austria, Poland and Belgium.

Extreme instances of monetary disorganisation occurred in the new states which had, for the most part, been subject to foreign occupation. In Poland, Hungary and the Baltic States, several currencies circulated side

by side in complete confusion, and the immediate problem was to establish new financial systems and at the same time to unify the monetary circulation. In no case was this transition accomplished without further inflation on a large scale. But the general monetary collapse was not confined to these new states. The greatest examples of depreciation occurred in Germany, Austria and Russia, though in Russia currency inflation was openly pursued as part of the machinery through which the destruction of the old order and the creation of the new were to be effected.

At this stage it is necessary to deal strictly with the main effects of these movements. It has already been shown that by means of inflation, the inflating Governments obtain a command over real resources in addition to what they have acquired through the ordinary channels of taxation. But the incidence of rising prices became very unequal, and its direct social consequences depended upon the power of individual money incomes to respond to price changes, while in general the more rapid the inflation, the greater the social anomalies which were created. The response of nominal wages to changes in the cost of living tends to be subject to a time-lag which is the direct source of industrial friction and social discontent, and in the case of fixed incomes the position becomes still worse. Business profits, on the other hand, appear to be excessive and are easily acquired, partly through the decrease in net labour costs, and partly through the gap which exists between the prices realised on a rising market and the prices of the raw materials which were purchased at a lower level. Moreover, the real burden of fixed capital charges is reduced, and this adds to the competitive advantages possessed by an inflating country over foreign rivals with stable currencies. More generally, the holders of dated obligations are deprived of part of the capital values of the sums which they have advanced, and debtors, including public bodies, enjoy a corresponding advantage.

The progressive effects of this influence become more

apparent when the depreciation has proceeded at a rapid rate, and the inducement to save new capital is reduced. In the extreme instances of monetary collapse which have been cited, "real" as distinct from "nominal" deposits at banks fell almost to vanishing point, and the same influence was operative with regard to insurance policies, which normally provide an important contribution to the fresh savings of the community. It is true that this effect is obscured during the period of inflation, as in Germany. When it becomes clear that the normal saving process is a futile misuse of resources from the standpoint of the individual saver, there develops a rapid rush to purchase real goods which will not depreciate with the value of the currency, and this increased velocity of circulation serves to intensify the depreciation from which it proceeded. The counterpart of this in industry is the immediate utilisation of profits for fresh capital extensions. The real position which emerges on the reform of the currency is expressed by a shortage of working capital, which is more subject to a loss in real values than fixed capital. This shortage proceeds partly from the factors already mentioned, partly through efforts to convert liquid capital into fixed capital, and partly through the so-called "flights of capital" abroad to stable centres.

The effects of inflation on the foreign exchanges are not less important but perhaps more involved. Before the war, exchange rates fluctuated within narrow limits round their gold parities, and these were determined on the basis of the fixed weights of gold which constituted the standards of value in the different countries. Thus there was the same weight of pure gold in a sovereign as there was in 4.866 dollars, or in 25.2215 francs or lire, or in 12.071 Dutch florins, or in 20.42 marks. Actual rates of exchange were governed by conditions of demand and conditions of supply in the exchange market at the time, and there were certain variations in these actual rates in response to changes in these governing conditions. But given the possibility of free gold

movements from one centre to another there would be certain outside limits to these fluctuations. These limits, which were known as the "gold points," were determined by the cost of remitting gold from one centre to another. Thus in the case of France and the United Kingdom the gold par of exchange was roughly £1 = 25·22½ with the gold points 10 centimes on either side.¹ If, therefore, the actual rate of exchange should fall below 25·12½ francs, it would be cheaper for anyone in the United Kingdom with a remittance to make to France to obtain gold from the Bank of England in exchange for notes, and to remit that gold in payment of his debt rather than purchase a bill or draft in the exchange market. Similarly, if the actual rate rose above 25·32½ francs, there would be a tendency for gold to pass from France to London.

This high degree of stability which was possessed by exchange rates under gold standard conditions was the result of a tendency for gold itself to reach a uniform value as between gold standard countries. With the possibility of free gold movements the value of gold or the level of gold prices would tend to be uniform over the different gold standard countries. Under normal conditions, therefore, the rate of exchange between two currencies is an expression of the fact that after allowance has been made for transport costs, customs duties, etc., a certain number of currency units of the one country has the same real purchasing power in that country as another number of other currency units has in the second country. Under these conditions, £1 in the United Kingdom might be supposed before the war to have had the same command over goods and services as 25 francs had in France. If this were not so, products of one of the countries would have been cheap to purchasers in the other, while the products of the latter country would have been dear to purchasers in the first.

¹ Further complications arise in connection with the gold-premium policy of the Bank of France, for a discussion of which reference may be made to *Clare's Money Market Primer*.

In consequence, exports from the first country to the second would be stimulated and imports from the second would be discouraged, and forces would be set in operation tending through the foreign exchange market to bring the rate of exchange into a position of equilibrium in the sense described.

It is not the purpose of this volume to discuss the theory of the foreign exchanges in detail, and the foregoing account may suffice to indicate briefly the nature of the forces which are operative. Provided the fundamental features are recognised it will be evident that the abandonment of the gold standard and the adoption of inconvertible paper currencies introduce no essentially different features, even where these currencies are depreciated. It follows from the above analysis that if the value of the franc in France and the value of the pound in the United Kingdom rise or fall in the same proportions, the normal rate of exchange should remain unchanged. In the same way, a relative rise in prices in one country, denoting a fall in the internal value of that country's unit of money, should be followed by a proportionate increase in the number of units of that country's money which exchanges for a given number of the money units of the other country. This provides the essence of the so-called "purchasing-power-parity" theory, which may be summarised in the following terms¹:—"The purchasing-power parity of any two currencies may be defined as the rate of exchange at which either currency would possess the same purchasing power in both countries"; and the following rule has been devised for the calculation of normal exchange rates between depreciated currencies²:—"When two currencies have been inflated, the new normal rate of exchange will be equal to the old rate multiplied by the quotient between the degrees of inflation of both countries."

An example may be useful. We may suppose that

¹ *Fed. Res. Bull.*, Sept. 1923.

² Cassel, *The World's Monetary Problems*, p. 37.

as compared with 1913, which is taken as the base year, prices in the United Kingdom have risen to an index of 150 and that French prices have risen to an index of 300. If the pre-war rate of exchange were 25 francs. to the £, the new normal will be 50 francs to the £. Thus :

$$\begin{aligned} 300 \text{ present francs} &= 100 \text{ pre-war francs.} \\ &= 4 \text{ pre-war pounds.} \\ &= 6 \text{ present pounds.} \\ \therefore 50 \text{ ,, ,,} &= 1 \text{ present pound.} \end{aligned}$$

Suppose now that the actual exchange between francs and sterling does not coincide with the normal calculated in this way, and to simplify the position it may be further supposed that the internal price levels are stable in the two countries; *i.e.* that the currencies are depreciated but not depreciating. Let the actual rate be 55 francs to the pound. In that case, French products will be cheap to British purchasers and British goods will be dear to French purchasers. A British merchant by spending £100 could obtain 5500 francs, and by spending that sum of francs could buy French goods which when sold in England would realise £110. Conversely, a French merchant could only acquire £100 for 5500 francs, and for that sum would only be able to purchase British goods to the value of 5000 francs in France. British imports from France would therefore be encouraged, while British exports to France would be checked; the British demand for francs would increase relatively to the supply of francs; the price of francs in terms of sterling would rise, and that movement would continue until the exchange settled at about 50 francs, which can be regarded as the true equilibrium rate for the two currencies. Thus, given certain conditions of stability the actual rate and the normal parity will tend to coincide; or, expressed differently, the internal value of the currency as measured by its purchasing-power parity and its external value as measured by the actual exchange rate will be in equilibrium.

At this stage a number of complicating elements enter into the problem. Some of these are concerned with the method of calculating the new normal parity. Index-numbers of prices are employed, but different indices when combined will yield different results. In the case of wholesale price indices most countries have several of these, and over long periods these different indices follow a similar course, but there may still be variations as between them according to the weight which they give to particular groups of commodities. Moreover, slight differences in the actual indices in one country may give wider differences in the calculated parities when combined with the index-numbers of the second country. Mr. Keynes, again, has disputed the practical validity of such calculations when based upon indices of wholesale prices on the grounds (1) that these are built up for the most part from the price quotations of the raw materials of international trade, and (2) that the prices of these international commodities are uniform for all parts of the world market, since they adjust themselves to the actual exchange rates current at the time. To that extent it may be argued that calculated parities based upon the usual wholesale price index-numbers tend to understate the disparities between internal prices in two countries. For the purpose of obtaining a more accurate comparison, Mr. Keynes suggested that cost-of-living indices should be employed rather than the indices of wholesale prices.

For the purpose of the present theoretical analysis these statistical complications may be ignored. It will be assumed that valid calculated parities can be obtained. A further complication then enters into the problem in so far as, under conditions of inconvertible paper standards, the normal calculated parity is not necessarily a stable parity similar to the gold parity between two gold standard currencies, but is subject to change with every alteration in the relative positions of the two price levels. Under these conditions, future prospects contain a more than usual amount of uncertainty, and that will tend to

be reflected in the actual exchange rates which obtain in the market.

Further difficulties emerge when it is found that under the conditions which have been mentioned, actual exchange rates frequently diverge from the calculated parity, and it is important that the possible explanations of these divergencies should be understood. Thus if we calculate the purchasing-power parity between francs and sterling by means of the French index-number of wholesale prices (*Statistique Générale*) and the *Statist* index for the United Kingdom for June 1925 and June 1926, we get 91 and 129 francs to the £ sterling as the calculated parities for the two dates. The actual average rates for these two months were 102 and 166 francs. In other words, in June 1926, whereas 129 francs in France could purchase as much as £1 in this country, it required 166 francs to purchase a unit of British currency. This is the phenomenon which has been much discussed, viz. the external under-valuation of a depreciating currency.

To illustrate the foregoing points it may be useful to compare the actual exchange rates with the purchasing-power parities as calculated by different index-numbers. Comparative figures are given in the following table :

PURCHASING-POWER PARITIES.

	Average Rate of Exchange.	(1) <i>Statist</i> and <i>Stat. Gén.</i>	(2) <i>Economist</i> and <i>Stat. Gén.</i>	(3) Cost of Living U.K. and Paris.
June 1925	102 francs	91 francs	86 francs	57 francs
June 1926	166 "	129 "	126 "	71 "
Sept. "	170 "	134 "	129 "	78 "
Nov. "	144 "	114 "	113 "	83 "
Dec. "	123 "	111 "	109 "	86 "

It will be seen that even the use of wholesale price indices reveals a considerable divergence between the actual exchange and the calculated parities, and that a still greater divergence emerges when cost-of-living data are employed for the purpose. That latter result pro-

ceeds from the fact that in the United Kingdom the cost of living index-number shows a greater percentage increase over the pre-war base than do the indices of wholesale prices, while in France the opposite relationship obtains. This may be taken as illustrating the advantages which have accrued to British visitors to France during the period in respect of the relatively low cost of living which they experienced when French prices were converted into sterling.

It should be observed that such a disparity as between the internal and the external values of a currency which is undervalued abroad cheapens the exports of that country to foreign purchasers and makes imports from abroad dear to home purchasers. In time, given stability in the respective price levels in the two countries, this disparity would disappear and the actual exchange and the new normal would tend to coincide; and as the disparity becomes narrower the prices of imported commodities will tend to fall to the general price level. The rapid appreciation of the franc from September 1926 provides an illustration of this point.

JULY, 1914 = 100.

	Aver. stg. exch.	General Index.	National Prod.	Import Prod.
		(45 Articles)	(29 Articles)	(16 Articles)
June 1926	166 francs	754	682	883
July "	198 "	854	733	1074
Aug. "	171 "	785	722	902
Sept. "	170 "	804	743	912
Oct. "	165 "	767	745	808
Nov. "	144 "	698	698	700
Dec. "	123 "	641	648	628

The data cited show a remarkable degree of price convergence during the last six months of 1926, and that coincided with the rapid appreciation in the external value of the franc and the narrowing of the gap between the actual exchange and the calculated parities. In fact,

the evidence points to the gradual elimination of whatever "export bounty" may have existed owing to the earlier under-valuation of the franc abroad. Converting the general index-numbers cited into the gold prices at the exchange rates ruling for the months given, we find that the course of gold prices in France was upwards.

	French Gold Prices.	German Gold Prices.	U.S. (Bur. of Lab.).
June 1926	114	135	152
July "	107	134	151
Aug. "	115	134	149
Sept. "	118	136	151
Oct. "	116	138	150
Nov. "	121	138	148
Dec. "	131	137	147

Comparison is made with the course of gold prices in Germany and the United States, and the convergence which emerges suggests that by the end of the year, a stable French exchange of 125 francs to the £ represented a suitable stabilisation rate with fair correspondence between internal prices and world gold prices.

This phenomenon of under-valuation has been persistently in evidence in most cases during the period of currency inflation. From 1920 up to the stabilisation of the German mark, complaints were heard that German exporters could undersell their competitors in foreign markets because of the advantage which they derived from the excessive depreciation of the mark exchange, though it was often overlooked that the same discrepancy which cheapened exports from Germany also made imports to Germany particularly dear and in some cases prohibitive. And if a public body attempts, under these conditions, (a) to purchase the necessary imports from abroad by paying for them in its own currency, and (b) to sell them at lower prices within its own country, it will merely depress the external value of the currency still further, while at the same time adding to its own

financial difficulties. One of the most difficult of practical foreign exchange problems is to account for the discrepancies between actual exchange rates and the purchasing-power parities as calculated in the manner which has been described. To some extent these difficulties are statistical; but there are also others which are more strictly economic and which cannot be subjected to exact quantitative measurement. The first of these latter difficulties proceeds from the time element in the problem. The comparisons which were made were based upon relative changes in price levels as between the countries concerned, and it was implied that the pre-war position which was taken as the base for these comparisons was a position of equilibrium as regards international trade. But over a period there may be changes in that international trade position. The equation of exchange between the goods and services of one country and those of another country may alter over a number of years. Or, again, there may be one-sided changes in the fiscal arrangements under the heads of tariffs and bounties, or export prohibitions, or price discriminations against foreigners of the kind imposed by Germany during the later stages of the depreciation of the mark. For these reasons the real gap between the external and the internal values of a currency may be greater or less than the apparent gap which is suggested by a comparison of price index-numbers. But in the case of heavily depreciating currencies there are other factors of which account must be taken.

In part the explanation may be found in a number of psychological conditions. The value of a currency abroad is more sensitive to uncertain factors than the domestic value of the same currency, and when it is necessary to hold a quantity of depreciating currency units the external value will be affected by the possibility of still further depreciation; *i.e.* exchange dealers will tend to anticipate some further depreciation within the country before that has actually occurred. Thus it

might be suspected that the national finances of the country in question would not be balanced without further inflation. Such an expectation, if it occurred, would tend to react directly upon the foreign exchange market, and the exchange would fall perhaps before the additional inflation had occurred.

Psychological influences may operate in a still more concrete sense, and it is useful to visualise the factors which govern the external value of a currency in the foreign exchange market. These factors are factors of demand and supply. Under normal conditions these proceed from the visible and invisible items of trade. During exceptional periods, however, some of these factors may be reinforced. Two examples of this reinforcement may be taken: (1) speculation, and (2) the so-called "flight" from a currency, though there are points where both of them are involved.

(1) *Speculation*.—This speculative element may proceed from different causes. It is known, for example, that in the early months of the mark inflation after the war, many foreign traders, as in Britain and America, had sold goods to Germany and had been credited with certain sums in marks. In so far as these traders allowed their balances to remain in Germany, the foreign exchange market would not be required to effect their conversion into sterling or dollars. And what happened was that many of the traders concerned allowed their balances to remain in Germany in the hope that the exchange would improve. But as the inflation proceeded, the exchange became more and more unfavourable and hopes of a recovery became more remote, until they finally disappeared. Consequently there came a time when there would be a sudden rush to convert these balances into sterling and dollars in an attempt on the part of these traders to cut their losses. Whenever this occurred, the immediate supply of marks on the exchange market would be increased, and that would tend to precipitate a sudden slump in the external value of the German currency. In the particular instance cited, such a move-

ment did occur, although the exchange recovered after the rush to convert had been exhausted.

The other form of speculation is of that curious and ignorant type which was prevalent some years ago. On the Continent the craze was particularly acute, and large quantities of depreciating currencies were held abroad on speculative account in the vague hope that great recoveries would be made in the future out of which large fortunes would be procured. It has been said that the German Government was obliged to encourage the sale of marks abroad as a means of obtaining supplies of stable currencies which could not be secured in the form of foreign loans.¹

(2) Similar in character is the phenomenon of the "flight" from a currency which is depreciating. What that means is that a stage has been reached when the growing distrust of the currency within the country is reflected by a movement to convert holdings of it into foreign stable currencies. That distrust, therefore, reacts on the external value of the currency, while within the country it operates through the increased velocity of circulation.

In the case of a rapidly depreciating currency the general result is that the currency is considerably undervalued abroad. During the later stages of the collapse of the mark there were few commodities which could not have been purchased at cheap rates by foreigners who first acquired marks by the sale of stable currencies. An attempted defence against this position took the form of additional export duties, the actual prohibition of the export of certain essential commodities, and the practice of making price discriminations against foreigners. Still later, and before the stabilisation of the Belgian franc, complaints were current in Belgium that goods were being largely bought by Dutch purchasers who crossed the frontier with the single object of availing themselves of the opportunities afforded by the undervalued franc. Nevertheless the efforts made to check the repercussion

¹ Cf. Cassel, *Econ. Jour.*, Dec. 1919, p. 493.

of inflation in this form never succeeded in completely stopping the movement, and while the initial purchase of depreciating currencies abroad on speculative account tended to maintain these currencies at a higher level than they would otherwise have reached, the unloading of these purchases precipitated further slumps and incidentally lowered the value of the currency within the country itself. The process virtually represents the raising of a species of foreign loan by the inflating country; but it represents a floating rather than a funded indebtedness and is liable to be made redeemable without notice.

When this stage has been reached, the fall in the external value of the currency tends to proceed more rapidly than either the rise in internal prices or the increase in the circulation. The gold value of the paper circulation is then falling, and it may decline to a small proportion of its value at the beginning or early stages of the inflation. In the case of Germany the gold value of the paper circulation fell from 4.8 milliards at the end of 1920 to 2 milliards in June 1922 and to 116 millions in August 1923,¹ and whereas the pre-war circulation of what now constitutes the Soviet Republic amounted to about 1700 million gold roubles, by the beginning of 1923 it only reached 135 million. Even in the case of France, despite the expanding paper circulation, the gold value fell from 11.679 milliards in 1923 (average) to 10.894 milliards in 1925 (average), and reached its lowest point at 7.283 milliards in July 1926. The following table indicates the movement in France between January and July 1926:

INDEX-NUMBERS.

	Jan.	April	May.	June.	July.
Average sterling exchange .	100	112	122	129	153
Prices	100	103	109	117	132
Note circulation	100	103	104	107	111

¹ Keynes, *Monetary Reform*, p. 51.

During the final stages of complete monetary collapse the monetary unit may be abandoned as the standard of value though maintained as a medium of exchange. Shopkeepers, for example, will calculate in terms of a stable unit of account, such as the dollar and the pound, and fix their prices at the exchange rates ruling at the moment. It is at this stage that internal prices will rise at a particularly rapid rate until they move in conjunction with exchange rates with stable currencies. This phenomenon was in particular evidence in Germany, and it was partly apparent in France at the time of the crisis in July 1926.

A curious position emerges under these conditions. The use of money is reduced to a minimum, and even to a point of inconvenience. The increase in the paper circulation will not have kept pace with the depreciation of the unit, and there may result an insufficient volume of currency to enable even those minimum requirements for cash to be satisfied. Hence the phenomenon of a literal shortage of currency in the midst of apparent profusion. Any check, therefore, to the depreciation of the unit can be followed by an expansion of the circulation, since the uses to which the currency will be put can be conveniently extended. This result is more apparent when the stabilisation of the currency has been achieved. Thus the gold value of the Russian circulation increased to 318 million gold roubles at the beginning of 1924 and to 1287 million at the end of 1925.

A type of vicious circle is therefore developed during the inflationary period, but two main stages may be distinguished. In the first of these, the fall in the external value of the currency reflects the fall in the internal value together with some anticipation of further depreciation. In the second, the mistrust of the currency abroad operating to effect a general collapse in its external value is reflected within the country by its further depreciation. The point of distinction between the two phases lies in the fact that in the first the internal depreciation gives

rise to the external depreciation, whereas in the second that relationship is reversed.

The condition of the national finances from which the original disturbance proceeded cannot remain unaffected by this series of events. The budget, which in its first unbalanced state gave rise to the creation of new currency, remains unbalanced because of the rising prices which affected its expenditure. Former estimates are exceeded, and the real value of the revenue from taxation imposed when the value of the unit of money was higher is reduced and becomes inadequate. There may be an exception to this in the case of revenue from *ad valorem* duties provided the prices of the goods taxed by this method rise in proportion to the increase in the general price level, but the tax revenue tends on the whole to remain definitely inelastic. The gap between revenue and expenditure is in consequence increased, fresh inflation is made inevitable, and the process is repeated.

The problem is complicated on the side of the floating indebtedness. As confidence declines there is a growing unwillingness to hold even short-dated Treasury bills, and these may be presented in large quantities for repayment. That danger, however, is really the result of the impossibility of ensuring the redemption of these bills out of revenue receipts, though the tendency at the time is to regard it as the cause of the financial difficulties of the exchequer. In Germany no real budgeting was attempted during the period 1922-4. "The Government lived on borrowing, open credits being available at the Reichsbank against Treasury bills. It was an era of unrestricted and unlimited floating debt."¹ In May 1923, only 4.3 per cent. of the German Government's expenditure was covered by tax receipts; in July the proportion was 3.4 per cent., and in October it fell to about 1 per cent. The floating debt, which was 8000 milliard marks at the beginning of April, reached 1,196,295 milliards at the end of August.

¹ D'Abernon, *German Currency: its Collapse and Recovery, 1920-6*, p. 11.

There are, therefore, two inseparable problems to be solved—the attainment of budget equilibrium and the stabilisation of the currency. But just as it was possible to distinguish two main phases of the depreciation, so, in the approach to this double problem, the point of emphasis may undergo a certain change. The task might be successfully achieved if financial reforms enabled the budget to be genuinely balanced and further inflation to be stopped, in which case the value of the unit of money would adjust itself to a normal level in relation to the conditions of supply. On the other hand, it is frequently protested that the disequilibrium of the budget and the consequent further issue of notes cannot be cited as the real cause of the rapid depreciation of the currency, since the latter has now proceeded at a much greater rate than the fresh addition to the note circulation would warrant. From this it is concluded that budget equilibrium cannot be secured until the currency has first been stabilised. The real justification for this latter conclusion is to be found in the difficulties of preparing adequate estimates for taxation purposes while the value of the unit of money is still falling. There are two questions which should be considered :

(1) Under the conditions cited, can budget equilibrium, in fact, be attained ?

(2) If so, will that be effective in stopping the depreciation of the currency ?

The difficulties inherent in the attempt to secure the first result need not be minimised, for although drastic economies may be accomplished under the head of State expenditure, and though new taxation may be imposed, the rising price level may still create a "gap" between expenditure and receipts. One method of securing the result is illustrated by the case of Austria, where the possibility of discontinuing the use of the printing-press was conditioned by the fact that the proceeds of a foreign loan were made available for the Treasury to cover budget deficits for a period of two years, during which monetary and financial reconstruction could be effected.

Since the necessary guarantees for such a loan are not likely to be forthcoming from the country itself, the application of this method, as in the instance mentioned, may require the co-operation of a consortium of the Powers in the form of the League of Nations, and some supervision over the national finances of the country which is to benefit from the loan may have to be exercised.

Another method, which is independent of foreign financial assistance, may be illustrated by the attempt of Poland to solve the problem early in 1923. The particular failure of the method in this case may be attributed to political factors which brought about the fall of the Government before the experiment had time to be tested. To meet the persistence of the "gap" between expenditure and receipts, it was proposed to introduce a new stable unit of account to replace the depreciating mark, and then to express taxation and expenditure in terms of this new unit. By this means taxation would still be paid in Polish marks, but in terms of the new unit, and at rates to be fixed periodically by the Ministry of Finance, so that tax receipts would come more and more to respond to the rise in the price level. Between November 1921 and March 1922 a similar procedure was adopted in Russia. The application of this method under certain conditions must necessarily be difficult. It will require severe checks to public expenditure and the rigid enforcement of new real taxation, and it will take time before the attempt can be completely successful.

The answer to the second question assumes that the problem of the budget is satisfactorily solved along lines similar to those already indicated, and that no further supplies of paper money are created. In so far, however, as the currency may be seriously undervalued abroad in comparison with its internal value, some amount of readjustment will still be necessary. Either the internal value of the unit of money must depreciate still further until it is brought into correspondence with

its external value, or its external value must rise till it corresponds with its internal value. The first of these alternatives would occur if foreign holdings of the depreciated currency were allowed to return and raise the level of prices within the country. But it might be possible to avoid this result if arrangements were made to fund the floating debt constituted by foreign holdings of the currency by enabling or compelling those to be converted into long-dated obligations of the Government in question. In the other case, if the rise in internal prices was checked, some improvement would occur in the external value of the currency. There would be renewed confidence, and funds which had been transferred during the period of rapid depreciation would tend to be repatriated.

The conclusion which emerges is that even under the conditions cited, the attainment of budget equilibrium may be a difficult but not necessarily an impossible task. But it does not follow that the internal depreciation of the currency will immediately be checked when budget equilibrium is established. If no further issues of paper money are made, the internal price level may still have to rise unless steps are taken to stabilise the price level by removing the excess of money which is still capable of influencing the circulation. More generally, the problem of stabilising the currency has still to be solved, and in that connection there are two alternatives—viz. between (1) stabilising at the external value and accepting a further internal depreciation, and (2) stabilising at the internal value and accepting an improvement in the external value of the currency to the level of its purchasing-power parity. As will appear in the sequel, neither method enables the difficulties of the transition period to be avoided, but some choice must ultimately be made, and that choice should be based upon a consideration of the balance of advantages as compared with the disadvantages which must be accepted.

In general, exchange stabilisation can be more easily

accomplished. What is involved here is that the Government or the central bank should declare its willingness to buy and sell foreign exchange at certain fixed rates, which for simplicity may be taken as those ruling at the time of the decision. To do this implies that the Treasury or the central bank has at its command ample resources available for the purpose. These resources may consist of gold and foreign credits. In most cases there have been considerable gold resources which have remained idle in the vaults of the central bank during the period of currency depreciation, while if there are no available foreign credits, there remains the possibility of securing these by means of new foreign loans. Further foreign loans may, however, be difficult to secure if the credit of the Government has been seriously impaired, while there may also, as in the case of France in 1926, be political objections to the proposal to incur additional foreign indebtedness, apart from the external difficulties occasioned by the failure to ratify agreements in respect of existing indebtedness. On the other hand, the available gold reserve may be ample for the purpose provided it is fully employed, and there is the further advantage of this method, that the necessity of having to borrow abroad is avoided. But it is necessary in the first instance to overcome a certain reluctance to employ that gold reserve in what has the appearance of a large financial gamble. Monetary stability may be a condition of securing real budget equilibrium, but if the opportunity to secure that result is not accepted, the gold reserve might be depleted and finally lost without any permanent advantage being attained. Nevertheless, provided the necessary financial reforms are effected, the employment of the gold reserve in an endeavour to "peg" the exchange at some existing rate may succeed in securing the desired result, and there is experience to suggest that the experiment may prove less difficult and more successful than was at first anticipated. The experience of Poland, in that connection, is again instructive. Between June and December 1923 the

dollar rate in marks rose from 104,000 to 6,375,000. Towards the end of January 1924, when the rate had risen to fully 9,000,000, the Treasury's gold reserve, which only amounted to \$2.5 million, was boldly employed in an attempt to peg the existing rate, and a stable exchange was, in fact, achieved at 9,250,000. Moreover, the subsequent reserve of the Treasury was found to be larger than at the time the intervention occurred. The explanation of this rapid success is easily discovered. Provided the fall in the exchange is effectively checked, the "flight" of capital abroad will also be checked, and funds which have already been transferred abroad will tend to be repatriated. This in turn will lighten the task of the stabilising body, which finds that instead of losing its entire gold holding it is able to increase its holding of foreign currencies.

We have seen that there is reason for the view that even during the later stages of currency depreciation the attainment of budget equilibrium is not necessarily an impossible task. But it has also appeared that it need not be the first step in the process towards monetary and financial reconstruction. Thus, considering the period of extreme inflation as a whole, the line of causation tends to be reversed, and whereas budget deficits in the earlier stages may have set forces in operation which caused the depreciation of the currency, in the later stages the rapid depreciation of the currency proceeding in part from other factors may have been a genuine cause of budget deficits. To that extent, therefore, it may be expedient to concentrate primarily upon the task of stabilising the value of the currency, and therefore, or coevally, to proceed to secure budget equilibrium.

That thesis was implied in the recommendations of the French Committee of Experts which reported in July 1926. The policy actually adopted by the Poincaré Ministry, however, concentrated rather on the problem of the budget. Expenditure was curtailed and a new group of taxes imposed, while at the same time efforts were directed towards raising the value of the franc to

as high a level as was possible without provoking a serious economic crisis.

The task of effecting stabilisation involves several possibilities, and in each case considerable readjustment must be made. In the more extreme instances of currency depreciation which are at present under consideration, it has been found that actual exchange rates tended definitely to undervalue the currency abroad in relation to its internal purchasing power. Stabilisation may therefore be accomplished either at the internal value or at the external value; but since normal stability requires that the discrepancy between the two values shall be made to disappear, the readjustment to be accomplished will depend upon whether the currency is stabilised at the one value or at the other.¹

The problem here is one of determining the rate at which the central bank will be prepared to buy and sell foreign exchange without limit. It may be supposed, in the first instance, that it is decided to stabilise the currency at its external value, which is lower than its internal value. For the purpose of illustration it will be supposed that the level of world gold prices is represented by an index of 140 as compared with 100 pre-war; and that internal paper prices in the country in question are represented by an index of 10,000, and that the dollar exchange, which before the war had a gold parity of 20 to the dollar, is now quoted at 1550. Under these conditions, and assuming that a true purchasing-power parity can be calculated from the above indices, the purchasing-power parity would be 1428, and the actual exchange would be considerably undervalued abroad. Expressed otherwise, the level of gold prices in the country concerned would be represented by an index of 129, or 11 points below the world level. The position now is that the central bank is authorised to stabilise the exchange at its existing dollar rate. In this case, equilibrium requires that internal prices will rise till the index reaches 10,850. At that point the

¹ Cf. Gregory: *The First Year of the Gold Standard*.

purchasing-power parity and the actual stabilised rate of exchange will coincide, and the level of gold prices in the country concerned will be equal to the world level.¹ During the period of adjustment there may be a phase of trade activity associated with the rising price level, and that may continue until a position of real equilibrium has been reached. But the peculiar advantages of the inflationary period will gradually diminish until a certain crisis is developed and the artificial nature of the "boom" is disclosed. With the closing of the disparity as between the external and the internal values of the currency, the apparent advantages of the exporting industries will be removed, since their money costs will increase with the rise in domestic prices, while their receipts from sales abroad, when re-converted into local currency at a stable exchange rate, will remain unaffected. A similar check to activity will be manifest in the case of trades which are not producing for foreign markets. The advantages of holding stocks on a rising market will disappear when the price movement approaches its completion, and a severe reaction may be experienced when existing stocks are unloaded on a large scale.

The other case is represented by the attempt to stabilise the exchange at a rate which corresponds with the higher internal value of the currency. This procedure was recommended for Germany in 1922, though it was not adopted. In terms of the illustration cited above, the rate of stabilisation would be 1428 to the dollar as compared with the rate of 1550 to which the actual exchange had fallen. It might possibly be argued, as in the Experts Report in Germany, that the low external value of the currency reflected primarily the lack of confidence abroad, and that provided proper financial and monetary reforms were effected, an important

¹ The position is that at the date of stabilisation the internal value of the currency exceeds its external value, and the latter by stabilisation has been fixed. There will then emerge an increased demand for that currency. The central bank will acquire a larger holding of stable foreign currencies which serve as the basis for a larger internal note issue.

immediate recovery in the actual exchange would be experienced. Under these conditions the readjustment will take the form of a rise in the external value of the currency, and that will react on those exporting industries whose domestic money costs may remain stable, but whose receipts from sales abroad, when reconverted into local currency at an improving rate, will be diminished. In either case a crisis is likely to occur, but whereas in the first of the two alternatives the crisis is for the time delayed, in the second it is more immediate.

There remains to be considered another set of conditions which were illustrated by the instances of the United Kingdom and the countries of Scandinavia. We may suppose the case of a country where there was a disparity between the external and the internal values of its currency, but where the former was the higher and not the lower, as in the examples hitherto considered. Such a position might occur if there were reasons for expecting that the country in question would succeed in returning to the gold standard at the pre-war par of exchange at some near date. It might be that the policy based upon that decision had not yet been put into effect, but if the expectation became general, a new demand for that country's currency might develop in anticipation of the profits which would accrue when its value rose. In this way certain speculative factors might well precipitate a rapid appreciation of the exchanges before any corresponding improvement in the internal value of the currency had been apparent. More generally, any future change in the internal value of a currency, if that is anticipated, tends to be reflected in the actual exchange before that change has in fact occurred. If there is an expectation that the value of the unit of money will fall, people will be less willing to hold stocks of it; similarly, if the expectation points to a rise in the value of the unit of money, the willingness to hold currency will increase.

The problem here concerns the external over-valuation of a currency and the necessary adjustment which has

to be effected if the currency is stabilised at the higher value. The fact that the currency is over-valued abroad will imply that exports are discouraged and imports encouraged, and if the currency is stabilised at the higher external value, equilibrium will require a certain fall in internal prices. These export trades will find themselves handicapped, since their domestic costs will have remained unchanged, while with the higher exchange they will receive less in local currency for the goods which they have sold abroad at world prices. Some amount of compensation might occur if the raw materials for the exporting industries were imported, but there may be other items of cost which are more inflexible. There may, therefore, be some immediate trade difficulties until the readjustment as regards equilibrium has been completed.

The process of effecting this readjustment may be initiated by the adoption of measures to ensure an immediate contraction of credit, or that contraction may be allowed to develop in itself. In the first case, the official rate of discount will be raised and steps will be taken to make that rise effective. In the second case, imports will have been encouraged and exports discouraged, and the resultant exchange movement will be such as to deplete the gold reserves of the central bank. The effect of this will be to precipitate a rise in the official discount rate, and ultimately the credit contraction will be effected.

The preceding discussion has been concerned with the type of readjustment which is necessary if the internal and external values of a currency diverge at the time of stabilisation. Certain other aspects of the problem remain to be worked out with reference to the general post-war tendency to stabilise depreciated currencies on a gold basis. In that connection there is a distinction to be made, according as it is proposed to restore the pre-war gold standard or to adopt a new standard. In the first instance, the object is to restore the gold standard at the pre-war gold par of exchange, and that implies that prices in the country in question will have to be

reduced until they stand to pre-war prices in the same ratio that current American prices stand to pre-war American prices. Deflation of this character necessarily involves considerable disturbance, so that it has to be considered whether or not there are advantages in returning to the pre-war standard which will outweigh the disadvantages which must be experienced during the process of attaining that end.

The alternative which presents itself is to stabilise the currency not on the pre-war gold standard but on a new basis. That is the process of "devaluation" which consists in the establishment of a new and lower gold parity than that which had formerly existed; or, expressed otherwise, to make the paper currency of the country convertible into a smaller quantity of gold than it was convertible into before the war. It may be useful to work out the implications of this method of devaluation before examining those of deflation. It is a method which has particular reference to a number of the countries of Europe. To fix the conception, it may be supposed that as compared with the pre-war base, United States prices are represented by an index of 140, while British prices are represented by an index of 170. Other things remaining the same, and assuming that a true purchasing-power parity can be calculated from these indices, the new normal rate of exchange should show a fall in sterling to 82 per cent. of its old value in dollars; *i.e.* \$4.00 as compared with the pre-war parity of \$4.86. This new rate (or purchasing-power parity) would be normal to the new conditions, and provided no further price movements were in operation, the actual exchange and the purchasing-power parity would tend to coincide. Now if we suppose that that condition had been reached, a new gold parity could be adopted to coincide with the purchasing-power parity then established. That could be done by reducing the weight of gold which constituted the standard of value in this country to 82 per cent. of its former weight. Before the war the sovereign contained 113 grains troy of pure gold, while the dollar

was equivalent to 23.22 grains; on that basis there was the same weight of pure gold in £1 as there was in \$4.86. After devaluation the weight of the sovereign would be reduced to 92.66 grains, and on that basis the new gold par of exchange would be \$4. Convertibility could be restored to the note issue and gold movements could once more become free. If, on the other hand, the actual exchange stood at \$4 and convertibility and freedom of gold movements were restored as under pre-war conditions, gold would be rapidly drained abroad, since those who had to remit to America would find it cheaper to obtain gold for export from the Bank of England in exchange for notes, rather than to purchase an American credit at the market rate of \$4. Certain reactions would, of course, follow from this movement. Notes would be withdrawn from circulation and cancelled when gold was given in exchange for them, and forces would be set in operation tending to effect a contraction of credit and a fall in prices. If the gold reserves were large and the necessary fall in prices was small, the readjustment could be effected without experiencing a complete drain of the gold-holding of the central bank; but if the gold reserves were small or the necessary fall in prices was very great, the restoration of convertibility and freedom of gold movements on the pre-war basis would probably involve the complete exportation of the existing gold stocks.

As regards devaluation, the currency should first be stabilised, and the devaluation constitutes an official recognition of the depreciation of the currency relatively to gold. The practical problem in the decision to devalue or deflate must be considered in relation to the extent of the depreciation which has occurred. Where that depreciation in relation to gold was only moderate, a proposal to devalue the currency might conceivably undermine confidence in the financial good faith of the country in question.¹ In the case of the

¹ On the other hand the argument for devaluation would tend to be strengthened if the value of gold itself was rising.

United Kingdom the proposal would have to be considered in relation to the foreign indebtedness of the country and in relation also to the invisible income as regards the balance of indebtedness. Strict comparison of the effects of the two policies is difficult to make. Where, as in the instance of this country, the currency experienced a certain external over-valuation, deflation involved certain immediate difficulties, which devaluation might have avoided. But against these must be set the long-period consequences, where the advantages would appear to lie on the side of restoring the gold standard at the pre-war gold parity.

The general effects of such a policy of deflation are the reverse of those outlined in the discussion of inflation, and the process has sometimes been advocated as a means of rectifying certain of the anomalies which have been created by the previous depreciation of the currency. Within certain limits there may be compensatory results to be obtained, but against these must be set the fresh anomalies which proceed from a more or less rapid fall in prices. Wages which remained at the same nominal level would increase in real purchasing power during the period of falling prices, but these nominal wages would be subject to demands for reductions at least proportionate to the fall in prices, and if these reductions were secured real wages would be unaffected. But the process involves much friction before it is completed. The full pressure will be experienced in those industries which are subject to foreign competition, but in other trades, where some degree of "shelter" can be obtained, the movement will be more easily resisted. Hence, while after deflation the level of real wages may not be lower than before, there may be a considerable relative disparity as between wage levels in different industrial groups. And in so far as the export trades require the services of the sheltered group, a certain burden may be imposed upon the former on account of the "stickiness" of sheltered prices. There are, of course, other factors which tend to restore a normal balance, but these involve time and a considerable degree of possible friction.

In the same way the real values of dated obligations will be increased as prices fall, and creditors will gain at the expense of debtors. In certain cases this apparent gain will serve to rectify losses already inflicted upon creditors during the period of currency depreciation, but there can be no guarantee that equity will be really satisfied. Obligations of this kind are contracted at different dates and for different durations, so that the restoration of value already lost becomes definitely unequal. The point may be illustrated. We may suppose that three debts were contracted at different dates which may be taken as 1913, 1920 and 1925. Suppose also that in 1920 the purchasing power of the unit of money has fallen to four-fifths and in 1925 to one-half of its purchasing power in 1913; *i.e.* the price levels would be represented by indices of 100, 125 and 200 at the three dates. If, then, as a result of deflation, prices are reduced to an index of 150 in 1926, the real value of the debt contracted in 1925 will be increased by one-third as compared with its value in 1925, while the debt contracted in 1920 will be restored from five-eighths to five-sixths of its initial value, and the debt of 1913 will be restored from one-half (in 1925) to two-thirds of its original value. Consequently, if equity is to be fully satisfied, it would be necessary to effect a revaluation of indebtedness by reference to the purchasing power of money at the times when the various debts were incurred. This could be effected by constructing a scale of depreciation which would serve as a basis for revaluation.¹

The dislocation to which trade and industry are subject during deflation tends to intensify the normal difficulties of post-war reconstruction. Since the earlier inflation has proceeded from excessive Government borrowing from the banks, a reduction in that indebtedness must be secured, and if that is effected by means of increased taxation the real burden of that additional taxation will be increased during the period of falling prices. Economy of consumption will therefore be

¹ Cf. Hargreaves, *Restoring Monetary Standards*, 1926.

forced on the community. But at this point the time element becomes important. A sudden deflation may cause the real burden of debts to be increased too sharply. On the other hand, a prolonged process of deflation may produce a psychological atmosphere which does not respond readily when the process is completed. With a falling price level orders for new production will be postponed in order that purchasers may obtain the benefit of lower prices. Stocks of goods will tend to be unloaded, and if this occurs on a large scale, prices may slump heavily. Experience, moreover, suggests that a rise in the internal purchasing power of the unit of money during deflation will be accompanied by an even more rapid rise of its external value in terms of foreign currencies, and that fact may involve a certain overvaluation of the currency abroad which will react immediately upon the exporting industries of the deflating country. When deflation was pursued in Czechoslovakia in 1922, the value of the crown in Zurich rose by 136 per cent. between January and August, while its internal purchasing power did not rise by more than 40 per cent. in the course of the year.

From the standpoint of the national finances the advantages of a policy of deflation must depend largely upon the relative importance of the country's foreign indebtedness to its other obligations. When foreign loans have been contracted on a gold basis, every fall in the exchange will increase the amount in local currency which has to be provided out of current revenue for the service of the debt, while every rise in the exchange will have an opposite effect. It is conceivable that the advantage to be derived from an appreciation of the currency in this connection might be considerable, but that condition did not obtain in the instance of deflation referred to above, since the amount of the service required for the external indebtedness of Czechoslovakia represented only a small proportion of the national expenditure. And it remains to set against any possible advantage of this kind the increased real burden of the domestic

debt, if the ultimate price level should be lower than the average at which that debt was contracted. Further difficulties may also arise if the deflation is severe. Trade depression will react in definite ways upon the national finances. Revenue will decline, and while certain items of expenditure may be reduced with lower prices, there may be new items of outlay connected with unemployment relief, etc.

These points may be illustrated with reference to France. The public domestic debt at the end of March 1926 was 288 milliards (paper). The foreign debt amounted to 36.6 milliards gold. Taken at the average rate of exchange for July 1926, that latter item would be equivalent to roughly 280 milliards of paper francs, a figure approximately equal to the total domestic debt. But at the rate of exchange for December 1926, the external debt would only be equivalent to about 175 milliards. Then as regards the long-dated domestic debt it is rather evident that a very great fall in prices would still have to occur before the real burden of that debt to the State was increased.¹

Practical considerations suggest that the possibility of restoring former gold standards by the method of deflation presents itself only in the case of countries in which currency depreciation relatively to gold has been moderate. In the extreme instances which have been discussed the method had to be rejected, but even in the Latin countries of France, Belgium and Italy the method was inapplicable.² In July 1926 the French franc averaged 198 to the pound, or almost eight times its pre-war parity. Wholesale prices for the same month stood at an index of 836. To restore the pre-

¹ Between July and December, internal prices in France fell by 25 per cent., thereby increasing the real burden to the State of the domestic debt, but even after this fall, the level of prices was probably higher than the average level at which the domestic debt was contracted.

² Nevertheless the French Government in 1922 declared against a policy of devaluation for the franc. At that time the franc was worth fully 8 cents. At present it is worth about 4 cents. The circumstances under which devaluation was repudiated have therefore entirely changed.

war parity by the method of deflation would involve reducing the internal paper price level to the neighbourhood of 150, which may be taken as representing the level of world gold prices, and if deflation took the form—as had been suggested—of annual repayments of 2 milliard francs by the State to the Bank of France, a period of some eighteen years would elapse before the repayment of the Bank's advances to the State would be completed.

The alternative is represented first by stabilisation, and secondly, if it is desired to return to a gold standard, by devaluation. That devaluation may assume different forms. One of these is represented by the example of Finland, where it was considered inadvisable to alter the current circulation by effecting a new issue exchangeable for the old circulation at a prescribed rate. Under these conditions devaluation consisted in reducing the weight of gold which constituted the standard to an amount which gave a new gold parity equal to the dollar rate at which the currency had been stabilised.

The procedure in Germany was rather different. At the date of stabilisation the paper mark had depreciated to one-billionth of its pre-war value. There would clearly be much inconvenience in the preserving of a system of accounting under which prices would be expressed with such a multiplicity of noughts. Devaluation, therefore, took the form of the issue of a new currency to be exchanged for depreciated marks at the rate of one new mark for one billion old marks, while after a certain date the old circulation was demonetised. By this method stability was restored at the old sterling parity of 20.43 marks.

Finally, the method employed in Austria may be taken to illustrate a combination of the first two. In 1923 the crown was stabilised at 71,000 to the dollar, and at that rate the gold crown was equivalent to 14,400 paper crowns. At the end of 1924 the schilling was introduced as the new unit of currency and made equivalent to 10,000 paper crowns. New gold parities there-

fore resulted, and in the case of sterling the par of exchange was altered from 24.02 crowns to 34.585 schillings.

In conclusion, the general nature of these restorations which have been effected should be observed. Where currency reforms have been accomplished, the monetary systems have been linked to gold, and so the way has been prepared for a resumption of the general use of gold as the standard of value. But in no case has the pre-war monetary organisation been fully restored without modification.

It will be convenient at this stage to summarise briefly certain of the changes which have occurred. (1) Gold circulations, although only partially important before the war, have not been resumed in the European countries. Switzerland and Holland might be cited as exceptions to this, but while a gold circulation was again possible, the public appeared to indicate a preference for paper. (2) Gold movements have not yet become altogether free from restriction of some kind. In the case of Sweden the Riksbank has been granted a monopoly of the right to make imports of gold. Gold exports from Poland are only permitted under licence, and from Russia and Germany exports are strictly under control.¹ (3) The convertibility of notes into gold, which before the war was regarded as an essential feature of the full gold standard, has been modified in certain important directions, and there is the apparent paradox that the Act of 1925 which restored the gold standard in the United Kingdom also withdrew from Bank of England and currency notes the quality of being fully and freely exchangeable for gold on demand. Henceforth gold would be available at the same fixed purchase price, but "only in the form of bars containing approximately four hundred ounces of fine gold." (4) In the majority of countries, and more especially among the new countries,

¹ The Bank of the Netherlands delivers gold for export "to those countries only which in their turn are prepared to release gold (to Holland) as soon as their rates of exchange reach the gold export point to the Netherlands." Cf. Annual Report of the Bank for the year ending March 1927.

a gold exchange standard has been introduced; *i.e.* the local currency is maintained at par not directly with gold, but with other gold standard currencies. This system, which applied to India and Austria before the war, has now been generally extended, and has been put forward as, among other reasons, a useful mechanism for economising in the future demand for gold by concentrating the world's gold stocks in one or a few main centres. To maintain the system effectively requires that the central bank has full control over the monetary system of the country in question and that it is willing and able to buy and sell foreign gold currencies at fixed rates, and for that purpose the central bank must have at its command large reserves not of gold but of foreign currencies upon which it can draw when the occasion arises. But the normal functioning of the system presupposes that the value of the local currency is maintained in a state of equilibrium with the external price level, and the recent example of Poland may be taken as a warning against the attempt to pursue two independent policies at the same time.

CHAPTER II

THE UNITED KINGDOM

DEVALUATION apart, the problem of restoring the gold standard in the United Kingdom became one of securing the necessary adjustment between sterling prices and the level of prices in the United States, which had remained throughout on a gold basis. Some discussion of price movements in the latter country is therefore essential. That discussion may be conveniently arranged in respect of three periods which are to be distinguished: (1) the period prior to September 1924, (2) the period from September 1924 to May 1925, and (3) the period since the passing of the Gold Standard Act in the latter month.

The period of post-war deflation in the United States witnessed a fall in the Bureau of Labour's index of wholesale prices from 247 in May 1920 to 141 in July 1921 and 138 in January 1922. By November 1921 the New York re-discount rate had been reduced to 4½ per cent., as compared with 7 per cent. in June 1920, and 6½ per cent. in May 1921, and on June 23, 1922, a further reduction to 4 per cent. was effected. During that year there was a marked credit expansion and wholesale prices rose to an average of 155 for the last six months. The index of production in the basic industries,¹ which had fallen from 95 in the first quarter of 1920 to 64 in July 1921, rose to 71 for the last quarter of 1921 and to 97 for the last quarter of 1922. By March 1923, wholesale prices had risen to 159 and the index of production reached 107 in May. The trade activity which had developed, however, was partly

¹ Modified to allow for seasonal variations. Monthly average, 1923-5 = 100 (new series).

inflationary, and in February 1922 the New York re-discount rate was advanced to $4\frac{1}{2}$ per cent., and was reinforced by open-market operations which made the credit restriction more effective. The effect of the continued gold influx during 1922 and 1923 had a special degree of importance in relation to the credit movements of the period. In these two years net imports of gold amounted to \$532 million, but whereas the influx in 1920 and 1921 had the effect of enabling member banks to reduce their indebtedness to the reserve banks, the liquidation of their indebtedness had been completed, and the influx during 1922 and 1923 enabled a credit expansion to be made without resort to additional reserve bank credit. Between the spring of 1922 and the end of 1923 the member banks extended an additional volume of credit of over \$3,300,000,000, representing an increase over the period of some 14 per cent.¹

At the beginning of 1923 the open-market holdings of the Federal reserve banks amounted to \$712 million, while re-discounts for member banks were slightly less, *i.e.* \$628 million. By the third quarter of the year open-market holdings were reduced to \$270 million, increasing to \$440 million at the end of the year, while re-discounts were roughly \$850 million. The volume of reserve bank credit in use was therefore but little altered, but its composition was changed, and the indebtedness of member banks to the reserve banks was increased. Subsequent, however, to the rise in the re-discount rate in February, the industrial and commercial demand for credit at the member banks continued to increase, but from May prices declined, and fell to 150 in August and to an average of 152 in the last quarter of the year. The index of production in the basic industries similarly declined from 107 in May to 100 in September, and 96 in December. In 1924 wholesale prices continued to fall to 147 in the second quarter of the year, and the production index reached its lowest point at 83 in July. The period was one of industrial readjustment, during

¹ Cf. *Tenth Annual Report of the Federal Reserve Board*, p. 2.

which accumulated stocks were reduced, but there was a marked recovery in the last quarter of 1924. The unloading of accumulated stocks was followed by a renewed demand for industrial raw materials, and the good harvest conditions were reinforced by the general world shortage of wheat in 1924. Successive reductions in the New York re-discount rate brought the rate down to 3 per cent. in August, and again the funds at the disposal of the market were increased during the latter half of the year by open-market purchases by the reserve banks. Total earning assets of the reserve banks, after falling from \$1211 million at the end of 1923 to \$825 million at the end of July 1924, rose to \$1249 million at the end of the year; the holdings of United States securities at the same dates were respectively \$133 million, \$505 million and \$540 million. The general policy of the Federal Reserve Board since 1923 had aimed at "maintaining a steadying influence on credit conditions," not as reflected merely by price index-numbers, but as reflected by the combined indices of activity and information which were available. Meanwhile wholesale prices had risen from 145 in June 1924 to 161 in February 1925, representing an increase of 11 per cent. in a period of seven months. The index of production rose from 83 in July 1924 to 100 in December and 105 in January 1925.

Taking, therefore, the period prior to the passing of the Gold Standard Act of May 1925, prices in the United States were subject to four movements corresponding to distinct phases of economic activity. (1) From the second quarter of 1920 to the first quarter of 1922 the Bureau of Labour's index-number of wholesale prices fell from 245 to 140, or by approximately 43 per cent. (2) The second movement witnessed a rise of 12 per cent. to 157 in the first quarter of 1923. (3) The third phase revealed a downward movement of fully 6 per cent. to the second quarter of 1924; and (4) the final movement was accompanied by a rise of fully 9 per cent. to the first quarter of 1925.

British prices, having fallen to an average of 162¹ in the first quarter of 1922, remained relatively stable during the period of rising United States prices, and the exchange rose from \$4.31 in the first quarter of 1922 to \$4.68 in the first quarter of 1923, or by more than 6 per cent. Again, during 1923 and the first half of 1924, while United States prices were falling, the British index displayed no particular tendency until the beginning of 1924, and the average exchange fell from \$4.68 in the first quarter of 1923 to \$4.29 in the first quarter of 1924, or by fully 8 per cent. Finally, between the second quarter of 1924 and the first quarter of 1925, while the United States prices rose by fully 9 per cent., British prices only increased from 164 to 167, or rather less than 2 per cent. The sterling exchange, however, rose by fully 10 per cent., from \$4.34 to \$4.78 on the basis of quarterly averages.

It is necessary then to examine more closely the extent to which British and United States prices were adjusted on the basis of the exchange rates ruling over the period. Such a comparison may take account of the cost-of-living index-numbers in the two countries as reflecting the prices of goods and services which are not immediately and directly affected by exchange fluctuations. The United States cost-of-living index employed is that relating to thirty-two towns, and that fell during the first period from 214 in June 1920 to 166 in September 1922. From that month, and seasonal variations apart, the index showed a slight upward tendency to 173 in December 1924. The British cost-of-living index fell from its highest point at 276 in October 1920 to 169 in June 1923, then rising to 181 in December 1924.

The following table affords a comparison of the actual exchange movements with the course of the purchasing-power parities, (1) on the basis of cost-of-living indices, and (2) on the basis of the index-numbers of wholesale prices:

¹ Board of Trade index.

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PURCHASING-POWER PARITIES.

		Actual Exchange.	Cost of Living Indices.	Wholesale Price Indices.*
1922.	1st Qr.	\$4.31	\$4.37	\$4.21
	2nd "	4.44	4.51	4.47
	3rd "	4.44	4.51	4.78
	4th "	4.51	4.59	4.78
1923.	1st "	4.68	4.67	4.87
	2nd "	4.63	4.89	4.74
	3rd "	4.56	4.84	4.73
	4th "	4.42	4.75	4.59
1924.	1st "	4.29	4.65	4.43
	2nd "	4.34	4.87	4.36
	3rd "	4.44	4.84	4.40
	4th "	4.58	4.65	4.41
1925.	1st "	4.78	—	4.64

* Bureau of Labour and Board of Trade.

On the basis of the cost-of-living indices, therefore, sterling was slightly under-valued during 1922.¹ On the basis of wholesale prices the under-valuation was apparently greater except for the first quarter of the year, when sterling was slightly over-valued. Incidentally, moreover, unemployment diminished during the year, the unemployed percentage of insured persons falling from 16.2 in January to 11.9 in September and 12.2 in December. During 1923 the same under-valuation persisted to a rather greater extent on both sets of indices, except for the first quarter of the year, when the actual exchange appeared to be in harmony with the cost-of-living indices. The quarterly averages of unemployment percentages showed little change round 11.6 for the year. In 1924 sterling remained under-valued abroad on the basis of the cost-of-living indices, but was slightly over-valued during the second half of the year on the basis of wholesale prices. Unemployment continued to decline during the first six months to 9.4 per cent. in

¹ It should be noted that a new scale of United States tariffs came into operation in this year.

June, but increased during the latter half-year to 11 per cent. in the last quarter.

Comparison of cost-of-living indices therefore indicates that sterling was under-valued during the three years in question, except for the first quarter of 1923, when there was an apparent equilibrium. On the other hand, on the basis of wholesale prices sterling was apparently over-valued during the first quarter of 1922 and the last nine months prior to the return to the gold standard by the United Kingdom.

There remains, however, the relationship of the different price levels within the United Kingdom to be considered. Following the method adopted by Mr. Keynes,¹ we may examine the relative movements of world gold prices and the level of "sheltered" prices as reflected by the British cost-of-living index and the index-number of British wages. Since the United States Bureau of Labour's wholesale price index-number and the British Board of Trade's index largely cover a similar group of commodities which enter into international trade, the unsheltered level of world gold prices is taken on the basis of the average of these two indices at respective dates. The sheltered price index is taken as the average of the gold cost of living and the index of wages also converted where necessary to a gold basis.² The final column in the accompanying table gives the average unemployment percentage of persons insured under the Unemployment Insurance Acts.

Thus during the first eighteen months up to the middle of 1923, the unsheltered level of world gold prices as reflected in column (3) rose by fully 8 per cent., but the level of sheltered prices as reflected in column (6) fell by fully 7 per cent. The result was a gradual approach towards a uniformity in the two price levels.

¹ *Nation*, 12.2.27.

² "These," wrote Mr. Keynes, "taken in conjunction with such things as rent, rates, cost of social insurance, railway charges, and the various items on either side of the National Budget, which are practically fixed in terms of money, are pointers to the sheltered value of sterling."

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GOLD PRICES. (Pre-war = 100.)

	Unsheltered.			Sheltered.			(7) Ratio of (6) to (3).	(8) Unem- ploy- ment.
	(1) Bureau of Labour.	(2) Board of Trade.	(3) Aver- age.	(4) Gold Cost of Living.	(5) Gold Wages.	(6) Aver- age.		
1922.								
1st Qr.	140	143	142	164	190	177	125	15.2%
2nd "	147	146	146	166	183	174	119	13.5%
3rd "	154	143	148	163	173	168	114	12.0%
4th "	155	145	150	166	166	166	111	12.2%
1923.								
1st "	157	151	154	169	170	169	109	11.8%
2nd "	156	152	154	160	169	164	107	11.0%
3rd "	152	147	149	162	163	163	109	11.7%
4th "	152	146	149	160	157	158	106	11.3%
1924.								
1st "	151	146	148	157	151	156	105	10.8%
2nd "	147	146	147	152	158	155	105	9.5%
3rd "	149	150	149	156	163	159	107	10.4%
4th "	154	160	157	168	168	168	107	11.0%
1925.								
1st "	161	165	163	176	178	177	109	11.3%

In the first quarter of 1922, sheltered prices were 25 per cent. above the unsheltered level; in the second quarter of 1923 they were only 7 per cent. above the unsheltered level. It is significant, moreover, that during that period the unemployment figures showed a decline from 15.5 per cent. to 11.0 per cent.

In the course of the next twelve months the unsheltered price level after a fall to 149 in the third quarter of 1923 remained relatively stable, though with a slight downward tendency. The sheltered price level, on the other hand, continued to fall by about 5 per cent., and in the first half of 1924, sheltered prices were only 5 per cent. above the unsheltered level. Unemployment totals continued to show a decline to 9.5 per cent. in June 1924.

The third phase extends from the second quarter of 1924 to the first quarter of 1925. Unsheltered prices

rose by about 11 per cent. over the period, but sheltered prices rose by fully 14 per cent. The relative position of the two levels was therefore worsened and the sheltered price level in the first quarter of 1925 was 9 per cent. above the unsheltered level. Unemployment, moreover, increased from 9.5 per cent. to 11.3 per cent. over the same period.

The preceding analysis for the three and a quarter years prior to the return to the gold standard reveals two important conclusions. (1) Unemployment declined during the period when the under-valuation of sterling increased, and increased when the under-valuation of sterling diminished or disappeared. (2) Unemployment declined during the period when the gap between sheltered and unsheltered prices was contracted and increased when the gap was widened.

The analysis, however, would not be complete without some consideration of the extent to which similar movements had occurred in other countries. Detailed information as regards wages is not available for these countries abroad. The inquiry is, therefore, necessarily restricted to an examination of the movements of the gold cost of living to the level of gold wholesale prices. This is analysed in part in the subsequent chapters which deal with particular countries, but it may be convenient to summarise the position in the table on p. 53.

The comparisons as shown in that table indicate that while the ratio of sheltered to unsheltered prices in the United Kingdom was falling up to the autumn of 1924, an opposite movement was occurring in the United States. In the case of Germany the relative advantage enjoyed by that country was steadily diminishing; in Belgium and Italy it also declined; but in the case of France the relative advantage was still very great. From the autumn of 1924 to March 1925 the gap between sheltered and unsheltered prices increased in the United Kingdom but diminished in the United States, and only a slight compensation resulted from the continued rise in the ratio in Germany and Belgium. It would not be

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RATIO OF GOLD COST OF LIVING TO GOLD WHOLESALE PRICES.

	United Kingdom.*	United States.	Belgium.	Germany.†	France.	Italy.	Sweden.
1923.							
March .	112	107	85	—	66	84	105
June .	105	111	86	—	71	86	106
Sept. .	110	112	88	—	67	86	109
Dec. .	109	114	86	—	65	86	110
1924.							
March .	108	113	82	76	71	90	107
June .	104	117	87	82	77	92	108
Sept. .	104	115	89	88	74	89	107
Dec. .	105	110	92	87	73	90	106
1925.							
March .	107	—	94	90	73	95	102

* Quarterly figures as in previous table. Ratio of col. (4) to col. (2).

† Quarterly figures.

valid to stress the details included in the above table, but in the absence of more complete information they may be taken as indicative of the general trend of relative price levels in the other countries.

The sterling exchange, which was 88.6 per cent. of parity in June 1924, rose rapidly during the autumn months and reached 96.4 per cent. of parity in December and 98 per cent. in February 1925. On the basis of comparative wholesale prices these high rates represented an over-valued pound. Several factors had contributed to this exchange movement. The Gold and Silver Export Control Act of 1920 was due to expire at the end of 1925, and would either have to be renewed or allowed to lapse. The former alternative would occur if the decision to return to the gold standard was to be postponed. The latter would occur if the gold standard was to be restored. Working on the latter assumption, the American demand for sterling increased, and this increased speculative demand contributed in the main towards the rapid appreciation of the pound. Official

and market discount rates, moreover, had been materially higher in London than in New York from the middle of 1924, and this coupled with the former expectation led to a considerable transference of liquid balances to London.

In June 1924, a Committee had been appointed by Mr. Snowden, who was then Chancellor of the Exchequer, to consider the conditions under which the issue of currency notes and Bank of England notes might be amalgamated. This problem was bound up with larger issues of monetary policy, and the rapid appreciation of the sterling exchange occurred during the interval in which the Committee was in session. The facts which presented themselves were briefly as follows:—In June 1924 the sterling exchange was 12 per cent. below parity and was apparently in harmony with the purchasing-power parity as calculated on the basis of wholesale price indices. When the Report was written the exchange had risen to parity, but on the basis of relative wholesale prices some degree of over-valuation probably existed. That in itself involved a certain degree of deflation in the United Kingdom if the exchange was to be maintained at its high level, on the assumption that United States prices did not rise to the British level, but a further deflation which involved a readjustment of $1\frac{1}{2}$ per cent. would enable the gold parity to be maintained. On these grounds the Committee recommended that the opportunity should be taken to return to the gold standard. Apart from devaluation, which had been ruled out, the alternative of postponing the decision to return to the gold standard involved experiencing a decline in the external value of the pound, a further period of uncertainty and instability of exchange rates, and finally, when the restoration of the gold standard was in fact to be accomplished, a period during which the external value of the pound would have to be raised. This alternative the Committee described as “a short-sighted policy, injurious to trade and industry.”

It is of some importance that United States wholesale

prices had been rising since the middle of 1924. During the last six months of the year the Bureau of Labour's index had risen by fully 8 per cent. The British Board of Trade's index had also risen by fully 4 per cent. There was, therefore, the possibility that the gap between the two wholesale price levels would be removed if (1) United States prices continued to rise, and (2) the rise in British prices was checked. The Committee on the Currency and Bank of England note issues had, in fact, agreed at the beginning of their inquiry, "that the return to parity and the resumption of the free gold market, though it ought not to be much longer delayed, could not be regarded as a matter of such extreme urgency as to justify a credit policy calculated to bring down domestic prices if the same practical result could reasonably be expected to be attained within a very few months by a policy designed merely to prevent them rising concurrently with a rise elsewhere." In any case, therefore, some form of credit restriction would be essential. As it happened, United States prices continued to rise up to February 1925, while British prices were checked as from January.

The high external value of sterling which had been reached was founded to some extent upon unstable factors. The speculative purchase of sterling in New York during the autumn of 1924 was essentially of this character, since the inducement to make purchases of this order diminished as the exchange approached nearer to parity and sales of sterling for profit-taking purposes were liable to check the rise and even to precipitate a decline. There was, however, a reinforcing influence, though also of an unstable character. Given that the exchange was close to parity, or more particularly that the gold standard was in fact restored, differences in discount rates as between London and New York might be expected to result in considerable movements of bank balances from one centre to the other. On February 27 the New York official rate was raised from 3 per cent. to 3½ per cent., and the Bank of England rate was raised

to 5 per cent. London market rates of discount, which were 0.4 per cent. below New York market rates in May 1924, were 1.8 per cent. above New York in December. In January and February 1925 the gap was reduced to 0.8 per cent., rising to 1.3 per cent. in March, 1.0 per cent. in April and 1.5 per cent. in May. A definite inducement to transfer bank balances to London therefore existed at the moment when profit-taking sales of sterling by New York were most likely to occur. This compensating factor, however, was equally unstable with the first, and it was only likely to be effective if the transfer of balances exceeded the volume of sales on speculative account.

The rise in official discount rates in February 1925 was followed by a certain fall in prices in both the United Kingdom and the United States, and it is probable that the influence of the rise in bank rate in the United Kingdom reacted definitely upon the United States, in so far as a large proportion of the United States exports are financed by British funds.¹ Between January and May the British Board of Trade's index-number fell by 7 per cent.; during the same period the Bureau of Labour's index fell by 3 per cent. In June the two index-numbers were identical at 157. The United States index of production fell from 106 in February to 101 in June, but the unemployment figures in the United Kingdom continued to fall from 11.5 per cent. in January to 10.9 per cent. in May.

In August, bank rate was reduced to 4½ per cent., and in October to 4 per cent. In December it was raised to 5 per cent. During the first three months of the working of the gold standard the net gold influx amounted to £8,749,000. From August to December there was a net *outflow* of £20,344,000, or £11,595,000 for the period of eight months. From January to April 1926 the influx was £1,935,000. During the next five months there was a net inflow of £8,935,000, followed by an outflow of £4,599,000 during the last quarter of

¹ Cf. Hawtrey, *Monetary Reconstruction*, 2nd edit., p. 152.

1926, or a net *inflow* for the year of £6,271,000.¹ The significance of these movements has to be considered in relation to (1) the financial policy of the Bank of England and (2) the adjustment of price levels. The second of these may be considered first.

The following table shows the relationship of United States prices to British prices on the basis of wholesale and cost-of-living indices during 1925 and 1926, and the first half of 1927.

		Ratio of United States Cost of Living to United Kingdom Cost of Living.*	Ratio of United States Wholesale Prices to United Kingdom Wholesale Prices.
1925.	1st Qr.	—	98
	2nd "	101	98
	3rd "	—	102
	4th "	101	102
1926.	1st "	—	105
	2nd "	104	105
	3rd "	—	100
	4th "	98	99
1927.	1st "	—	103
	2nd "	104	102

* Figures for June and December only available.

The cost-of-living figures, while not frequently obtainable for the United States, suggest that the United States level was if anything above the British level except at the end of 1926. The comparison of wholesale prices would appear to indicate that British prices were somewhat higher during the first half of 1925, but that the relative position changed during the next twelve months till United States prices were 5 per cent. above British level. During the last six months of 1926 the two wholesale price levels were practically in harmony. There is, therefore, in general no evidence that any particular

¹ The figures cited are taken from the *London and Cambridge Economic Service*, but do not correspond exactly with those given by Gregory in his *First Year of the Gold Standard*, p. 82.

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disadvantage accrued to the United Kingdom through any adverse relationship of British to United States price levels.

Continuing the comparisons given earlier relating to the relationship of sheltered to unsheltered price levels in the United Kingdom, the next table relates to the years 1925, 1926, and 1927 (first half).

	Unsheltered.			Sheltered.			(7)	(8)
	(1) Bureau of Labour.	(2) Board of Trade.	(3) Aver- age.	(4) United King- dom Cost of Living.	(5) United King- dom Wages.	(6) Aver- age.		
1925.								
1st Qr.	161	165	163	176	178	177	109	11.3%
2nd "	156	159	158	172	181	177	112	11.2%
3rd "	160	157	158	173	180	177	112	11.8%
4th "	157	154	155	176	180	178	115	10.9%
1926.								
1st "	154	147	150	173	180	177	118	10.3%
2nd "	152	145	148	168	180	174	118	13.8%*
3rd "	150	150	150	171	180	175	117	14.2%*
4th "	148	150	149	177	180	178	119	13.0%*
1927.								
1st "	146	142	144	169	181	175	122	11.0%
2nd "	144	141	143	164	181	173	121	9.0%

* Coal Strike. Excludes coal-miners, who were disallowed from benefit.

The table shows that while gold unsheltered prices (column 3) fell by about 9 per cent. over the period of two years, sheltered prices remained inflexible, and the widening of the gap between the two price levels, which was noted from the middle of 1924, has become steadily more marked, until in the last quarter of 1926 the sheltered price level was 19 per cent. above the unsheltered level. It is true also that unemployment declined further to 10.3 per cent. in the first quarter of 1926

despite the widening of the gap, but it would be necessary to make allowance for the operation of the coal-mining subsidy during that period.

As regards other countries the ratios of cost of living to wholesale price indices are as follows :

RATIO OF COST OF LIVING TO WHOLESALE INDICES.

	United Kingdom.*	United States.	Belgium.	Germany.†	France.	Italy.	Sweden.	Holland.
1925.								
March .	107	—	94	90	73	95	106	117
June .	108	111	91	97	72	88	109	117
Sept. .	110	—	91	101	73	89	111	118
Dec. .	114	114	95	99	66	92	113	114
1926.								
March .	118	—	89	100	70	93	116	119
June .	116	115	86	103	64	92	115	119
Sept. .	114	—	80	106	69	89	117	117
Dec. .	118	119	86	105	85	96	114	114
1927.								
March .	119	—	—	106	82	103	119	115
June .	116	120	—	107	85	103	116	112

* Quarterly averages as in previous table. Ratio of column (4) to column (2).

† Quarterly figures.

Thus the adverse movement which occurred in the United Kingdom was accompanied by a similar movement in the United States, Sweden and Germany. As regards Italy there was probably little relative change,¹ but in Belgium and France monetary disorganisation reduced the ratios except in the last quarter of the year, when the overwhelming advantage enjoyed by these countries was partially reduced. The general conclusion which emerges, therefore, is that since the return to the gold standard by the United Kingdom, the fall in world gold prices has not been compensated by any correspond-

¹ Since the draft of the above was written an appreciable rise in the Italian ratio has, in fact, occurred.

ing decline in internal prices and costs so far as these may be indicated by the cost-of-living figures. Apart from those countries, such as France and Belgium, where monetary dislocation became again important, that result appears to have been a feature common to all the countries examined, though in varying degrees.¹

The trade position of the United Kingdom as revealed by the quarterly Board of Trade returns may be summarised in the following table, which shows changes in value and volume as compared with the respective quarters in 1924.

	1925.				1926.			
	1.	2.	3.	4.	1.	2.	3.	4.
A. Total Exports :								
Value . . .	99	101	96	93	92	94	91	91
Volume . . .	109	94	96	99	107	81	86	81
B. Exports of Raw Materials and articles mainly unmanufactured :								
Value . . .	92	91	95	80	80	79	75	75
Volume . . .	90	85	90	96	86	52	33	46
C. Exports of articles wholly or mainly manufactured :								
Value . . .	99	103	97	94	92	95	92	92
Volume . . .	112	93	96	103	111	84	93	88
D. Imports of articles wholly or mainly manufactured :								
Value . . .	100	94	94	97	95	90	89	92
Volume . . .	124	138	90	101	130	112	112	131
E. Total Imports :								
Value . . .	103	100	101	97	95	92	92	88
Volume . . .	113	110	92	100	112	103	107	104

The returns for the last three quarters of 1926 are

¹ The problem of United States agriculture in this respect corresponds with the problem of British export industries in this period.

necessarily affected by the prolonged coal dispute. Taking, however, the twelve months ending in March of that year, the volume of total exports after a sharp fall during the first quarter of the gold standard year recovered steadily till the volume in the first quarter of 1926 was practically identical with the volume in the first quarter of 1925. The real volume of manufactured imports, on the other hand, was greater in the second quarter of 1925 and the first quarter of 1926 than in the first three months of 1925. It would be impossible to assign to each of the various relevant factors its precise degree of importance in relation to these changes. The coal subsidy and the reimposition of the McKenna duties and the embargo on foreign capital issues in London would have to be considered. But over the period of three years 1924-6 the adverse visible trade balance of the country increased considerably. The Board of Trade's figures¹ for invisible items of income are as follows :

	In million £'s.		
	1924.	1925.	1926.
Excess of Imports of Merchandise and Bullion	324	384	477
Estimated excess of Government payments abroad	25	11	—
Total	349	395	477
Net Shipping Income	140	124	120
Income from Overseas Investments	220	250	270
Income from Short Interest and Commissions	60	60	60
Miscellaneous	15	15	15
Total	435	449	465
Net balance	+86	+54	-12

The foreign and colonial capital issues in London,

¹ *Board of Trade Journal*, 27.1.27.

however, were £99 million in 1925, and £122 million in 1926.¹ To some extent the official figures of invisible income are probably under-estimated, but the general result is clear. Taking the two years 1925-6, the amount available for fresh overseas investment, on the official estimates, was only £42 million, as against £220 million actually loaned. The difference of £180 million would appear to represent the amount of the net sales² of foreign securities held by British subjects plus the amount of short-term foreign loans raised in London.³

The position after the return to the gold standard in May 1925 may be said to have been one where the dollar exchange was maintained by the transference of bank balances to London as a result of the higher interest rates prevailing at that centre, and reinforced by the effect of the embargo on foreign loans, which was continued up to December 1925. The inducement to transfer balances from New York to London nevertheless diminished steadily from May to October 1925, the difference between London and New York rates falling from 1.5 per cent. to 0.1 per cent. over that period. In December bank rate was raised to 5 per cent.; the rise in the London market rate of discount, which had declined up to October, continued up to January 1926, and the margin over United States market rates also increased. During 1926 bank rate remained at 5 per cent., and the market rate of discount, after falling from 4.86 per cent. in January to 4.27 per cent. in June, increased steadily to 4.72 per cent. in November. Gold exports were checked at the end of 1925, and from May to September 1926 there was a large influx. It is reasonable to suppose that these gold movements reflected the ebb and flow of foreign balances. There is, in fact,

¹ As estimated by the *Statist*.

² *I.e.* after allowing for foreign securities purchased by British nationals.

³ Cf. Mr. Keynes in the *Nation*, 23.10.26. Also Gregory, *The First Year of the Gold Standard*, p. 92, where it is argued that part of the funds placed in London would have been placed there in any case apart from the temporary inducement afforded by higher interest rates.

a marked correlation as between the gold movements of the period and the margin between London and New York market rates of discount.

The question arises as to the effect of these gold movements on the policy adopted by the Bank of England. The following table illustrates the movements in deposits, securities and banking reserve :¹

	Total Deposits.	Total Securi- ties.	Reserve.	Gold Movements (Total).	Average Market Rate of Discount.
Average :	Million.	Million.	Million.	£	
May-June 1925 .	£122	£112	£31	+ 2,391,000	4.55%
3rd Qr. " .	129	109	37	+ 2,333,000	4.08%
4th " " .	126	118	26	-16,219,000	4.01%
1st " 1926 .	129	122	23	+ 2,194,000	4.54%
2nd " " .	127	114	27	+ 3,538,000	4.37%
3rd " " .	122	108	32	+ 5,138,000	4.40%
4th " " .	123	107	31	- 4,599,000	4.63%
1st " 1927 .	124	109	33	- 795,000	4.23%
2nd " " .	120	103	34	- 474,000	4.07%

This aspect of the question is one which has been much discussed. It has been held that the Bank of England has pursued a policy of credit restriction by open-market operations which reduced the volume of funds available in the market. On the other hand, it has been held that the Bank has adopted a policy of maintaining a stable volume of credit at the disposal of the market, also by means of open-market operations which were designed to neutralise the effects of gold movements. On the basis of the quarterly averages given above it does appear that "the Bank has not allowed movements in the reserve to *dominate* the position,"² at least from the middle of 1925. Thus while the reserve diminished

¹ The averages cited, of course, obscure the variations within the different periods, but in view of the controversy which has developed, the general trend over the period as a whole is of more importance.

² Cf. Gregory, *First Year of the Gold Standard*, p. 86.

by £14 million between the third quarter of 1925 and the first quarter of 1926, "total deposits" at the latter date were equal to the corresponding figure at the former. Moreover, during the first three quarters of 1926, "total deposits" fell by £7 million, despite the increase of £9 million in reserve. It might perhaps be argued that during this latter period the Bank did endeavour to reduce the volume of credit for the market by the sale of securities, and that owing to reduced demand resulting from the trade disturbance of the year, market rates of discount showed no appreciable rise until towards the end of the year. If, however, gold movements can be taken to reflect movements of foreign balances to and from London, the supply of funds in the market, while apparently reduced by the Bank, were largely compensated by the increase in foreign funds available. The evidence, therefore, does point to the maintenance throughout the period of the stabilisation policy pursued by the Bank.

These movements which have been described relate to the financial mechanism by which the gold standard has been successfully maintained, but they have left the fundamental position of relative price levels unaffected. In fact, as already indicated, and subject only to the similar movements which have occurred in other countries, the disparity between internal and external prices has widened considerably. The difficulty might be met if world gold prices rose by about 20 per cent. and internal prices remained substantially unchanged. Such a contingency, however, need not reasonably be expected. A partial fall in internal prices coupled with a smaller rise in external prices would bring about the same results, but again there is no particular reason why this happy combination of circumstances should be brought about. The third possibility of a real credit restriction calculated to reduce unsheltered prices affords no guarantee that the same disparity in relation to unsheltered prices will not remain. But the continuance of the present policy of maintaining the gold standard under conditions of

real maladjustment appears to imply a hope that either the first or the second possibility may occur.

The earlier discussion, however, has perhaps made it clear that this particular problem of maladjusted price levels is not the product of the return to the gold standard. It was particularly marked during the first half of 1922. In fact the four years 1922-6 have constituted a definite cycle in this respect. It is not necessarily, therefore, eliminated by abandoning the gold standard. The danger is that the effects of the maladjustment may be over-stated. As regards wage rates, it is a normal condition that "unsheltered" rates be subject to greater fluctuations than "sheltered" rates: similarly, "internal" prices are less flexible than world gold prices. But these are phenomena which are not confined to one particular country, though they may be intensified by semi-rigid social and political institutions. It should not be forgotten that particular difficulties have arisen for this country through the currency disorganisation of the other countries of Europe, and to that extent the problem should be reduced in intensity as a result of monetary reorganisation in those countries. But, taking a longer view, the analysis may have served to indicate the advantages which are likely to accrue from the adoption of any effective scheme which provides for the stabilisation of the value of gold.

CHAPTER III

SWEDEN, DENMARK AND NORWAY

A CERTAIN similarity may be observed between the position of Sweden and that of Switzerland during the period under review. Both were important neutral states, but war conditions reacted directly upon their respective currency systems, and both were confronted with problems arising from their membership of monetary unions. There were, of course, differences in degree. The geographical situation of Sweden was less unfavourable than that of Switzerland in the event of European hostilities, and large war-time earnings were obtained by the Swedish mercantile marine.

The main events of the war period may be summarised. On August 2, 1914, the convertibility of Riksbank notes was suspended, and on April 15, 1915, an amendment to the Bank Act was passed which enabled Parliament to maintain inconvertibility in the event of war or monetary crisis. In February 1916 the free importation of gold was suspended at the request of the Bank, and at the end of April the right of free coinage was also suspended. During the war period the gold holding of the Riksbank was greatly increased, and that movement continued even after the free importation of gold had been withdrawn.¹ It has been held that the rise in Swedish prices during this period indicated the

¹ It has been held that before the war Sweden held a relatively small gold reserve and did not "take quite its due share of the burden of keeping the world's gold reserve." There was practically no gold circulation although Danish and Norwegian gold coins were legal tender in Sweden, and as regards foreign payments "the Riksbank and the other banks help themselves by keeping sufficient balances abroad, or, if need be, get help by the credit of the Government." Cf. Wicksell, "The Scandinavian Gold Policy" (*Economic Journal*, Sept. 1916, p. 313).

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depreciation of gold and not the result of excessive paper issues. It is necessary, however, to distinguish between two main phases during the period.

The war requirements of the belligerent states were reflected directly in an increased demand for Swedish exports, but there were difficulties which prevented Sweden from obtaining imports of necessary materials from belligerent countries. In 1913 the visible trade balance was adverse to the extent of about 27 million kroner. During the war years the visible trade balance was favourable, and from 1914 to 1918 the aggregate excess of exports amounted to 134.5 millions. In addition there were large shipping earnings, the gross amount of which reached 630 millions in 1918 as compared with 197 millions, which was the average for 1913-15.¹ There was, therefore, a tendency for part of the favourable balance of indebtedness to Sweden to be remitted in gold, and the gold holding of the Riksbank increased from 108.5 millions at the end of 1914 to 285.6 millions at the end of 1918. The same course of events was also favourable to the return of Swedish securities formerly held abroad, and it has been estimated that 750 millions of these were repatriated between 1915 and 1923.² The bulk of the Swedish funded debt in 1913 was held abroad; after the war the greater part was held within the country itself.³

The granting of credit to belligerent countries was an important factor in the monetary developments of the war years. Exporters sold goods abroad against bills which they discounted, and in so far as the discounting banks held these bills they granted credit to the importing countries. The Riksbank's average holding of foreign exchange in 1913 was 98.8 millions. By the end of August 1916 it had risen to 236.4 millions.⁴ At the end of 1918, credits granted abroad by private banks

¹ *Federal Reserve Bulletin*, June 1924.

² Department of Overseas Trade, *Report on Sweden*, January 1925.

³ *Federal Reserve Bulletin*, January 1922.

⁴ Cassel, *Money and Foreign Exchanges after 1914*, p. 129.

reached a total of 467·1 millions as compared with the post-war position, when debts and bills outstanding showed a balance in favour of abroad.¹ With the subsequent depreciation of foreign currencies these Swedish banks incurred heavy losses on account of the magnitude of their holdings, and during the four years from 1918 to 1921 the Riksbank wrote off 87·4 millions under the head of "expenditure on foreign business and depreciation of foreign currencies."²

When the Bank, early in 1916, sought for the legal prohibition of gold imports it based its claim on the grounds that it was obliged by law to purchase gold at a fixed price, that its existing gold holding was sufficient to enable it to meet all probable claims, and that at ruling rates of exchange it could not dispose of gold abroad except at considerable loss. A more important argument, put forward by Cassel, was that gold imports should be excluded in order to prevent any further rise in prices due to that cause. It is significant, however, that the legal prohibition of February 1916 failed to stop the inward movement. During 1916 and 1917 the Riksbank's holding of Danish and Norwegian gold coin increased by 54·3 millions.³ These countries together with Sweden were members of the Scandinavian Monetary Union, which was formed in 1875 for the purpose of ensuring that the standard and subsidiary coins of any one member would be legal tender in any of the others.⁴ Consequently, with the Scandinavian exchanges favourable to Sweden during the war, gold tended to pass in that direction from Norway and Denmark. A more effective check was imposed towards the end of 1917, but the inflow was never completely stopped.

In the first of the periods to be distinguished the rise in Swedish prices was the result of the increased gold holding; in the second it was the result of an excessive note issue. The original idea of preventing further gold

¹ Cassel, *Money and Foreign Exchanges after 1914*, p. 130.

² *Ibid.*, p. 135.

³ *Ibid.*, p. 85.

⁴ A special convention in 1923 removed this qualification as regards gold coins.

imports may have had as its object the attempt to maintain the Swedish currency at a value higher than that possessed by gold, which had itself depreciated. But this result was not obtained, and the suspension of convertibility was renewed in 1920 because the internal depreciation of the Swedish krone exceeded the depreciation of gold. Thus after the initial period the Bank "had to buy gold in order to maintain the prescribed amount of gold cover for its increasing circulation,"¹ and in view of subsequent events it may well be doubted whether the policy actually pursued was ultimately beneficial to the Bank.

The course of prices indicates the relatively greater depreciation of the krone. In December 1918 the wholesale price index was 372, and though there was a sharp decline in 1919, it stood at 366 in June 1920. The dollar exchange fell from 95.3 per cent. of parity in June 1919 to 77.2 per cent. in January 1920, and 73.1 per cent. in December. Between 1920 and 1923 wholesale prices fell from 359 to 163, and the cost of living from 268 to 176.² These movements were accompanied by a rise in the external value of the krone from 5.70 to the dollar in 1920 to 3.72 in November 1922. (Par = 3.73.) During these years, however, the actual exchange represented a considerable over-valuation of the krone, and the immediate effects apparent within the country itself were reflected in the severe depression which developed. Official returns relating to some 200,000 workpeople showed that in 1921 26.6 per cent. of trade union members were unemployed, and though the average fell during 1922, it reached 33.2 per cent. in December of that year. Other difficulties were connected with the failure of the Russian and German markets, which were normally important outlets for Swedish exports, but the high percentage of unemployment prevailing during 1921 and 1922 may be primarily associated with (1) the rapid fall in internal prices and (2) the important external over-valuation of the currency.

¹ Cassel, *op. cit.*, p. 93.

² Yearly averages.

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In the second half of 1923 the actual exchange corresponded closely with the calculated parity on the basis of cost-of-living index-numbers in Sweden and the United States. In January of that year the dollar rate had risen above parity—26.9 cents as compared with 26.8 cents—but declined to 26.4 cents in October. Unemployment had greatly declined. Early in 1924 a definite return to the gold standard was effected, though it was decided upon against the advice of the Riksbank, and was only undertaken with the modification that gold imports were made a monopoly of the Bank. In March the Riksbank had applied for official sanction to enable it to remain exempt from the obligation to redeem its notes in gold, but a special committee which was appointed decided in favour of the resumption of convertibility.

Up to October 1924 the krone remained below its dollar parity; from December to April 1925 it was above parity. The following table indicates the relevant price relationships:

	Sweden.		Ratio of Cost of Living to Wholesale Prices.	Trade Union Unemployment.*	Rate of Exchange. Par. 3.73 = \$1.	Ratio of Swedish to U.S. Cost of Living.
	Wholesale Prices.	Cost of Living.				
1924. March	162	173	107	13.9%	3.79	102
June	158	171	108	7.4%	3.76	101
Sept.	163	174	107	7.0%	3.76	102
Dec.	168	178	106	15.5%	3.71	103
1925. March	168	177	106	12.0%	3.71	—
June	161	176	109	8.2%	3.74	101
Sept.	157	175	111	8.5%	3.73	—
Dec.	156	176	113	19.4%	3.73	99
1926. March	149	173	116	14.7%	3.73	—
June	150	172	115	9.6%	3.73	98
Sept.	146	171	117	9.1%	3.73	—
Dec.	150	171	114	19.0%	3.73	97
1927. March	145	170	117	14.1%	3.73	—
June	146	169	116	9.5%	3.73	98

* The unemployment figures reveal seasonal movements and are unsuited for the present purpose.

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The immediate effect of the restoration of free gold exports was apparent in the large gold efflux which followed. During 1924 the gold holding of the Riksbank fell by 37 million kroner to 237 million at the end of the year, and the foreign exchange holding also diminished. Important foreign credits were arranged in New York in May 1924, but at the end of the year the krone was apparently over-valued on the basis of both comparative wholesale prices and cost-of-living index-numbers. Swedish wholesale prices were 11 per cent. above the United States Bureau of Labour's index, while the Swedish cost of living was 3 per cent. above that for the United States. The actual exchange, on the other hand, was at a premium. Since then the readjustment would appear to have been effected. It will be noted, however, that the ratio of Swedish cost of living to wholesale prices has increased during 1925 and 1926 to an extent which was almost identical with the corresponding increase which occurred in the United Kingdom.

There is little to choose between either the nature or the form of the monetary problem as that presented itself in Norway and Sweden, and it will be convenient to deal with the two countries together. In both cases the apparent advantages of political neutrality were accompanied by certain difficulties from which they could not well escape. Norway had a mercantile marine which was small in relation to others, but which nevertheless constituted an important national asset, and the revenue obtained from this source was large if somewhat precarious during the war years. Denmark again, in virtue of her proximity to Germany, was able to obtain a convenient outlet for her products, but considerable difficulty was experienced in obtaining necessary imports, particularly of feeding-stuffs, which were normally derived from the United Kingdom, the United States, and from Argentina. In both cases the war involved important reactions on their domestic industries, and, as in Sweden, the maintenance of exports required that

extensive credit facilities should be granted to foreign purchasers.

The general tendency during the war years was for the gold stocks of the neutral countries to increase through imports from the belligerents, and, as in Sweden, the increase in Norway and Denmark was large. Comparing the position at the end of 1919 with the position at the end of 1913, the gold reserve in Denmark was 226 million kroner as against 73·4 millions, and in Norway 148 millions as against 44 millions. But there were considerable gold movements as between Scandinavian countries for reasons which have already been discussed. The flow of gold from Denmark and Norway to Sweden was an indication of the greater depreciation of the currencies of the former as compared with that of the latter.

At the middle of 1914 the note circulation of the Bank of Norway was 124 million kroner. By the end of 1919 the circulation had increased by 266 per cent. to 454 millions. Deposits in the private banks (excluding savings banks) increased from 571 millions at the end of 1914 to 3299 millions at the end of 1919, and 3540 millions at the end of 1920. In Denmark the note circulation increased from 159·8 millions in the middle of 1914 to 489·3 millions at the end of 1919, representing an increase of 203 per cent. Private bank deposits increased from 906 millions (March 1914) to 3545 millions (March 1919).

As was to be expected, the rise in prices was greater in Norway than in Denmark, and in both it was greater than in the case of Sweden. Wholesale prices in Sweden reached their maximum at 366 in June 1920, while the maximum in the case of Norway was represented by an index of 425 in September, and in the case of Denmark by an index of 403 in October. By the end of 1921 the indices were 172 for Sweden, 178 for Denmark and 269 for Norway.

Common features also obtained as regards the public finances. Before the war the public revenue of Den-

mark was 124 million kroner, and exceeded expenditure by $12\frac{1}{2}$ millions. Deficits, however, occurred up to 1918-19 and again in 1921-2. During the war a heavy naval and military expenditure became necessary on account of the geographical situation of the country, and that was further increased by outlays on Government subsidies and later on account of unemployment relief. In 1918, out of a total Government expenditure (excluding capital expenditure) of 533 millions, a sum of 191 millions was incurred on account of State control, subsidies and unemployment relief. The national debt increased from 361 millions before the war to 1061 millions in March 1921 and 1189 millions in March 1924. In Norway the position was still less favourable and budget deficits were almost unrelieved. The national debt, which before the war amounted to 357.5 millions, increased to 1054.3 millions in June 1919 and to 1680 millions in 1924.¹

The trade position of Norway normally shows an adverse visible balance, against which are important invisible items of income from shipping and tourist traffic. In 1913 the excess of visible imports was 160 millions and the gross shipping earnings (two-thirds of which are regarded as net earnings) were estimated at 218.6 millions. This item became large during the war years, but no reliable estimates of its magnitude appear to be available. For the three years 1922-4 the excess of imports averaged 519 millions and gross shipping earnings 488 millions.² In 1924 the income from tourist traffic was estimated at 20.5 millions, while an additional 65 millions has to be included for the proceeds of whale oil sold direct from the whaling grounds.³

Denmark's excess of imports in 1913 was 140 millions, and gross shipping earnings were estimated at about

¹ Cf. *Economic and Financial Conditions in Norway*, No. 2, 1926.

² Cf. Reports of Department of Overseas Trade, and *Statist*, 23.5.25.

³ A detailed estimate for 1925 is given in *Economic and Financial Conditions in Norway*, No. 1, 1926.

99 millions. In 1914 there was an excess of exports of 62 millions owing to a decline in imports and an increase in exports. In the subsequent period the commercial position has been subject to greater fluctuations than was the case with Norway.

At the end of 1919 the sterling exchange in Norway was 18.60 kroner, and the Danish exchange 20.58 kroner, the par in each case being 18.18. During the following year, as might be expected, the external value of the Norwegian crown depreciated more rapidly than the Danish unit. Since 1922 the depreciation of the former currency was almost continuous until the rapid appreciation in 1925 and 1926. For 1922, 1923 and 1924 the average rates were 25.40 kroner, 27.50 kroner and 31.72 kroner. In the case of Denmark prices fell more severely in 1920, and the index-number (wholesale), which averaged 308 in that year, fell to 202 in October 1921 and 180 in October 1922. In addition a loan of \$25 million had been raised in New York, and the exchange moved rapidly in a direction more favourable to Denmark—passing from 25.72 to the £ in November to 19.05 in January 1921, while during 1921 and 1922 it ranged between 19 and 22 kroner. From that time, however, the Danish crown again depreciated, the sterling rate rising from 20.60 in June 1922 to 26.22 in October 1923 and 27.15 in March 1924. This movement reflected an internal depreciation, and wholesale prices which had averaged 181 in 1922 rose to 210 in 1923 and 234 in 1924. The depreciation of the Norwegian krone was even greater, and the wholesale price index averaged 232 in 1923 and 267 in 1924.

The final reform stage in the case of Denmark dates from the end of 1923, and what was intended was that there should be a gradual appreciation of the krone until its pre-war parity had been restored. In November, two foreign loans were raised amounting to £5 million,¹ and these were intended to constitute an "exchange equalisation fund" which would be managed by the National Bank. A temporary period of exchange

¹ £2.7 million in London and \$10 million in New York.

stability was secured, but there was no appreciation. At the end of 1923 the dollar exchange was 5.90 kroner as compared with the purchasing-power parity of 4.51 kroner on the basis of comparative cost of living indices. In January the official discount rate was raised from 6 to 7 per cent., and in February all exchange transactions were controlled by a specially constituted "Valuta control." Five months later a special committee was appointed to examine and report upon the position, and the recommendations of that body were embodied in the Valuta Law of December 1924. In that report the proposal for stabilisation and devaluation on the basis of the existing exchange was rejected in favour of a scheme of gradual but continued deflation until the pre-war parity was restored.

By the Valuta Law of December the suspension of the Bank's obligation to redeem its notes in gold was continued, but for the purpose of its exchange policy it was provided with the proceeds of a State-guaranteed loan of \$40 million. The exchange policy was defined as follows:—"Upon provision of the valuta credit, the National Bank shall maintain such a rate for United States dollars that the Copenhagen exchange rate shall not exceed 5.74 up to 1st July, 1925; 5.60 during the half-year ending 1st January, 1926; 5.46 during the half-year ending 1st July, 1926; and 5.32 during the half-year ending 1st January, 1927." In special circumstances some relaxation might be allowed, but the rate was never to rise above 5.74 kroner to the dollar.

The success of a policy of this kind depended upon the internal appreciation of the krone, and means were adopted to effect the necessary deflation. A special income and capital tax was imposed to yield 44 millions, and out of the proceeds the State was to repay 40 millions advanced by the Bank.¹ The note circulation, which averaged 478 millions in 1924, averaged 438 millions in 1925, and has since fallen to 400 in May 1926. Whole-

¹ Since then the English Treasury Bill system has been introduced to replace the older method whereby the State borrowed directly from the Bank.

sale prices for the corresponding dates were 234, 157 and 140, so that, comparing 1925 with 1924, the internal value of the krone was raised by about 33 per cent.

The mere announcement of the official policy was sufficient to induce factors to operate to bring about a rapid external appreciation. The following table shows the extent of the movement :

	\$	£
Dec. 1924	5.66	24.17
June 1925	4.97	24.10
Dec. "	4.05	19.60
June 1926	3.78	18.37

Thus the krone had risen from 67 per cent. to 99 per cent. of its gold parity between December 1924 and June 1926, and while the official policy aimed at raising the krone to 5.32 to the dollar by the second half of 1926, the actual exchange had raised the krone above that value by June 1925, or twelve months before the appointed time. The nature of the movement becomes clear from the statement¹ of the Finance Minister, that the foreign credits which had been arranged had not been used, so that speculative forces may have been chiefly responsible for the rapid rate of appreciation.² From the beginning of 1927 the gold standard has been in operation, on the basis of the present system in the United Kingdom. The National Bank is under an obligation to redeem its notes in gold when notes of a minimum of 28,000 kroner are presented.

The relevant price movements are indicated in the table on p. 77.

The unemployment figures are subject to seasonal variations which render comparisons difficult. But it would appear that even in June 1925, after the exchange movement had commenced, the krone was somewhat under-valued abroad on the basis of comparative costs of living. At the end of the year the actual rate coincided

¹ Cf. *Times Trade Supplement*, Banking Section, 19.6.26.

² The Act of December 1924 was amended in December 1925 in a form which obliged the Bank to maintain the dollar rate at 88.75 per cent. of parity during 1926. The exchange credit of \$40 million was renewed for another year.

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		Ratio of Cost of Living to Wholesale Prices.	T.U. Unemploy- ment.	Dollar Rate.	P.P.P.*	Ratio of Danish to U.S. Cost of Living.
1923.	June .	98.5	—	—	4.48	120
	Dec. .	99.5	21.0%	—	4.51	121
1924.	June .	97.3	5.0%	—	4.72	127
	Dec. .	94.4	17.1%	5.66	4.76	128
1925.	June .	98.2	9.1%	4.97	4.69	125
	Dec. .	110.2	31.7%	4.05	4.06	109
1926.	June .	110.8	16.3%	3.78	3.92	105
	Dec. .	114.6	32.7%	3.73	3.83	103
1927.	June .	115.8	18.5%	3.73	3.86	102

* On cost-of-living basis.

closely with the calculated parity, but a definite over-valuation is apparent in June 1926. Meanwhile the relative positions of the Danish wholesale-price index and the cost-of-living index were reversed. At the end of 1924 the latter was fully 5 per cent. below the former. In June 1926 the cost-of-living index was more than 10 per cent. above the wholesale-price index. It is significant that the unemployment percentage, which is normally low at the middle of the year, was 16.3 as compared with 9.1 in June 1925 and 5.0 in June 1924. The full process of price readjustment has therefore not been completed.

In the case of Norway somewhat similar movements occurred, although the appreciation of the Norwegian crown was less rapid and there was greater uncertainty as to the official policy. In February 1924 the dollar rate averaged 7.49 kroner; by December it was 6.63 kroner. By the end of the following year the krone had risen to about 75 per cent. of its gold parity—4.92 kroner to the dollar in December. Meanwhile a special commission which had been appointed in September reported in January 1926 in favour of stabilisation at the existing rate. By June 1926 the Norwegian krone had risen to about 82 per cent. of parity, and after remaining stable for a period of three months appreciated further to fully

94 per cent. of parity in November and December, and reached 96·18 per cent. of parity in February 1927. Thus the stabilisation policy embodied in the Act of June 1926 was not made effective, and the further rise of the krone towards parity has now almost been completed.

The course of relative price levels is shown below :

	Ratio of Norwegian Cost of Living to Wholesale Prices.	T.U. Unemployment.	Dollar Rate.	P.P.P.*	Ratio of Norwegian to U.S. Cost of Living.
1924. March .	95	12·0%	7·36	5·46	146
June .	96	4·9%	7·40	5·54	148
Sept. .	96	5·2%	7·22	5·67	152
Dec. .	96	12·5%	6·64	5·80	154
1925. March .	98	11·1%	6·58	—	—
June .	100	8·9%	5·88	5·60	150
Sept. .	105	13·5%	4·78	—	—
Dec. .	106	26·1%	4·92	4·90	133
1926. March .	109	25·9%	4·66	—	—
June .	112	22·1%	4·52	4·65	125
Sept. .	112	22·3%	4·56	—	—
Dec. .	116	29·6%	3·95	4·51	121
1927. March .	122	30·0%	3·75	—	—
June .	121	—	3·86	4·33	116

* On cost-of-living basis.

Thus there has been a steady increase in the ratio of Norwegian cost of living to wholesale prices over the period of three years covered by the table. It would appear, however, that on the basis of comparative cost-of-living indices, the krone was not over-valued before 1926 despite the rapid appreciation which had occurred during the preceding two years. During 1926, on the other hand, the over-valuation was considerable. The unemployment figures, despite the seasonal variations, greatly increased. As in the case of Denmark, therefore, complete price readjustment has not been effected, and the depression which became acute in both countries during 1926 may be attributed to this fact.

CHAPTER IV

HOLLAND

THE pre-war metallic circulation of Holland was composed of gold pieces of 5 and 10 gulden and silver and bronze coins of small denominations. The actual circulation of gold, however, was not important and was definitely discouraged by the central bank. The Netherlands Bank was the sole bank of issue and its notes possessed legal tender status except at the bank itself, where they were convertible into gold or silver. The metallic cover prescribed for the Bank was fixed by Royal Decree, and since 1864 had remained at 40 per cent. of its sight liabilities. In practice the bulk of this reserve was composed of gold, and in June 1914 the Bank held a gold reserve of 160 million gulden against a note circulation of 322 millions. An additional note issue was made shortly after the outbreak of war. This was an issue of currency notes by the State, but its magnitude was not important. These notes were first authorised to replace silver coins which had disappeared from circulation, and the issue reached a maximum of 70 millions at the end of 1918.

The indirect reactions of the war upon Holland were important. Public expenditure on defence was greatly increased and the annual budgets closed with large deficits, which were also maintained throughout the post-war period. The public debt, which amounted to 1161 millions at the beginning of 1914, increased in ten years to 3371 millions. Commercially the country was handicapped through its geographical proximity to the belligerent countries. Much of the external trade of the country, which normally consists of goods in

transit to and from Germany, was restricted as a result of the prohibitions imposed by other countries. During the later years of the war the external trade of the country declined rapidly and reached its lowest point in 1918, when exports only amounted to 381 millions as compared with 3083 millions in 1913, and imports 608 millions as compared with 3918 millions.

The immediate effect of the outbreak of war was reflected by a decline in the external value of the gulden in terms of other currencies. This sudden decline in exchange rates resulted from the withdrawal of credits by other financial centres, and the alarm caused in Holland by the sudden drain on the gold reserves of the Bank led to the suspension of the clauses in the Bank Act relative to the redeemability of notes in specie. The export of gold was prohibited and the legal reserve ratio was reduced to 20 per cent. These conditions of crisis were nevertheless of short duration, and by the end of 1914 an influx of gold had commenced in large quantities. During the subsequent years this inflow assumed still larger proportions, and resulted in a great expansion in the note circulation of the central bank. Between June and December 1914 the gold reserve of the Netherlands Bank increased by 48 millions; in the period of the next four years up to the end of 1918 there was a further increase in the gold reserve of 517 millions, thus bringing the total gold reserve up to 725 millions at the end of the war, or four and a half times the amount held when the war commenced. The note circulation had increased over the same period by more than three times, from 322 millions in June 1914 to 1069 millions in December 1918, and prices, which reached their maximum in 1918, averaged 392 for the year (1913 = 100).

By the end of 1920 wholesale prices had fallen to an index of 223. At the same date the gulden had fallen to 75.6 per cent. of its dollar parity as compared with a purchasing-power parity on the basis of comparative cost-of-living index-numbers of 89.2 per cent. Thus

at that date the gulden was materially under-valued abroad. During 1921 the fall in Dutch prices continued, and at the end of the year the wholesale price index stood at 165. Meanwhile the exchange had risen to 85.3 per cent. of dollar parity in March, though it afterwards declined to 78.9 per cent. in September. At the latter date the calculated parity was 88.9 per cent., so that the under-valuation still remained. By March 1922 the exchange had risen to 94.3 per cent. of parity, but the calculated parity on the basis of cost-of-living indices was 87 per cent., so that the under-valuation had now become an over-valuation. During the remaining nine months of that year the actual exchange continued to rise to 99 per cent. of parity, but since the calculated parity also rose to 96.6 per cent. the degree of over-valuation was materially reduced. This sharp narrowing of the gap between the actual exchange rate and the purchasing-power parity resulted from a fall of fully 8 per cent. in the Dutch cost-of-living index, and the slight increase of almost 2 per cent. in the United States cost-of-living index over the same period.

The table on p. 82 relates to the four years from 1923 to 1926.

The table indicates that on the basis of comparative wholesale prices in Holland and the United States the gulden was under-valued during 1923 and 1924. On the basis of comparative cost-of-living indices there was a slight under-valuation of the gulden abroad between June 1923 and September 1924, but the margin between the actual rate and the calculated parity was small. At the end of 1924 the gulden was over-valued on the basis of cost-of-living indices, but slightly under-valued on the basis of comparative wholesale prices.

The decision to return to the gold standard was announced in the Dutch Parliament on April 28, 1925, and the removal of the embargo on gold exports was effected coevally with the return to the gold standard by the United Kingdom. But, as distinct from the dollar value of the pound, the gulden had approximated

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	Wholesale Prices.	Cost of Living.	Ratio of (2) to (1).	T.U. Unemployment.	Rate of Exchange.	P.P.P.*	P.P.P.†
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1923.							
March	156	173	111	11·9%	39·5 cts.	39·3 cts.	43·6 cts.
June .	149	174	117	8·2%	39·2 "	39·5 "	44·3 "
Sept. .	145	173	119	10·0%	39·3 "	40·0 "	45·2 "
Dec. .	154	178	115	13·7%	38·0 "	39·1 "	42·6 "
1924.							
March	155	179	115	11·2%	37·1 "	38·2 "	41·5 "
June .	151	173	114	5·8%	37·4 "	39·3 "	41·0 "
Sept. .	158	177	112	8·2%	38·5 "	38·8 "	39·7 "
Dec. .	160	181	113	12·7%	40·4 "	38·4 "	41·5 "
1925.							
March	155	179	116	9·4%	39·9 "	—	39·9 "
June .	153	179	117	6·6%	40·1 "	—	—
Sept. .	155	179	116	7·7%			
Dec. .	155	177	114	16·0%			
1926.							
March	145	169‡	120	7·9%			
June .	144	171	119	5·9%			
Sept. .	140	164	117	7·2%			
Dec. .	147	168	114	12·1%			
1927.							
March	144	166	115	9·1%			
June	149	167	112	6·0%			

* On cost-of-living basis.

† On basis of comparative wholesale price indices.

‡ New series since March 1926.

(Par of exchange: 1 Gulden = 40·196 cents.)

close to its gold par of exchange for a considerable period before this announcement was made. The necessary readjustment of Dutch to American prices was therefore already effected, and the return to the gold standard raised no particular difficulties.

CHAPTER V

SWITZERLAND

THE position of Switzerland involved many unique features during both the war and post-war periods. By its geographical situation the country was deprived of certain of the advantages which might otherwise have accrued from her neutrality, and was compelled to suffer from the dislocation occasioned in adjoining states, and at the same time to incur a heavy war-time expenditure of her own. The possibility of invasion called for mobilisation and additional expenditure on defence, and throughout the period a series of nine mobilisation loans was raised to finance the outlay incurred. Commercial relations were affected by the country's isolation among a group of belligerents. Tourist traffic, which normally affords a large revenue, was suspended, and though certain exporting trades benefited from the war demands of the belligerents, there were others the foreign demand for whose products was less urgent, and in these cases adverse reactions were experienced. Normally Switzerland imports about two-thirds of her food supply and about three-fourths of the raw materials of her main industries. Transport difficulties frequently made it impossible to secure the requisite imports of these commodities even when supplies were otherwise available, while in certain instances the countries of origin were obliged to reserve their supplies to safeguard their own war requirements. Important general considerations have therefore to be related to the monetary and financial developments of the period.

Before the war, notes of the National Bank were convertible into gold,¹ and a maximum gold cover of 40 per cent. was prescribed, the remaining 60 per cent.

¹ They did not possess legal tender status until August 1914.

being securable by trade and bank bills. In 1918 this prescribed cover was reduced to $33\frac{1}{2}$ per cent. At the outbreak of war the note circulation amounted to 409 millions, against which there was a metallic reserve of 192 millions in gold and 6 millions in silver. In addition there was a gold and silver circulation amounting to 150 millions. For several reasons it is difficult to make any exact quantitative measurement of the increase in the quantity of currency since 1914. The pre-war metallic circulation is purely an estimate. During the war part of the metallic circulation was returned to the coffers of the Bank, but some part was hoarded. Moreover, in later years, Swiss notes acquired a certain circulation in adjoining countries where currency depreciation became rapid, and a certain hoarding of notes occurred within the country itself.

Before the war these bank-notes were not issued in denominations below 50 francs. But with the withdrawal of gold from circulation it became necessary to substitute a supply of paper of suitably small values. This was done in the first instance by the Treasury, which issued its own notes, though these were guaranteed by the National Bank, which dealt with them as part of its circulation. Some 30 millions were issued in this way, but these have now been withdrawn. Since 1918 the Bank has been authorised to issue its notes of denominations from 5 to 25 francs.

Between July 1914 and December 1920 notes had increased from 409 millions to 1024 millions or by 151 per cent. The gold holding of the National Bank had also increased from 170 millions to 478 millions and the silver holding from 21 millions to 122 millions. By December 1922 the increase in the note circulation had been reduced to 139 per cent. above July 1914, and wholesale prices were 75 per cent. above pre-war. At the end of 1921 the dollar was at a discount as compared with the Swiss franc, and when the gold influx increased, an attempt was made to restore an internal circulation of gold coins. The compulsory convertibility of National Bank notes, however, was not restored. During 1922

the discount of the dollar was converted into a premium, and by April it was estimated that at least 117 millions of gold had been returned to circulation.¹

The later developments date from the second half of 1924. In October of that year the Swiss franc once more reached its gold parity and was subsequently quoted at a slight premium. Despite budget disequilibrium, a determined effort had been made to raise the value of the franc to that level and to maintain it stable. In its Report for 1924, the National Bank declared that the pre-war mechanism of the discount rate was not yet fully applicable for this purpose in the absence of free gold movements as between the different centres, and that the Bank aimed rather at the exercise of a greater discrimination over the quality of bills accepted for discount. The object of this policy "was to hinder the extension of too large credits abroad and to restrict the demands upon the fiduciary issue on account of long-time loans." This, however, does not appear to have prevented the inflow on a considerable scale of foreign funds.

Since the end of 1924 the franc exchange has been held at parity, but convertibility has not been restored to the notes of the National Bank. Since the end of 1925, however, it has been possible to import or export gold under a general licence. It may have been that in postponing the return to a convertible note issue the authorities had in view the uncertain state of the federal finances. But as the franc not merely rose to parity but was quoted for a time at a slight premium, the Bank found itself in the unusual position of endeavouring to prevent the gold influx which would normally have followed. What appears to have happened is that even a slight premium made it profitable to buy gold coins of the Latin Union abroad at their metallic values and place them in circulation in Switzerland at their nominal value.² And since these coins were generally of short

¹ *Memorandum on Currency, 1913-24.*

² Cf. Eighteenth Annual Report of the Swiss National Bank, for the year 1925.

weight, the receiving country was faced with the prospect of having to incur the expense of recoinage at a later date. The Federal Council, in fact, considered the placing of a complete embargo upon gold imports, but this step became unnecessary when the premium disappeared.

The following table summarises the relevant data as regards price levels since 1922 :

	Wholesale Prices.	Cost of Living.	Ratio of (2) to (1).	Cost of Dollar.*	Unemployment.	Ratio of Swiss to U.S. Cost of Living.†	Ratio of Swiss to U.S. Wholesale Prices.
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1922.							
1st Qr.	168	174	104	99%	62,000†	100	120
2nd "	161	158	98	100%	37,000†	95	109
3rd "	163	157	96	101%	32,000†	95	106
4th "	172	160	93	103%	39,000†	95	111
1923.							
1st "	180	180	100	103%	30,000†	95	115
2nd "	182	176	96	107%	16,000†	99	117
3rd "	177	176	99	108%	15,000†	98	116
4th "	182	170	93	109%	21,000†	98	119
1924.							
1st "	181	170	94	111%	19,000†	99	120
2nd "	177	167	94	109%	9,000	99	120
3rd "	170	167	98	103%	—	99	114
4th "	170	171	101	100%	11,000	99	110
1925.							
1st "	169	169	100	100%	11,000	—	105
2nd "	162	167	103	100%	8,000	96	104
3rd "	159	164	103	99%	10,000	—	100
4th "	156	163	104	100%	15,000	91	99
1926.							
1st "	151	164	108	100%	17,000	—	98
2nd "	145	162	112	100%	11,000	92	95
3rd "	146	161	110	100%	12,000	—	97
4th "	147	161	109	100%	16,000	92	99
1927.							
1st "	146	160	109	100%	17,000	—	100
2nd "	147	159	108	100%	9,000	93	102

* Per cent. of cost at par.

† End-of-quarter figures.

Throughout the period, therefore, the Swiss cost of living has remained below that in the United States, but it was not until the second half of 1925 that Swiss wholesale prices came into correspondence with the level of wholesale prices. In the first quarter of 1922, with the exchange at par, Swiss wholesale prices were 20 per cent. above the level of United States prices. On the basis of wholesale price indices the franc was heavily over-valued although no apparent over-valuation existed on the basis of cost-of-living indices. Over the period from the middle of 1922 to the last quarter of 1924 the franc was at a discount, but on the basis of comparative wholesale price indices the over-valuation persisted. Since the middle of 1925 that over-valuation has apparently been eliminated, and gold prices in Switzerland remained below the price levels in the United States on both sets of indices. But during the period of falling gold prices from the end of 1924 to the middle of 1926, the gap between the Swiss cost-of-living index and the wholesale price index has widened.

CHAPTER VI

GERMANY

THE reorganisation of the German monetary system will constitute in some respects the most remarkable achievement of the post-war period in virtue of the complexity of the problem and the demoralisation which had been occasioned by the previous collapse of the mark. The detailed history of that period has yet to be written, and this chapter will only endeavour to survey the main features of the reconstruction. But, as in other cases, there are a number of preliminary considerations to be adduced.

Financial factors apart, the actual conduct of the war did not present Germany with any important problems of material reconstruction. For the most part, the conflict was located outside of her own territory, so that no great amount of devastation had to be repaired. But the aftermath of the war raised serious issues. The Peace Treaty deprived Germany of her colonies, the bulk of her mercantile marine, together with valuable territorial districts which had formerly been incorporated in the Reich. The general trade position of the country was, therefore, subject to important modification, apart from the complications of the subsequent monetary and financial disturbances. Before the war the visible trade balance of the country was adverse, but the existence of large invisible items of income converted this into a favourable net balance, and Germany was, in fact, an important lender of capital to other countries. That general position was altered as a result of the war. Invisible items of income disappeared or were reduced, while the immediate demand for visible imports from abroad was urgently increased.

This general position was further complicated by the monetary and financial policies adopted both in the war and post-war periods. Current ideas at the beginning of the war envisaged a victorious struggle of short duration, after which the war expenditure which had been incurred would be recouped out of indemnity receipts from the defeated Powers. In the Reichstag in 1915 Dr. Helfferich defined the official policy as consisting of the raising of loans, the issuing of paper money, the reduction of expenditure, the raising of war taxation, and finally, at the conclusion of peace, the presentation to their opponents of a bill for the war expenditure which had been forced upon the German Government. In the pursuit of this general policy there was no serious effort to cover the additional expenditure out of tax receipts. Whereas, in 1913, tax receipts had covered 81·8 per cent. of the total expenditure, in 1914 the proportion was only 27·8 per cent., and in 1915 only 6·9 per cent. With the subsequent inflation, even the ordinary budget from which military expenditure was excluded remained unbalanced, the deficit rising from 480 million marks in 1916 to 1250 million in 1917 and to 2879 million in 1918. In 1913 the Imperial funded debt amounted to 4·8 milliards; at the date of the Armistice the funded debt was 97 milliards and the floating debt 45 milliards.

The war loans which were raised to provide additional funds for the increased expenditure were largely inflationary in character; in large measure they were subscribed not out of fresh real savings, but out of credit advances specially created for the purpose. Throughout the war period, nine such loans were issued, and in each case the proceeds were employed for the purpose of funding the additions to the floating debt.

The pre-war circulation of the country, including notes and coin, amounted to approximately $5\frac{1}{2}$ milliards, of which gold and silver represented fully 3 milliards and Reichsbank notes 2·4 milliards. During the war, gold and silver were largely withdrawn from circulation, and

at the end of 1918 the paper circulation, including Darlehnskassenscheine, or loan bank notes, amounted to 32 milliards. No very reliable indices of price movements are available during this period. Bank deposits between 1913 and 1918 increased from 13.7 milliards to 48 milliards.

The new loan banks (Darlehnskassen) were rapidly developed, and these granted advances to the public against War Loan scrip and other forms of security. In addition they had powers of note issue, and the paper created in that way represented an important element in the inflationary process.¹ Before the war the Reichsbank was obliged to hold gold cover against its notes to the extent of one-third, while the remaining two-thirds might be covered by ordinary commercial bills. In 1914 an important series of modifications were introduced. Reichsbank notes were rendered inconvertible, while loan-bank notes and Treasury bills were allowed to serve as legal cover for Reichsbank notes in addition to gold and commercial bills. By these means the Imperial Government was enabled to obtain resources to supplement its tax receipts, and the phenomena of inflation were directly experienced.

In the post-war period there was a progressive depreciation of the currency, but it is possible to distinguish certain main phases. The first of these coincided with the immediate reactions to the war itself. At the time of the Armistice there was a financial crisis reinforced

¹ The establishment of the Darlehnskassen had been determined upon before the war and the actual *personnel* of the ninety main branches had been appointed. Their activities were those of pawnbrokers "which issued paper, Darlehnskassenscheine, for pledges, which were stamped and returned to their owners. . . . It was not itself legal tender, though possessing a Kassenskurs (*i.e.* was accepted at Government offices and at the Reichsbank), but could be converted at the Reichsbank into notes which were both legal tender and inconvertible, and was reckoned as gold together with the Reichskassenscheine for backing those notes." Cf. Loveday, "German War Finance in 1914," in *Economic Journal*, March 1916, p. 49. The Reichskassenscheine represented a Government issue of notes of small denomination, the amount of which had been increased from 120 to 240 million marks.

by the political revolution; deposits were withdrawn from the banks and Government obligations were presented for repayment. Partly for this and partly for other reasons the note circulation continued to increase. Under the conditions which prevailed no complete reorganisation of the national finances seemed to be immediately possible. Public expenditure proved to be greatly in excess of the estimates which had been prepared and much more in excess of the incoming revenue to the Treasury. Moreover, the public credit had been seriously shaken and it was no longer possible to obtain subscriptions to long-dated loans. Hence the increase in the public indebtedness in the post-war period is reflected in the floating debt, which increased from 45 milliards in November 1918 to 86 milliards in November 1919. At the latter date also, the note circulation had increased to 49 milliards, and the mark exchange, which before the war had a gold parity with sterling of 20.42, now stood at 180 to the £.

In 1920 and 1921 the exchanges displayed different movements. In the spring and early summer of 1920 there was a considerable improvement, the value of the mark rising from an average of 335 to the £ in February to 152 in July. This improvement reflected in part the renewed confidence abroad which had been inspired by the financial proposals associated with the name of Erzberger, and there was a certain speculative movement based upon the anticipations of a rapid recovery. But the renewed confidence was without real foundation. The budget deficit for the year 1919-20 reached a figure of 57 milliards, while that for 1920-21 approached 90 milliards. The floating debt had increased to 272 milliards at the end of 1920, while the note circulation amounted to 81 milliards. Between July and November the mark exchange fell from 152 to the £ to 265. That was followed by another period of improvement and comparative stability extending till May 1921, and that improvement in turn was succeeded by a further rapid decline. The position was further complicated at this

stage by the problem of Reparations. Under the Peace Treaty the decision of the Reparation Commission as regards the damages for which Germany was to be held responsible was to be notified to the German Government by May 1921, and the London Ultimatum which followed stipulated a schedule of payments some of which had to be met immediately. A sum of one milliard gold marks was to be paid by August, and while that amount was forthcoming, it was mainly provided out of the proceeds of a short-dated loan which was repayable before the end of the year. At the same time part of the valuable territorial district of Upper Silesia was ceded to Poland, and this, together with the cessions already effected, further handicapped the economic recovery of the country. The external value of the mark, in consequence, depreciated rapidly from 247 to the £ in May to 1041 in November. The paper circulation had now reached a total of fully 122 milliards. In December the mark exchange showed a certain recovery due to a certain revival of confidence founded on the possibility of the flotation of an important foreign loan on behalf of Germany, but, like the former anticipations, this new confidence was misplaced, and the recovery was short-lived. Throughout 1922 the mark exchange displayed a rapid and progressive depreciation, passing from 811 to the £ in January to 1410 in June, 14,145 in October, and 34,858 in December. Reparation payments had been demanded in ten-day instalments of 31 million gold marks, in respect of which Germany was ultimately in default, and in May the request was made for a moratorium.

There was already evidence of a certain "flight" of capital abroad, and that movement tended to reinforce the particularly rapid external depreciation of the currency. In December 1922, internal prices, as measured by the index-number of the *Frankfurter Zeitung*, stood at 147,480 as compared with 100 for July 1914. Many important anomalies, moreover, were experienced from this progressive depreciation. Real wages were low,

especially in the case of skilled labourers and professional workers. The bonded debts of industrial concerns, the long-dated debts of states and municipalities, and the mortgages on property had been virtually extinguished. Deposits at the six main Berlin banks, which amounted to fully 5 milliard gold marks at the end of 1914, amounted to only 850 million gold marks in December 1922. The resulting shortage of working capital, however, was obscured by the apparent ease of the money market caused by fresh inflation. Interest rates, though nominally very high, did not represent the real price of capital. They represented rather insurance premiums required by lenders against the further depreciation of the currency.¹

But the national finances were unable to derive any lasting advantage from the virtual obliteration of their dated debts. Continued inflation with soaring prices increased the expenditure of the public authorities, while the same depreciation destroyed part of the gold values of the taxes which had been imposed. As regards industry, complaints were common in other countries that the external under-valuation of the mark gave rise to forms of "exchange dumping," but it was too often forgotten that the same phenomenon which gave to German exporters a certain relative competitive advantage also made foreign imports particularly dear to German purchasers. The following indices of the Federal Statistical Bureau illustrate this point in respect of the period under consideration :

PRICES, 1913 = 100.

	Goods Produced.	Goods Imported.	All Commodities.
1921 (Average) . . .	1,786	2,533	1,911
1922 (Average) . . .	29,655	56,818	34,182
1922 (Dec.) . . .	128,330	243,230	147,430

¹ Cf. Bonn, "The Effects of Currency Inflation," in *Is Unemployment Inevitable?* p. 157.

This advantage from external under-valuation in so far as it existed did not, however, assist the process towards recovery. Under certain conditions, imports would have been checked and exports stimulated and the external value of the mark might have recovered to its true parity with other currencies. In the case of Germany the visible trade balance remained adverse and invisible items of income had been destroyed. Larger coal imports became necessary as a result both of the deliveries in kind to France and of the loss of the coal-fields of the Saar and Silesia. The balance of indebtedness in consequence remained unfavourable even apart from payments in respect of Reparations. In order to meet these Reparation demands, the payment of which was stipulated in gold or dollars, Germany had to acquire an additional supply of the latter currency, and could only do so by the unrestricted use of the printing-press for the issue of more marks.

The next phase coincided with the occupation of the Ruhr from the beginning of 1923, and the policy of passive resistance which was adopted in that area imposed additional heavy burdens upon the national finances of the Reich. On the one hand, the seizure of the Ruhr customs reduced the revenue obtainable by the Reich, while, on the other, large sums were expended in the support of the passive resistance of the populace. After a further fall in the external value of the mark at the beginning of the year, a short period of comparative stability was secured in March and April through the repurchase of marks, partly with foreign currencies held by the Reichsbank, and partly, though probably to a small extent, by the use of the gold holding; but this could not be maintained, and the dollar value of the mark fell from 0.03 per cent. of its former gold parity in January to 0.00014 per cent. in August. In terms of sterling the average exchange was 130,750 in February, 99,256 in March, 507,567 in June, and 18,349,000,000,000 in December. The short-lived improvement in the spring of 1923 was not accompanied

by any check to the expanding note circulation, though there was a slight fall in prices from 677,000 in March to 639,300 in April as measured by the index of the *Frankfurter Zeitung*. The gold value of the circulation, however, rose rapidly during the first quarter of the year.

It is from this time that there occurred the final collapse of the currency, and data as regards prices and exchange quotations cannot be regarded as containing any precise quantitative significance. Only small proportions of the Government expenditure were covered by tax receipts. Between April 1 and the middle of June tax receipts amounted to 2,447 milliards, or only 24 per cent. of the outgoings for the same period.¹ The bulk of the expenditure was covered by Treasury bills, which were discounted by the Reichsbank without limit and exchanged for notes. Between November 1922 and June 1923 the floating debt increased from 839 milliards to 10,275 milliards. In October 1923, Government receipts from taxes and fees amounted to only about one per cent. of the Treasury's payments during the month. Confidence had now been destroyed and the mark rapidly ceased to be employed as a standard of value. Foreign stable currencies were employed as the basis for the calculation of prices, mark prices being calculated at the rate of exchange ruling at the moment. The value of the mark was again falling more rapidly than the paper circulation increased. Comparing July 1923 with the average for 1921, the paper circulation was 490 times higher, but the dollar rate was 12,500 times higher. Consequently the gold value of the total circulation declined rapidly. Before the war it was some 5½ milliards. In 1921 it averaged 4.4 milliards; in April 1923 it was less than 1 milliard and in August it was only 282 million gold marks. By the beginning of 1923 the gold reserves of the Reichsbank exceeded the gold value of the entire paper circulation.

One aspect of this development was the literal shortage

¹ Cf. D'Abernon, *German Currency: Its Collapse and Recovery*, p. 12.

of currency which emerged even with the use of currency reduced to a minimum, and many institutions came to issue their own notes without legal authority.¹ Another feature of the official policy during the final stages of the collapse was reflected in the rapid fall in the gold reserves of the Reichsbank. In part this depletion was the result of developments in respect of Reparations. In August 1922 Germany was required to make out four Treasury bills in favour of the Belgian Government, and when these were met it was at the expense of a fall in the gold reserves of the Reichsbank of 206.6 million gold marks. From the beginning of the year, however, up to the end of November, the gold reserves of the Reichsbank fell by 538 millions from 1005 millions to 467 millions. The payments to Belgium, therefore, do not account for the whole decline. Another indeterminate part was employed to pay for Government imports of food and coal necessary to maintain the passive resistance in the Ruhr area.² And there were frequent spasmodic attempts to steady the exchange at fixed levels.

Meanwhile the general attitude towards the problem had undergone an important change within the country itself.³ Up to the beginning of 1923 there had been those who had definitely supported a policy of systematic depreciation. Industry, it had been found, was actively stimulated and unemployment had disappeared though real wages had greatly fallen. Would not the bounty on exports caused by the external under-valuation of the currency enable German industry to recover foreign markets which it had lost on account of the war? And did not currency depreciation make it impossible for any definite settlement of the problem of Reparations to be concluded? With the final collapse in 1923, even the advocates of systematic inflation found their position untenable. The export bounty did not succeed in making the balance of indebtedness favourable, even

¹ Cf. D'Abernon, *German Currency: Its Collapse and Recovery*, p. 7 n.

² *Ibid.*, p. 18.

³ Cf. Bergmann: *The History of Reparations*, p. 216.

without allowing for Reparation payments, and events in the Ruhr intensified the difficulties both directly and indirectly. The general attitude within the country came, therefore, to reveal a sudden change of direction. The question at issue assumed a new form; it was not whether stabilisation should be attempted, but rather how stabilisation could be secured.

It may be noticed that some approach to that question had already been made. In 1922 a number of foreign experts, including Professor Cassel, Dr. Vissering, Mr. Keynes and Mr. Brand, had been invited to report on the possibility of securing monetary stability under the conditions which then prevailed. Two reports were issued in November of that year, the Majority Report bearing the signatures of Cassel, Keynes and Brand. The problem which had presented itself was of the nature of a vicious circle. The balancing of the budget and the stabilisation of the currency were interdependent. Without some stability in the value of the mark, budget estimates became unreal and real revenue became inadequate for the expenditure which was incurred, while without a balanced budget there seemed to be no escape from further inflation. There was the additional complication arising out of Germany's obligations in respect of Reparations, and the uncertainty of the position as well as the magnitude of the claims made on the Reich constituted a factor which made disequilibrium well-nigh inevitable. Those payments in Reparations which had already been made had not represented surpluses of Government revenue over expenditure. Under these conditions it was necessary for the Committee of Experts to examine the significance of the Reparation problem in relation to the general monetary and financial position. And both the Majority and Minority Reports agreed that an immediate moratorium in respect of Reparation payments should be granted.

The main points of the Majority Report may be summarised :—(1) Immediate stabilisation required that a Reparations moratorium should be granted for a period

of time, the length of which would depend upon the possibility of balancing the budget and obtaining a real budget surplus. (2) An international loan would facilitate the revival of confidence, but "pending a final settlement of the Reparation question on sound lines, no credits can be obtained from a foreign consortium except on a very modest scale to supplement and support Germany's own efforts." (3) There were certain technical considerations which made the position peculiarly susceptible of control. Although the gold reserve of the Reichsbank had been depleted it was still large, and in fact amounted to almost twice the gold value of the entire paper circulation. No other currency, it was remarked, "has fallen into decay with so great a potential support still unused." (4) Stabilisation should be effected at a low value, though perhaps at a value somewhat higher than that actually obtaining at the moment. And (5) a new currency unit should be adopted after stabilisation had been accomplished.

The Majority Report, therefore, held that the mark could be immediately stabilised subject to certain general conditions, and it was contemplated that the rate of stabilisation should correspond with the higher internal value of the mark rather than with its lower external value. What that meant was that the Reichsbank (or an independent Board of Exchange Control which might be specially established for the purpose) would be authorised to purchase drafts in marks at a fixed price, and for that purpose the gold reserve would have to be freely employed. If, moreover, the particularly low external value of the mark was due to "a failure of confidence"—as it was held—the adoption of adequate measures would precipitate a rapid immediate improvement.

The further details of the Majority proposals need not be considered, since they were not, in fact, adopted. The paper circulation increased from 1293 milliards in December 1922 to 116,000 milliards in August 1923, while the gold value of that expanding note circulation

fell from 700 million gold marks to 116 millions between the same two dates.¹ The official attitude remained characteristically confused. It was pointed out that the fall in the value of the mark was more than in proportion to the increasing circulation, and it was concluded that since there was a scarcity of money, the obvious remedy was to increase the circulation still further. In August a number of financial proposals were constructed, including measures for increased taxation and for the issue of a gold loan, and though these were sanctioned, the results obtained were unimportant. It could now be said that the Government was paying its way solely by the issue of notes; and by the end of the year all confidence had been lost; the paper mark was now being generally refused and domestic trade was completely dislocated.

Several schemes were evolved for the issue of a new currency against some stable security, and the first efforts at reorganisation were initiated by the decree of October 15, which instituted a new Rentenbank with powers to effect a new note issue subject to definite conditions. Rentenmark notes were first issued on November 15. On November 30 the Reparation Commission appointed a special committee of experts "to consider the means of balancing the budget and the measures to be taken to stabilise the currency," and the Dawes Report, which was presented to the Commission in April 1924, formed the basis of subsequent reforms. It is therefore significant that the initial efforts were made by Germany herself without external assistance and while the Ruhr occupation was still in force.

The Rentenbank was founded for the double purpose of providing a new stable currency and relieving the Government of certain of its financial embarrassments. The remaining gold reserves being now inadequate for the security of the new issue, some other basis had to be devised. The new Rentenmark was equal to a gold mark, 4·2 Rms. being equal to \$1, and also to one billion

¹ Cf. Keynes, *Monetary Reform*, p. 51.

old paper marks. This latter corresponded with the external value of the mark, since on November 20 the rate of exchange was 4,200,000 million paper marks to the dollar.¹ At that rate, therefore, there was a simple means of converting paper marks into Rentenmarks by scoring off twelve noughts. Then the capital of the new Rentenbank was fixed at 3200 million Rms., and that was to be raised by compulsory contributions from the holders of industrial, commercial, agricultural and banking properties.² Contributions from those liable to make them were to take the form of mortgages or bonds to 4 per cent. of the value of the property pledged in gold marks, and bonds created in this way were to take precedence over other forms of commercial indebtedness. They were also to run over a minimum period of five years and were to bear interest at 6 per cent. per annum. In other words, the new bank was founded with a credit of 3200 million gold marks on the security of real property.

On the basis of these bonds and mortgages the Rentenbank issued 5 per cent. gold mortgage bonds (Rentenbriefe), and these in turn served as the security for the new notes, which were to be redeemable in exchange for the mortgages of the Bank. The amount of the new note issue was not to exceed the amount of the capital and reserves, viz. 3200 millions, but the Government was to receive a loan to enable it to redeem all its Treasury bills discounted with the Reichsbank and to cover budget deficits for the ensuing two years.

Although 3200 million gold marks of mortgages had been authorised by law, only 2400 millions were placed, since the Government found itself unable to impose bonds upon property located in occupied territory. Of that amount of Rentenmark credits, one half was placed at the disposal of the Government—300 millions for the

¹ Between November 14 and November 20 the mark exchange had fallen from 1,260,000 millions to the dollar to 4,200,000 millions; equivalent to 18½ billions to the £ sterling.

² Agriculture and industry generally were to contribute equal shares.

purpose of redeeming the floating debt of Treasury bills (this portion being free of interest and without date as to redemption) and 900 millions for ordinary budget purposes and at a rate of 6 per cent. The remaining half was taken to provide credit facilities for industry and agriculture through the medium of the Reichsbank. One of the supplementary conditions of the scheme was the guarantee of the Government that no further attempt would be made to discount new Treasury bills with the Reichsbank; consequently the success of the arrangement depended upon the reorganisation of the national finances.

The credits placed at the disposal of the Government were even more favourable than might have been first expected. On November 15 the gold value of discounted Treasury bills was 320 million gold marks, but by November 20 that gold value had fallen to 191.6 millions. Thus there remained a balance of 108.4 millions out of the credit of 300 millions which had been ear-marked for the redemption of these bills, and that balance could be employed to supplement the other 900 millions provided for ordinary budget purposes. The reorganisation of the national finances occurred from December, when, as the result of a series of measures, the tax system was codified and extended on a gold basis. In short, taxation might still be paid in paper marks, but at current rates of exchange in terms of the gold mark. With the new currency confidence revived rapidly, mainly because the supply of new currency was limited in quantity, and having secured stability the gold value of the entire paper circulation increased at a rapid rate. The position of the national finances immediately improved. In October the revenue from taxes and fees in gold marks was negligible. In December it amounted to 334 millions, in January 1924 to 521 millions, in February to 445 millions, and in March to 632 millions. On the side of expenditure drastic measures were adopted. The personnel of State departments was reduced and considerable economies were effected. These effects,

combined with the cessation of passive resistance in the Ruhr, enabled the transition period to be passed without collapse, and in March 1924 there was actually a surplus of receipts over payments.

The new Rentenmarks were not qualified as legal tender nor could they be employed except in internal circulation. The security against which they were issued was far from being highly liquid and they maintained their value only by being rigidly limited in supply. While the authorised circulation of Rentenmark notes was fixed at 3200 millions, the actual issue never exceeded 2000 millions, and since part of that was held by the Reichsbank, the effective circulation did not generally exceed 1800 millions.¹ The increase in the volume of currency during the first half of 1924 is indicated below:²

GOLD MARKS.

	January 31.	March 31.	June 30.
Reichsbank notes	483·6 m.	689·9 m.	1097·3 m.
Rentenbank notes	1196·3 m.	1760·3 m.	1771·6 m.
Coin	1·1 m.	25·9 m.	194·7 m.
Miscell.* including "notgeld"	596·7 m.	348·1 m.	65·0 m.
Total	2277·7 m.	2824·2 m.	3128·6 m.

* Rentenmarks were first issued against the withdrawal of "notgeld" from circulation.

Industry, however, could not recover immediately from the dislocation which had been caused during the final collapse of the currency in the summer of 1923, and in the first quarter of 1924 unemployment remained at a high level and was reinforced by the staff reductions in the public services necessitated by the reorganisation of the national finances. Many difficulties remained to be surmounted. The demand for liquid resources on the part of industry was reflected in the rising total of

¹ D'Aberson, *German Currency*, p. 33.

² *Ibid.*, p. 35.

industrial credits, and this found expression also in the increasing note circulation. But the increase in the monetary circulation was not to be expected to exercise a correspondingly proportionate increase in the price level, in view of the greater demand for currency under more stabilised conditions. It would be dangerous to draw precise conclusions from price index-numbers at this stage, but in April the mark exchange in New York revealed a weakening movement, and this was interpreted as a warning that some restrictive measures were necessary. As a result a policy of "credit-rationing" was adopted by the Reichsbank, and despite the protests elicited by this check, the movement was successful in restoring the exchange to its dollar parity.

At this point it is necessary to take account of the progress made as regards Reparations. The details of the Dawes proposals fall under three main heads:— (1) A definite scale of annual payments was devised in respect of Reparation payments, rising from 1000 million gold marks in 1924 (£50 million) to 2500 million gold marks (£125 million) in 1928–9, this latter figure to be the standard payment for subsequent years, though it might be supplemented by reference to a composite index of German "ability to pay." (2) A foreign loan of 800 million gold marks was to be raised, and this was to enable the budget contribution of 1924 to be met without adding to the financial difficulties of the reconstruction period. The schedule of annual payments and their composition are detailed below :

	1924-5.	1925-6.	1926-7.	1927-8.	1928-9.
Foreign Loan . . .	800 m.	—	—	—	—
Budget	—	250 m.	110 m.	500 m.	1250 m.
Industrial Debentures	—	125 m.	250 m.	300 m.	300 m.
Railway Bonds . . .	200 m.	595 m.	550 m.	660 m.	660 m.
Transport Tax . . .	—	250 m.	290 m.	290 m.	290 m.
Total	1000 m.	1220 m.	1200 m.	1750 m.	2500 m.

(3) The Reichsbank should be reorganised "as an essential agency for creating in Germany a unified stable currency." As regards this third proposal the details may be summarised as follows:

(a) The reorganised Reichsbank was to be a private corporation with a paid-up capital of 400 million gold marks, and, with certain minor exceptions, was to have the exclusive right of issue for a period of fifty years. (b) Paper already in circulation was to be withdrawn and replaced by a new uniform currency. (c) During the fifty years of the Bank's charter the Government was not to issue coins of denominations greater than 5 marks, and the supply of these coins was not to exceed 20 marks per head of the population. (This condition did not apply to gold coins containing their full value in metal.) (d) The Bank was not to grant loans or discounts having a maturity when the advance was made of more than three months, and no bills or notes were to be discounted unless they bore three names of known solvency. (e) Advances might be made to the Reich from time to time, but these were not to exceed 100 million gold marks at any one time, and the period of these advances was not to exceed three months. (f) Notes might be issued for circulation against gold coin or bullion, statutory discounts, demand credits in foreign banks, and foreign commercial trade bills with maturities not greater than three months. (g) These notes were to be qualified as full legal tender and were to be repayable to bearer on demand at the head office. Payment might be made, at the option of the Bank, in

- (1) gold coins of legal weight and fineness;
- (2) gold bars in denominations of not less than 1000 gold marks or not more than 35,000 gold marks;
- (3) demand drafts payable in gold or in foreign currencies.

(h) This convertibility might be suspended temporarily at the inception of the Bank, but in that case every

effort was to be made to maintain the exchange at or near its gold parity. (i) As regards reserves, a normal legal reserve of $33\frac{1}{3}$ per cent. was suggested, but a smaller proportion might be permitted in time of exceptional pressure, but only under certain penalties. The pre-war method of imposing a tax on the deficiency was revived, together with certain provisions as to the rate of discount. (j) The legal reserves of the Bank should be kept in the form of gold bars or coin, or in the form of demand deposits in foreign banks and repayable in gold. (k) Provision was also suggested for a special reserve in gold or gold deposits to the amount of 12 per cent. of the Bank's deposit liabilities, though this might also be relaxed subject to the payment of a tax on the amount of the deficiency. (l) As regards profits, 20 per cent. of the profits available in any year should be placed to surplus or reserve until the Bank's paid-up capital and surplus amounted to 12 per cent. of its average note liabilities during the preceding six months. A sum of 8 per cent. of the share capital should then be allowed for distribution to stock-holders, while any surplus remaining was divisible equally between the stock-holders and the Government in the form of a franchise tax.

The new Reichsbank law of August 30, 1924, was framed on the basis of these proposals, and provided for the calling-in of the existing note circulation and its replacement at the rate of one new Reichsmark for one billion old marks. Provision was also made for the liquidation of Rentenmark notes and for the final winding-up of the Rentenbank within a period of two years, and for a reduction in the rate of interest on its mortgages from 6 to 5 per cent. On certain points of detail the previous suggestions were modified. Thus the legal reserve against notes was fixed at 40 per cent. (instead of $33\frac{1}{3}$ per cent.), and of that proportion 75 per cent. was to be in gold either in the Bank's own vaults or held with foreign banks of issue. A special cover of 40 per cent. of deposit liabilities was to be held in the

form of deposits with other banks. Working credit advances not exceeding 100 million marks were to be granted to the Government, and of not more than 200 millions to the railways and post-office. But the Bank was also to grant a permanent loan to the Government of 100 millions at 2 per cent., and repayable on the withdrawal of the Bank's charter, and a further loan of 125 millions at 3 per cent. repayable in fifteen years. Finally, as to the distribution of net profits (defined as above), the Government's share of the first 50 millions was to be one-half, of the second 50 millions three-quarters; and of any further balance, nine-tenths.

At the beginning of 1924 there was a certain revival in trade, which appeared first in the textile industry, but spread rapidly to other forms of activity. In some respects, however, this immediate revival resembled the post-war boom of 1919, in that purchases were unrestrained and tended to exceed the limits of effective demand. Reinforced by speculative influences, this movement was reflected by rapidly growing imports, while exports, after declining from the end of 1923, increased only moderately. The visible trade balance, therefore, became increasingly adverse during the first half of 1924, and since there was little in the way of invisible income, the exchange revealed a weakening tendency which induced the credit restrictions initiated by the Reichsbank in April. These restrictive measures, as already indicated, took the form of a rationing of credit by the central bank, and a certain amount of disturbance ensued. But the exchange was safeguarded and returned quickly to parity. Wholesale prices as measured by the *Frankfurter Zeitung* fell from 151.9 in April to 115.9 in June. Unemployment rose sharply up to July, but from that month there was a steady and rapid decline for a period of a year. Then during the last quarter of 1925 unemployment rose to a very high level, but declined somewhat during 1926. Taking now the three years 1924-6, the gold cost of living increased steadily, while the wholesale price index-number (*Frank-*

furter Zeitung) tended downwards. In consequence, the ratio of these two price levels was altered in an important degree. Up to the third quarter of 1925 the gold cost-of-living level remained below that of wholesale prices; since that time it has been above the level of wholesale prices. Moreover, the course of wages, both nominal and real, was upwards to the beginning of 1926, so that with rising labour costs and a falling price level the relative advantage formerly enjoyed by German industry must have been materially reduced.

	(1) Wholesale Prices.	(2) Cost of Living.	Ratio of (2) to (1).	Wholly Unem- ployed.	* Weekly Wages Skilled Labour- ers. Nominal.	Real (Index).	† Weekly Wages Unskilled Labour- ers. Nominal.	Real (Index).
1924.					Rms.	Rms.		
1st Qr.	141	107	76	22.7%	28.75	77.6	22.79	92.4
2nd "	138	113	82	9.8%	33.70	86.1	25.07	96.3
3rd "	134	118	88	11.8%	35.85	87.7	26.51	97.5
4th "	141	112	87	7.9%	37.41	88.5	27.83	99.0
1925.								
1st "	146	132	90	7.1%	39.36	86.1	29.34	96.4
2nd "	142	137	97	3.8%	42.14	88.8	31.14	98.6
3rd "	143	144	101	4.1%	44.40	89.0	32.80	98.8
4th "	144	142	99	12.0%	45.68	92.9	33.70	103.0
1926.								
1st "	139	139	100	22.0%	46.00	95.6	33.94	105.9
2nd "	136	140	103	18.2%	45.99	94.9	33.93	105.2
3rd "	134	142	106	16.5%	46.07	93.7	34.01	104.0
4th "	138	143	104	15.0%	46.33	93.6	34.33	104.2
1927.								
1st "	138	145	105	14.5%	—	—	—	—
2nd "	139	146	105	7.4%	—	—	—	—

* Pre-war, 34.63 Rms.

† Pre-war, 23.05 Rms.

The monetary influences of the period are important. The policy of credit rationing initiated in April 1924 was relaxed somewhat towards the end of the year. In September the ration was increased by 10 per cent., while discounts were extended from 6 to 8 weeks to 3

months, and in December the ration was further increased to 15 per cent. above the April level. In 1925 some further modifications were introduced, such, for example, as "the announcement of the Reichsbank that it was prepared to rediscount acceptances of certain first-class banks and banking establishments without including these in the regular credit quota."¹ But the volume of "industrial credits" of the note-issuing banks increased rapidly from the middle of 1924. In April 1924 these had amounted to 2177 million Rentenmarks, declining to 2031 million in July, then rising to 3044 million in December, and, after a period of comparative stability in the first quarter of 1925, increasing to 3301 million in July 1925, after which there was an important contraction to 2066 million in June 1926. The movements in bank rate showed a reduction from 10 to 9 per cent. in February 1925, to 8 per cent. in January 1926, to 7 per cent. in March, to 6 per cent. in July, and to 5 per cent. in January 1927. But large foreign credits had been made available in 1924 and 1925, though these were generally of short duration and were therefore liable to be withdrawn should the gap between foreign and German interest rates be contracted. But the movement was important as a means of supplementing the limited credit available from the central bank. Also as regards the maintenance of exchange stability there was a tendency for that to be endangered as a result of the large foreign credits which were available. During 1925 the Reichsbank took up all foreign exchange bills originating from foreign credits and offered to it; "for foreign credits which were not used directly to pay for imports could be made available for domestic purposes only when converted into Reichsmarks. But, on the other hand, by the purchase of foreign exchange the Bank at the same time performed its duty in respect to currency policy. For instance, if it had declined rather large offerings of foreign exchange, the stability of the currency would have been imperilled, and an over-valuation of

¹ Annual Report of the Reichsbank for 1925.

the mark in comparison with foreign currencies would have come about. In the interest of import and export trade and of obtaining credits, and for general currency reasons, it seemed imperative to avoid such a departure from parity, even though in the long run it might have brought gold into the country."¹

The expansion in the gold and foreign currency reserves of the Reichsbank is indicated below :

REICHSBANK.

	End of			
	1913.	1924.	1925.	1926.
Gold	1170 m.	760 m.	1208 m.	1831 m.
Discounts and advances	1989 m.	2084 m.	1925 m.	1913 m.
Reserve in foreign currencies	—	253 m.	403 m.	519 m.
Notes	2594 m.	1941 m.	2960 m.	3756 m.

Since 1924, moreover, the total money circulation has increased rapidly from 2.3 milliards at the beginning of 1924 to 4 milliards at the beginning of 1925 and fully 5 milliards at the end of 1926. Deposits and advances of the seven main banks, excluding the Reichsbank, also increased, but the ratio of cash reserves to deposit liabilities was low, and the possibility of extending the total of loans depended upon the possibility of increasing cash reserves. Hence the general banking position turned directly upon the position of the central bank.

As regards the Reichsbank, the gold holding at the end of 1926 was larger than before the war, but at the latter date there was an important gold circulation which no longer exists. Again, notes were roughly 50 per cent. greater in volume, while discounts and advances were almost at the pre-war level. But no great expansion of commercial credit on the basis of central bank advances seemed to be possible without a further increase in gold reserves.

¹ Annual Report of the Reichsbank for 1925.

In that connection it should be noticed that despite a large adverse visible trade balance, Germany was able to import large quantities of gold from abroad. In 1923 that adverse visible balance was only 36 million gold marks; in 1924 it was 2556 million; in 1925, 3564 million; and in 1926 only 132 million. Thus the important factor in 1924 and 1925 was the large volume of foreign loans which both enabled Germany to pay for the excessive imports and to increase her holding of foreign balances convertible into gold. But the process was subject to much criticism—*e.g.* by Dr. Schacht on the ground that large foreign borrowings constituted a heavy charge on German industry, and that the necessary foreign exchange to meet interest and sinking-fund payments could not be obtained from the proceeds of German trade.¹ In 1925 the volume of foreign loans raised in Germany was estimated at 1455 million gold marks, and for the first eleven months of 1926 a preliminary estimate was given at 1562 million.² But some part of these loans would not represent fresh borrowings in so far as they were employed to repay existing indebtedness, and a further allowance should be made to cover expenses of issue. Again, there are other relevant items which cannot easily be measured; *e.g.* the repatriation of private balances which were remitted abroad during the flight from the currency.³ But in 1926 the adverse visible trade balance was greatly reduced, while the apparent volume of foreign borrowings increased. The net change

¹ But cf. the Second Annual Report of the Agent-General for Reparation Payments. "The service on long-term issues, aside from the external loan of 1924, amounts to about 250,000,000 Reichsmarks a year, in addition to the other external obligations which Germany has to meet. This is not in itself a heavy charge for an active industrial and trading nation like Germany."

² Estimates vary considerably. The Agent-General for Reparations gave a figure of 1255 millions for 1925, while the Reichsbank gave a figure of 2½ milliards. The data cited above are taken from the *Times* (Annual Financial Review), February 1, 1927.

³ The second Reparation Committee estimated that at the end of 1923 some 6½ milliard marks of German capital were domiciled abroad.

was important and was described in detail in the Report ¹ of the Agent-General for Reparation payments covering the second year of the Dawes Scheme. Thus "in the second year of the Plan, Reparation payments transferred in the form of foreign currencies, amounting in all to 416 million gold marks, were somewhat more than equalled by the surplus derived from the export of goods and services to somewhere around 600 million Reichsmarks." To some extent the increase in German exports during 1926 is to be accounted for by temporary factors connected with the prolonged coal stoppage in Great Britain. The real position as regards external loans to Germany cannot readily be determined, for, in addition to the factors already mentioned, part of her foreign borrowings appear to have been re-loaned to countries of Eastern Europe. And in view of the more favourable trade position in 1926, "the proceeds of foreign loans, except as they may have been re-employed abroad, have in large measure been turned in at the Reichsbank in return for German currency, and so may be regarded as one of the contributing causes of the recent increase in the circulation." ²

Finally, there are two points to be noticed. Throughout 1926 the policy of credit-rationing adopted by the Reichsbank was discontinued, the use of credit being regulated by the bank rate. Then from August 23 the exchange was "unpegged." The first of these was possible without difficulty. The commercial banks holding large foreign balances preferred to sell foreign deposits to the central bank rather than discount ordinary domestic bills. The demand for credit at the central bank tended, therefore, to diminish, and the Reichsbank was able in part to increase its gold holding by converting part of its foreign exchange into gold, thereby improving its position. But the sale of exchange by the commercial banks

¹ November 1926. In this Report the aggregate of foreign loans raised for Germany during the two years of the Dawes Scheme is placed at 3.5 milliard marks, inclusive of the German External Loan of 1924.

² *Ibid.*

to the Reichsbank for the purpose of obtaining cash was largely governed by the knowledge that exchange could be re-bought at the same price. With the "unpegging" of the exchange this knowledge no longer existed, since the mark was free to fluctuate in an independent course. Hence the banks have again resorted to the practice of re-discounting bills with the Reichsbank as a means of obtaining cash when required, and to that extent the use of the bank rate as a regulator of the control of credit has been made more effective. Otherwise, by the sale of exchange, the banks could add to their cash reserves and have less resort to re-discounts.

CHAPTER VII

FRANCE

THE Bank of France has possessed the sole right of note issue since 1848, but the regulation of that issue was governed by no automatic machinery similar to that which obtained in other countries. Maxima note issues were prescribed from time to time and no provision for elasticity was made, so that an expansion of the circulation in excess of the current maximum could only be effected by a hasty revision of the legal limit. Both gold coins and silver crowns were legal tender to any amount, and notes of the Bank were convertible on demand into either. These considerations have to be compared with the relatively slow development of deposit banking and the consequent greater use of cash in ordinary transactions. In 1914, deposits in twelve leading French banks (excluding the Bank of France) amounted to approximately 5000 million francs, while the circulation of notes, gold and silver amounted to 12,500 million. These figures may be compared with the corresponding data for the United Kingdom, where notes and gold in circulation amounted to £160 million and bank deposits to roughly £1100 million.

The general changes occasioned by the war should be viewed in relation to the commercial position of the country. Prior to the war France was a creditor nation, with an adverse visible trade balance, but with large invisible items of export which yielded on balance large sums which were available for fresh capital investment abroad. On the basis of the five years 1909-13, the excess of visible imports (merchandise and bullion) over exports averaged 1456 million francs, against which were interest on foreign investments at 1700 million, shipping

earnings at 215 million, income from tourist traffic at 625 million, and miscellaneous items at 150 million. On the other hand, allowance should also be made for debit items such as interest on foreign capital invested in France; but the sum available for fresh investment abroad has been placed at fully 1200 million francs.¹

For the five years 1914-18 the visible trade balance (including bullion) showed an excess of imports averaging 12,236 millions, while the invisible items were greatly reduced. The reason for this latter development is to be found in the distribution of France's foreign investments. Before the war, these were variously estimated at from 40 to 45 billion francs, of which about one-half were in Russia, Austria-Hungary and the Balkan States, and on that portion no income was forthcoming. A further portion of these investments was in South American States which defaulted, and about 3½ billions were sold abroad during the war years.² At the same time it became necessary for France to contract large foreign loans after 1914, while loans granted by France were chiefly to countries such as Russia and Poland, where they were subsequently dishonoured. Thus the war closed on a new France which had gained in respect of territory but which had lost heavily in respect of her foreign investments.

The financial operations of the war period bore directly upon the monetary position. As in other belligerent countries, war expenditure was only covered to a small extent out of receipts from taxation, and the public indebtedness, both funded and floating, was rapidly increased. Taking the five years 1914-18, French public expenditure, including ordinary and extraordinary budgets, amounted to 170,649 million francs, of which only about 15 per cent. was covered out of receipts from resources other than loans. In the United Kingdom the corresponding figure was about 29 per cent. The French deficits for these years aggre-

¹ Moulton and Lewis, *The French Debt Problem*, p. 16.

² *Ibid.*, p. 354.

gated 144,414 million francs. Comparing 31st July, 1914, with 31st December, 1918, the public indebtedness increased from 34,186 million francs, all of which was domestic, to 154,393 million, of which 123,794 million was domestic.¹ These figures are inclusive of the floating debt, which was increased from 1609 million to 56,015 million.

During the post-war years the position was not improved. For the six years 1919-24, ordinary and extraordinary expenditure aggregated 303,600 million francs, of which 131,800 million, or fully 43 per cent., was covered from sources apart from loans, leaving an aggregate deficit of 171,800 million francs. The domestic indebtedness rose from 123,794 million at the end of 1918 to 284,250 million at the end of November 1924, the floating debt at the latter date being 90,688 million as compared with 56,016 million at the end of 1919. At the end of 1925 the domestic debt had risen to 286,380 million, of which the floating debt was roughly 94,000 million. The foreign debt (in gold francs) at that last date was 36,439 million.

The practical importance of this floating indebtedness warrants a more detailed examination. The two main forms of that indebtedness may be distinguished. Under the first head should be included advances to the State made by the Bank of France (smaller advances were also made by the Bank of Algeria), and these virtually represented the increased note issue made for Government purposes. Before the war a definite limit was placed on the amount which the State could borrow in this way, but financial difficulties had necessitated a series of expansions of this limit. By the convention of November 11, 1911, the limit had been fixed at 2900 millions, exclusive of a perpetual loan of 200 millions which was free of interest. Since that date thirteen expansions of the limit had been made, and the convention of December 17, 1925, fixed the maximum at 39,500 millions.

¹ Moulton and Lewis, *The French Debt Problem*, p. 68; cf. Peel, *The Financial Crisis of France*, p. 118.

At the end of 1925, advances actually made were within 3500 millions of this limit as compared with a total of 25,500 millions at the end of 1919 and 17,150 millions at the end of 1918.

Under the second head are Ordinary Treasury bills (*Bons ordinaires du Trésor*). These were employed before the war to cover temporary budget deficits, and at the beginning of 1914 they amounted to 410 millions out of a budget of 5 milliards. During the war years the use of these bills was diminished, and at the beginning of 1918 the total outstanding represented only some 30 millions.¹ From that period they increased in volume and reached approximately 3 milliards at the beginning of 1924, but financial policy had devised more important media of short-term borrowing. During the war a new type of Treasury bill had been introduced by M. Ribot to attract the available funds of small investors. These bills, which were known as National Defence bills (*Bons de la Défense Nationale*), were issued in denominations ranging from 100 to 1,000,000 francs, maturing in one, three, six or twelve months and carrying interest at from 3 to 5 per cent. free of tax.² The ready acceptance of this new type of investment enabled the Government to borrow large sums both for war purposes and to cover expenditure on reconstruction included under the budget of recoverable expenditure. At the end of the war period, bills outstanding reached a total of 22 milliards, although considerable amounts had been funded by conversion into long-dated obligations. Between January 1919 and January 1922 the volume of National Defence bills increased by fully 36 milliards to 58.42 milliards, this increase being the result of expenditure for purposes of reconstruction. Since that date a considerable reduction has been effected both by further funding operations and by repayments, the last of these being in 1925, when 5 milliards were funded and 4 milliards repaid. The

¹ *Rapport du Comité des Experts*, 1926, p. 150.

² In July 1926 the interest rates were raised to 3.6 per cent. on one-month bonds and 6 per cent. on twelve-month bonds.

following table indicates the main changes which have occurred in the volume of the floating indebtedness :

(In million francs.)

Date.	Treasury Bills.	National Defence Bonds.	Advances of Bank of France.	Bank of Algeria.	Miscell.	Total.
1.1.1914 .	410	—	—	—	1,022	1,432
1.1.1918 .	30	19,522	12,500	85	1,339	33,476
1.1.1922 .	1,942	58,420	24,600	—	3,621	88,583
1.1.1925 .	1,870	54,538	22,600	—	8,482	87,490
1.1.1926 .	2,393	45,735	35,950	—	9,609	93,687

Even, therefore, with the contraction in the volume of National Defence bills effected during 1925, the quantity outstanding presented a serious problem in view of the diminished credit of the State consequent upon prolonged currency depreciation.

At the end of June 1914, gold in circulation was estimated at 5 milliards and silver at 1.5 milliards. The note circulation was fully 6 milliards, against which there was a metallic reserve of 4 milliards in gold and 600 millions in silver. The pre-war maximum note issue of the Bank of France was 6.8 milliards, but the limit was raised to 12 milliards on August 5, 1914, when convertibility was suspended and gold exports were prohibited except in the case of the central bank. Since that date a series of thirteen revisions brought the legal maximum up to 58.5 milliards on December 4, 1925. The gold reserve of the Bank showed a certain increase after the outbreak of war partly as a result of imports from London and partly through the withdrawal of gold from circulation. To effect this latter concentration, gold louis and half-louis were demonetised and the melting of gold coins was prohibited. Later the actual gold stock was diminished in connection with the raising of foreign loans, and by the end of 1918 some 2 milliards were held abroad, mainly in London. The practice of the Bank,* however, has always been to include this

foreign holding in its statements, since it was intended to serve as security for the loans raised and would be repatriated when the loans were repaid. The following table indicates the relation between the gold holding and the note circulation :

(In milliard francs.)

End of	Notes.	Gold in Vault.	Gold Abroad.
1914 (July) . . .	6·7	4·1	—
„ (Dec.) . . .	10·0	4·1	—
1915 „ . . .	13·3	5·0	—
1918 „ . . .	30·2	3·4	2·0
1920 „ . . .	37·9	3·6	1·9
1926 (July) . . .	56·0	3·7	1·9
„ (Dec.) . . .	52·9	3·7	1·9

Thus between July 1914 and July 1926 the note circulation had increased by fully eight times, though the increase in the actual circulation is less when allowance is made for the greater territory within which French currency now circulates. It is clear, moreover, that the entire gold circulation was not added to the holding of the central bank and that some large amount was probably hoarded.

The course of wholesale prices as measured by the index of the *Statistique Générale* (July 1914 = 100) showed a continued rise to an average of 506 for 1920. From that year there was a fall to 332, which was the average for 1922 followed by a continued rise to 718 for 1926.

It is not necessary in this survey to examine in detail the "pegging" of the French exchange during the war period with the aid of credits arranged in London, New York and other centres. These succeeded in maintaining the sterling rate at a figure under 30 francs and the dollar rate above 17 cents. With the removal of exchange control in March 1919, rates fell to a more natural level, sterling rising to 45·40 in the same year and to 68·80

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in 1920. In New York the franc fell from over 18 cents in March 1919 to 9 cents at the end of the year and to 6 cents at the end of 1920. From that time a certain appreciation was effected in consequence of the deflation in 1921, and the dollar rate recovered to fully 9 cents, but the subsequent trend was persistently downwards to the crisis in July 1926. The next table summarises the movements in prices and the dollar rate in Paris together with the course of U.S. prices. It will be seen that at the beginning of 1920 and again at the beginning of 1922 there was no appreciable disparity between the actual rate of exchange and the calculated purchasing-power parity on the basis of the indices employed. In 1923 and during part of 1924 the "gap" between the two rates widened, then contracted during the second half of 1924 and the beginning of 1925, and subsequently widened again up to the middle of 1926. With this last disparity, moreover, the spread of French prices also increased, and at the date of the crisis in July the disparity reached a maximum.

Date.	French Prices.			Average Dollar Rate.	U.S. Prices, Bureau of Labour.	P.P.P.
	General Index.	Imported Products.	National Products.			
1920. Jan. .	497	547	469	11.88 frcs.	233	11.04 frcs.
July .	506	510	504	12.27 "	241	10.88 "
1921. Jan. .	415	349	452	15.64 "	170	12.66 "
July .	337	256	382	12.79 "	141	12.39 "
1922. Jan. .	320	277	334	12.21 "	138	12.01 "
July .	332	292	353	12.29 "	155	11.10 "
1923. Jan. .	395	396	395	14.98 "	156	13.12 "
July .	415	383	433	17.05 "	151	14.24 "
1924. Jan. .	505	531	490	21.43 "	151	17.34 "
July .	491	509	481	19.57 "	147	17.32 "
1925. Jan. .	525	558	507	18.54 "	160	17.01 "
July .	569	609	545	21.30 "	160	18.44 "
1926. Jan. .	647	741	594	26.61 "	156	21.50 "
July .	854	1074	733	40.49 "	151	29.32 "
1927. Jan. .	635	624	640	25.25 "	147	22.38 "
July .	633	674	611	25.57 "	144	22.77 "

The changes in the gold value of the note circulation are summarised as follows :

(In milliard francs.)

Date.	Notes in Circulation.	Converted at Average Rates of Exchange.
June 1920	37'55 (paper)	18'05 (gold)
" 1921	37'42	15'66
" 1922	36'04	16'31
" 1923	36'69	12'22
1st Qr. 1924	39'45	9'33
2nd " "	39'90	11'79
3rd " "	40'30	11'04
4th " "	40'62	11'29
1st " 1925	40'73	11'16
2nd " "	43'18	11'24
3rd " "	45'43	11'05
4th " "	48'98	10'20
1st " 1926	51'24	9'74
2nd " "	52'95	8'61
3rd " "	55'46	7'81
4th " "	53'61	9'41
1st " 1927	52'49	10'71
2nd " "	52'44	10'70

Thus while the gold value of the paper circulation remained relatively stable from March 1924 to September 1925, it declined rapidly during the first nine months of 1926.

The foregoing paragraphs have endeavoured to present in general outline the main features of the French problem in relation to the extent of inflation, the nature and the extent of the public indebtedness and the altered commercial position of the country. That general position was further complicated by the extent of the devastation in the northern provinces. These were the provinces which were primarily the industrial regions of the country, and the process of reconstruction was therefore of longer duration. Public expenditure after the war tended as a consequence to be greatly increased on account of the expenses of reconstruction, while important sources of

revenue had been damaged and reparation payments from Germany were still uncertain and indefinite. Then, in 1920, France along with other countries experienced the reaction to the immediate post-war boom and prices fell rapidly during 1921. From this time the general position became more obscure. The prevailing attitude both official and unofficial was one which presumed that Germany would be held effectively responsible for the devastation and the cost of reconstruction. This attitude, moreover, tended to foster a mentality which was hostile to any important forms of increased taxation. Some attempt was, in fact, made to increase the public revenue, but this was not sufficiently successful and even the ordinary budget remained unbalanced. There were three main budgets to be considered. The first was the ordinary budget, which has been mentioned. The second was the extraordinary budget, and that represented expenditure arising directly from the war, and this was almost entirely covered by public borrowings. The third was the budget representing expenditure on reconstruction, and that expenditure was supposed to be covered by payments from Germany; but these payments were not received on an adequate scale. Hence the Government was obliged to borrow for practically the whole of the reconstruction expenditure and for large deficits in the other two budgets.

During this period the aim of French monetary policy was never clearly defined and different groups of conflicting opinions emerged. In the convention of September 1914 the State had undertaken to repay the advances made by the Bank in the shortest time possible out of whatever resources it could command, and in certain quarters, which included among their adherents M. Robineau, the late governor of the Bank of France, it was held that the official policy should aim at a gradual deflation until the pre-war parity of the franc had been restored. To that end it was suggested that the State should repay the advances of the Bank at the rate of 2 milliards per annum. In that way, provided certain

safeguards were preserved, the circulation would be contracted and a period of falling prices would be initiated. But on that basis it would have required annual repayments extending over some fourteen years to redeem the advances made by the Bank between the outbreak of war and the end of 1925. Then, with falling prices extending over that period and of the magnitude implied, industrial depression would have set in, and that would have been so protracted that far-reaching social and political reactions would have been inevitable. In other quarters the restoration of the franc to its pre-war parity was regarded as outside the realm of practical policy, and the alternative and more modest suggestion was submitted that the official policy should rather aim at checking any further inflationary tendencies.

In December 1920, deflation was made part of the Government's policy. At that time the State's indebtedness to the Bank was 26,600 millions. An agreement was reached whereby 2 milliards annually were to be repaid until the State's indebtedness was completely liquidated. This agreement made the convention of September 1914 more explicit and it constituted the first genuine attempt at deflation. But the other conditions which were necessary to ensure the success of the policy were not fulfilled. In particular budget equilibrium was not secured, and in this respect the official policy differed from that which was accomplished in the U.K. at the same time.

In 1921 the first repayments of the Bank's advances were made and the total was reduced to a minimum of 21,200 millions in March 1922—*i.e.* a reduction of 5400 millions on the corresponding total at the end of 1920. Between the same two dates the note circulation was only reduced by some 2 milliards. But the repayments to the Bank were not accompanied by a balanced budget and were not made out of budget surpluses, but at the expense of an increase in the volume of the floating debt. For a certain period the public were both willing and able to invest larger sums in National Defence bills,

and with the depression in trade there was a greater inducement to employ idle funds in this way. It is significant that between December 1920 and March 1922 the holding of portfolio and Treasury bills of the four largest banks actually increased by 764 millions. Treasury bills are not entered separately, but since it may be presumed that the decline in trade activity would reduce the holding of commercial bills, the increase in the holding of Treasury bills may perhaps have been larger than the figures suggest.¹ Analysis of the floating debt in its other components suggests the same conclusion. During 1921 the volume of National Defence bills increased by 9.5 milliards.

Between 1920 and 1922 the external value of the franc followed an irregular course, but from the beginning of 1923—the date of the occupation of the Ruhr—it moved almost steadily downwards. Among other things, the occupation of the Ruhr helped to precipitate the final collapse of the German mark, but it did not improve the domestic position within France. The adoption of a policy of passive resistance by the inhabitants of the occupied areas was followed by a suspension of coal deliveries to France, and new and large purchases of that commodity had to be made from the U.K. and from the U.S. The reaction on the exchanges can be shown definitely. The dollar rate in Paris moved from 13.84 francs in December 1922 to 16.23 in February 1923, and after a certain recovery during the spring months fell to 17.05 in July and 19.02 in December 1923. In January 1924 a new series of financial measures was adopted; these were intended to curtail public expenditure and to increase the public revenue by a general increase of 20 per cent. in existing forms of taxation. To that extent it seemed that some radical reorganisation of the national finances would be effected, and this served to revive confidence in the external value of the currency. Partly on account of these measures,

¹ The commercial portfolio of the Bank of France fell from 3.31 milliards at the end of 1920 to 2.33 milliards in June 1922.

the French Government was able to negotiate new foreign credits in London and New York, including the \$100 million Morgan loan.

These foreign loans were immediately employed in an attempt to check the fall in the value of the franc abroad. The Bank of France, operating on behalf of the Government, was enabled to control the exchange market and, in fact, to precipitate a certain appreciation in the franc. Towards the end of the year a period of comparative stability was secured, but it was not maintained. The position of the national finances was again serious. It had been announced that the deficit would at least be 4 milliards, while the available resources of the Treasury were dangerously low. In order to meet these contingencies it was decided to make a new issue of 5 per cent. ten-year Treasury bonds. The subscriptions to this new issue amounted to some 4.9 milliards, but about 3.9 milliards of that total were subscribed by persons who first sold Treasury and National Defence bills to the banks, and these maturities which they sold were due to expire in the near future and there was a danger that they might not be renewed. In short, only about 1 milliard of new money would accrue to the Treasury. In 1925 the position became even worse, and though an attempt was made at the beginning of the year to repay a further part of the State's indebtedness to the Bank of France, fresh borrowings were essential. Apart from National Defence bills which might mature at any time, there were fully 21 milliards of Treasury bonds to mature at the option of their holders. The monetary position was undergoing rapid change. The note circulation, which had remained practically unchanged at 40 milliards in 1924, rose to 51 milliards at the end of 1925. Wholesale prices rose from an index of 525 to 646, and the dollar rate moved from 18.54 francs in January to 26.75 in December. The data already cited in the earlier tables illustrate the movements which occurred in more detail, and it will be seen that during this period the value of the franc fell much more rapidly than the quantity of money increased.

As on other occasions, the crisis in 1925 was complicated by a number of political issues, but the financial elements may nevertheless be distinguished. The demand for the repayment of National Defence bills had assumed large dimensions, and by the beginning of the year exceeded the volume of fresh issues. The position of the Bank of France was that its actual note issue¹ was closely approaching the statutory maximum of 41 milliards, and representations were made to the Government that some further extension would be necessary. The commercial portfolio of the Bank in particular had risen with the upward movement in prices from 5.2 milliards at the end of 1924 to fully 6 milliards at the beginning of February 1925. No satisfactory procedure, however, was suggested. The Herriot Government, eager to avoid further direct inflation, sought to overcome the difficulty by contracting a number of loans from the private banks—amounting in all to some 3 milliard francs—but when the scrip in respect of these loans came to be discounted at the Bank of France, the inflationary effect was produced, although the volume of advances to the State did not reflect the real change. Nor was it possible to limit the movement to a period of short duration, since repayments of the loans out of revenue surpluses could not be made, and in April the limit of the Bank of France's advances to the State was raised to 26 milliards and the limit of the note issue to 45 milliards.² Further extensions were made in the same year to 32 milliards and 51 milliards under the Painlevé-Caillaux Ministry, which was confronted at the outset of its career by the possible maturity of some 20 milliards of short-term debt, unless public confidence could be sufficiently restored to enable conversions and renewals to be made.

M. Caillaux's efforts at financial reorganisation involved the consolidation of the internal debt and the settlement of the external debt. In respect of the first of these a

¹ At the end of December 1924 it was 40.6 milliards.

² This was done after the actual circulation had, in fact, exceeded the former limit.

new gold loan was issued, under which interest rates would depend upon the course of the sterling exchange, but while subscriptions of over 10 milliards had been anticipated, the actual response only amounted to between 5 and 6 milliards. Simultaneously the negotiations in respect of the foreign debt proved equally unfruitful and further Bank borrowings became necessary to meet the internal debt maturities in September. The closing months of the year, therefore, witnessed a further sudden collapse of the monetary position. Between June and December the note circulation rose from 43 milliards to 51 milliards, advances of the Bank to the State from 25.65 milliards to 35.95 milliards,¹ internal prices from an index of 554 to 646 and the sterling exchange from 102 to 129 francs.

The Painlevé Ministry which followed in November was of short duration and was defeated on a proposal to effect a compulsory consolidation of the short-term indebtedness. A further "flight from the franc" was precipitated by this suggestion, and the movement was continued during the first half of 1926. The vicissitudes of the successive governments need not be discussed here. The protracted discussions of budget proposals were accompanied by a continued depreciation of the currency, and by June 1926 the depreciation became particularly rapid, sterling averaging 166 francs. Meantime a Committee of Experts had been appointed by M. Peret at the end of May, and the Report was available in July, when M. Caillaux was again Minister of Finance. For some weeks panic conditions prevailed. The refusal to grant extraordinary powers to M. Caillaux was followed by a political crisis, a new ineffective Ministry under M. Herriot, and finally a Ministry of the National Union under M. Poincaré.

The main elements in the panic of July may be noted. The budget position, which had shown some improvement, was suddenly changed. Excluding some twelve

¹ Roughly equal to the decline in National Defence bills outstanding owing to unwillingness to renew.

subsidiary budgets amounting to 6.6 milliards, the general budget estimates for 1926 had been drawn up to secure a small surplus of 160 millions on a total expenditure of 37.3 milliards. During the first quarter of the year the position was satisfactory, but the Moroccan campaign upset earlier calculations and domestic expenditure increased with the rise in prices (647 in January, 702 in May and 854 in July). Taking the first six months, receipts were much below half of the year's estimates, amounting to only 16.1 milliards, while expenditure was rising far above the original estimates. These estimates had been based upon a sterling exchange of 125, whereas the actual exchange in June averaged 166 and in July 198. Moreover, there were large payments to be met by the Treasury during the second half of the year. The Treasury, however, was virtually empty and the limit of the Bank's advances was again within sight. On July 21, M. de Monzie, who occupied the position of Finance Minister for a few days, intimated to the Chamber of Deputies that unless immediate measures were adopted, a suspension of Treasury payments would be inevitable. The sterling exchange rose to over 240 at its highest point.

At this stage the recommendations of the Experts' Report should be noted. Viewing the problem as essentially one of monetary instability, the experts endeavoured to foreshadow the means of establishing the franc once more on a gold basis, by giving a new legal definition to the value of the unit of account. The conditions under which this stabilisation was possible were considered under several heads. (1) As regards the balance of payments, and apart from the war years, the visible trade balance since 1920 had been close to an equilibrium, and in 1924 and 1925 there had been a small excess of exports over imports.¹ There were in addition important items of invisible income, but these were more than offset by the export of French capital. In general the commercial position was not unfavourable to the

¹ Again in 1926.

process of securing monetary stability. (2) A complete reorganisation of the national finances was imperative. But the Committee did not consider that important economies in the national expenditure could be effected except by certain administrative changes which would require time for their completion. On the side of revenue, additional taxation was essential, and the sums proposed were $2\frac{1}{2}$ milliards for the remaining months of 1926, and about 5 milliards on the 1927 budget. (3) The problem of the Treasury was more immediate. The magnitude of the volume of National Defence bills outstanding had made the Treasury the largest deposit bank in the country. If, therefore, any sudden demands for the repayment of these bonds should arise, the resources of the Treasury would be inadequate to meet them. Hence the proposal to effect a progressive voluntary consolidation by the offer, as soon as circumstances would permit, of "a first consolidation loan, corresponding to the conditions of the market and the legitimate desires of subscribers for security." Meanwhile it was desirable to guarantee the redemption of bonds outstanding, and the administration should be assigned to a special "Caisse de Gestion," which would be provided with certain funds out of the national budget, including the net product of the tobacco monopoly. (4) Whatever body was to be entrusted with the task of stabilisation had to have sufficient resources in francs and foreign currencies to enable its operations to be effective, and the Bank of France seemed to be more appropriate to the task than the State. The actual rate of stabilisation was a matter of choice between the two extremes of the actual rates current at the time and the rate corresponding to the cost-of-living index-number at the moment. "The figure of stabilisation must be sought between these two limits, account being taken of all the circumstances, notably of the necessity of retaining or attracting foreign capital, and inducing the rapid return of expatriated French capital."¹ The Committee, however, was not favourable to the employment by the Bank of its gold

¹ *Rapport du Comité des Experts*, p. 44.

reserves in the attempt to fix the exchanges. The alternative of securing adequate foreign loans implied external confidence in the scheme of reform to be introduced and the settlement of the amounts of existing indebtedness. Three stages in the process of stabilisation were distinguished: (a) the pre-stabilisation period, during which the actual rate would be made to approach the rate at which final stabilisation was to be effected; (b) the period of *de facto* stabilisation, during which the Bank would be known to be dealing in exchange at the prescribed rates; and (c) the period of legal stabilisation, when the stabilised rate would be incorporated in a new legal definition of the value of the unit of account.

The foregoing represents merely a summary of the Experts' Report. The possibility of a stabilisation crisis was recognised, but within limits it was inevitable. Much would depend upon the rate chosen for stabilisation, and therefore upon the extent of the necessary price readjustments. If the rate corresponded to a relatively low gold value, internal prices would have to rise by a considerable amount, and the greater the movement in this direction the greater the possibility of severe crisis when the limit had been reached. To that extent a relatively high gold value would mitigate the extent of the price readjustment which would be necessary, so long, of course, as no external over-valuation of the currency was created.¹ The raising of the actual rate to its true purchasing-power parity before stabilisation, in fact, seemed, therefore, to provide the best safeguard against any unnecessarily severe disturbance. But granted that the franc had been greatly under-valued abroad prior to this process, the improvement in the actual exchange would be considerable, and while this would merely remove certain of the abnormal advantages hitherto enjoyed by French export traders, it would also have other reactions in so far as the former under-valuation had enabled producing units of inferior efficiency to compete in the world markets.

The policy ultimately adopted by the Poincaré Ministry

¹ Cf. Gregory, *The First Year of the Gold Standard*, p. 140.

concentrated upon the balancing of the budget and the "rehabilitation" of the franc "to the greatest extent possible." The new tax proposals aimed at obtaining an additional $2\frac{1}{2}$ milliards of revenue in 1926 and an additional 9 milliards in 1927. New direct taxation was to yield 3.5 milliards; new taxes on consumption 3.9 milliards; and increased railway rates and freights 1.7 milliards. The treatment of the floating debt was on the lines suggested by the experts. The Caisse d'Amortissement which was set up was an autonomous bureau, independent of the Government, and supplied with funds out of the net profits of the tobacco monopoly, the proceeds of new property transfer and inheritance taxes, plus any budget surpluses which might be available. Obviously, however, the conditions for the success of such a sinking-fund arrangement depended upon the possibility of securing a real equilibrium in the main budget. The danger was lest the elaborate machinery which was established—involving an amendment to the Constitution and a special session of the National Assembly at Versailles (the first meeting since 1871)—should convey an impression of solvency which did not exist. If the national finances should not be equilibrated, the new proposals would merely repeat the fallacy of Pitt's early sinking fund in this country.

Conforming again to the recommendations of the experts, an attempt was made to add to the metallic reserves of the Bank by authorising the purchase of hoarded gold and silver coins at a premium.¹ This had been prohibited in 1916, but the prohibition was removed in July 1926 and the practice was initiated in September. The advantages claimed for this scheme were, (a) that unproductive hoards of metal coins were converted into acceptable bank-notes by liquid assets; (b) that the incentive to export national money was removed; and (c) that the Bank was able to acquire large exchange resources without resorting to foreign loans.² When the practice was first introduced the purchase price of

¹ *Rapport*, p. 46.

² Cf. Annual Report of the Bank of France for 1926.

gold coins was fixed at 19.75 francs per gramme of fine gold, but declined progressively to 14 francs as the external value of the franc improved. By the end of the year, gold and silver coins purchased by the Bank amounted to 341 million francs at their monetary parity, but to more than 1500 million if taken at their international market price.¹

As originally outlined, moreover, the proposal enabled the Bank to increase the legal limit for the note circulation (fixed at 58.5 milliards in December 1925) by the amount of notes issued against these purchased coins. As events developed the actual note circulation was reduced from 57 milliards at the beginning of August to 53 milliards at the end of the year.² During the same period the State's indebtedness to the Bank has been reduced by 2 milliards. Revenue figures which are now available indicate that receipts in 1926 were 42 milliard francs, or 12½ milliards greater than the corresponding figure for 1925. Expenditure figures have not yet been disclosed, but a recent statement of the Ministry of Finance declares that for 1926 the national accounts have been balanced and that there may have been a small surplus of 150 millions. The budget for 1927 as passed by the Chamber provides for an expenditure of just under 40 milliards with a small estimated surplus of 150 millions. These data are sufficient to indicate that although progress towards the balancing of the national finances has, in fact, been made, the position remains precarious, and any exceptional occurrences might have serious results. The danger is that if deflation should be carried to excess, the resulting reactions might reduce actual revenue receipts below the estimates, and while expenditure might also fall, it might prove to be inelastic, and the margin is very small.

The future of the financial position is, therefore, dependent upon the attainment of a real monetary

¹ Cf. Annual Report of the Bank of France for 1926.

² It is perhaps significant that the Report of the Bank for 1926 finds it expedient to remark: "It is unnecessary to add that this item of about 53,000,000,000 francs includes, without exception, all notes issued by the Bank for any purpose whatever."

stability. During the last five months of 1926 the external value of the franc appreciated rapidly. In September the sterling rate averaged 170 francs; in December it averaged 123 francs. Wholesale paper prices have also fallen since July and the index (*Statistique Générale*) fell from 854 in that month to 641 in December. The evidence, in fact, points to the conclusion that while the franc was greatly under-valued in June, July and August, that under-valuation has since been greatly reduced. The following table summarises the position by comparing the course of the actual exchange with the movements in the purchasing-power parities as calculated from the indices of the *Statistique Générale*.

	Average Exchange.	Purchasing-Power Parity.
June 1926	166 francs	129 francs
Sept. "	170 "	134 "
Nov. "	144 "	114 "
Dec. "	123 "	111 "
Jan. 1927	123 "	111 "
Feb. "	124 "	111 "
July "	124 "	111 "

The calculation of the purchasing-power parity in this manner, however, makes no allowance for any relative changes in the real ratio of exchange as between articles entering into international trade or for changes in customs duties as compared with 1913. It might well be that allowance for these changes would eliminate the apparently steady gap between the two rates as given above during the first half of 1927.

Further evidence may be adduced to illustrate the process of adjustment which has occurred. The rapid rise in the external value of the franc should in itself have been sufficient to add to the difficulties of the export trades, and the evidence suggests that these have been experienced. At the same time the French prices of imported commodities, which would be made particularly dear by the fall of the franc, would be cheapened

as the value of the franc rose. The next table illustrates these movements in more detail.

JULY 1924 = 100.

	Average Exchange.	General Index (45 Articles).	National Products (29 Articles).	Imported Products (16 Articles).
July 1926 . . .	198 francs	854	733	1074
Sept. " . . .	170 "	804	743	912
Nov. " . . .	144 "	698	698	700
Jan. 1927 . . .	123 "	635	640	624
Feb. " . . .	124 "	645	643	650
July " . . .	124 "	633	611	674

Especially in November there was a remarkable degree of convergence in the indices of the three groups of commodities, while in December the level of imported goods was below that of national products.

It is possible to illustrate the readjustment in another way, viz. by converting French paper prices into gold prices at the rates of exchange ruling during the period, and comparing the course of French gold prices with the levels of gold prices in other countries.

GOLD PRICES.

	France.	Germany.	Belgium.	United Kingdom (Statist).	United States (Bureau of Labour).
July 1926 . . .	107	134	—	148	151
Oct. " . . .	116	138	121	154	150
Dec. " . . .	131	137	123	146	147
Feb. 1927 . . .	131	137	122	146	147
July " . . .	130	138	121	144	145

The table indicates that French gold prices have risen rapidly towards the world level. The comparison with Belgium is interesting in so far as the two countries compete in similar markets, and if, as the figures suggest, French gold prices have now risen above the level of Belgian gold prices, the French industries in question

may encounter particularly keen competition from their Belgian rivals.

It was to be expected that something approximating to an adjustment crisis should have occurred in France as a result of these movements. Complete statistical evidence of this is not available, but there is evidence which points definitely to that conclusion. The silk mills at Lyons were compelled to resort to short time, and it has been interpreted as significant that the Government should have exempted export articles from the Business Turnover Tax which was first imposed in 1920, and which has since yielded large sums in revenue. The cost-of-living index, which shows an unbroken rise during 1925 and 1926, did not fall with the fall in wholesale prices from July 1926, and the ratio of gold cost of living to gold wholesale prices has risen rapidly. In December 1925 the ratio was 65.3 per cent., in June 1926, 64.3 per cent., and in December 1926, 86.6 per cent. Unemployment figures relate only to a small number of persons, but the general trend may be taken as indicative of broader movements. In the last quarter of 1925 the number in receipt of relief averaged 575; in the third quarter of 1926 the average was 348; by December the figure had risen to 10,178, and by March 1927 a figure of 82,000 had been reached.

Meantime the uncertainty as to the future remains. No official policy has been pronounced, though the Bank, acting on behalf of the Treasury, has succeeded in pegging the exchange. In certain quarters the idea of raising the franc to an even higher value is still entertained, and the official intentions, in so far as they have been revealed, seem to be to raise the exchange to as high a value as possible without effecting serious disturbance. During the recent debates in the Chamber on the budget for 1927, M. Poincaré argued that a sterling exchange of 122 did not necessarily involve a serious economic crisis. The truth of that conclusion remains to be seen, but the possibility that the exchange may still be raised presents uncertain difficulties for French exporting industries.

CHAPTER VIII

BELGIUM

THE financial problem in Belgium assumed rather a peculiar form in comparison with the problem as it developed in the other belligerent countries. The occupation during the war years deprived the Government of its ordinary sources of revenue, and whatever expenditure was incurred was financed by the Allied Powers. At the conclusion of peace the war indebtedness was transferred to Germany as a reparations liability. To that extent, therefore, the Belgian finances were relieved of an important burden during the period of post-war reconstruction. On the other hand, there were other obligations of indebtedness for which no relief was obtainable. There was expenditure on reconstruction after 1918, while the revenue system remained disorganised and inadequate, and large deficits were inevitable. The 1919 budget revealed a deficit of 6 milliard francs, of which $2\frac{1}{2}$ milliards were to be paid by Germany before May 1921. In 1921 there was a deficit of 5.2 milliards on the ordinary and extraordinary budgets. The total deficits for the period 1919-24 amounted to 20,155 million francs, covered to the extent of 8 milliards by State loans, 2.6 milliards by part of the proceeds of loans issued by the Federation of Co-operation for War Damages, and 9.6 milliards by Treasury bills.¹ As in the case of France, the position was unnecessarily complicated by the general expectation that "les Allemands paieraient tout." In the absence of expected reparations, therefore, large sums had to be borrowed both within the country and abroad. For some time it was possible to raise important long-dated internal loans, but

¹ Cf. Department of Overseas Trade, *Report on Belgium*, 1926, p. 21.

from 1922 the practice of short-term borrowing by six-month Treasury Bonds became more important. Foreign loans were also arranged to facilitate the work of reconstruction and the financing of heavy imports. Before the war the public debt amounted to $4\frac{1}{2}$ milliard francs. By the end of 1920 it amounted to 29.5 milliards, having been increased to the extent of 7.8 milliards by the withdrawal of German marks from circulation (described below), plus 10.2 milliards in respect of war damage advanced on behalf of Germany, and 7 milliards representing the deficits on the post-war budgets and exchange losses on foreign loans.¹ By September 1923 the public debt had increased to 40 milliards, and two years later, on the eve of the first attempt at stabilisation, it totalled 46 milliards, of which the floating debt represented 35 per cent. The interest charges on this total indebtedness constituted an important element in the public finances, and in 1926 these debt charges amounted to 2.73 milliards, or approximately 50 per cent. of the budget of 5.32 milliards.²

The war-time monetary position and its post-war developments may be described briefly. The National Bank had a note circulation before the war of 1000 million francs. At the outbreak of war, convertibility was suspended and there was a certain increase in the note issue corresponding to the greater re-discount of bills for the commercial banks and the greater governmental demand for advances. During the German occupation the National Bank was forbidden to continue its power of issue, and a special issue was made by the Société Générale, while German mark notes were given a forced circulation at the rate of 1.25 fr. At the time of the Armistice the National Bank had a circulation of 1262 million francs, and the Société Générale 1153 million;³ and the two issues were amalgamated.

¹ Cf. Department of Overseas Trade, *Report on Belgium, 1922*.

² Cf. Franck, *La Stabilisation Monétaire en Belgique*, p. 23.

³ Cf. *Revue d'Économie Politique*, Jan.-Feb. 1927, p. 7. "La Dépréciation et la stabilisation du franc belge," par. B.-S. Chlepner.

The German mark notes were at once withdrawn and replaced by Belgian currency or bonds at the rate at which they were forced into circulation.¹ On the completion of the conversion, a total of fully 6 milliard marks, equivalent to fully 7·6 milliard francs, had been exchanged. A sum of 1½ milliard marks was redeemed by the issue of 5 per cent. *Bons du Trésor de la Restauration Monétaire*, and the remainder—5·8 milliard francs—by advances from the National Bank. This latter represented the State's indebtedness to the Bank at the end of 1919. Under an agreement of November 1919, the German Government undertook to redeem the marks withdrawn by remitting six-month Treasury Bonds carrying interest at 5 per cent. as from May 1921. The difference between the rate of 1·25 fr. and the exchange-value of the mark when payment was made was to be further covered by German Treasury Bonds. This agreement, however, was repudiated, and a fresh arrangement was devised at the end of 1921 whereby Germany was to repay 4 milliards at the rate of 1·25 fr. in thirty annual instalments and at 2 per cent. interest, the remaining 2 milliards to be repaid at the rate of 0·25 fr. per mark.

At the end of 1920 the note circulation reached a total of 6260 million francs. The cost of living meanwhile showed a rise of 368 per cent. since April 1914. During 1921 the cost-of-living index fell to 379 in July, and after a rise towards the end of the year fell to its lowest point at 365 in May 1922. The sterling exchange, which stood at 30·20 francs at the middle of May 1919, rose to 53·42 by the corresponding date in 1922, and then to 70·95 in a further six months. In May 1922, however, there was no evidence that the franc was under-valued in the sterling exchange, the purchasing-power parity (on the basis of the *Statist* index-number of the Belgian wholesale price index) being 55·48 francs. By May 1923 the actual exchange had risen to 80·50, and after a

¹ This represented the mark as greatly over-valued in comparison with its actual exchange value; the mark was worth only about 65 centimes.

further rise during the following twelve months remained relatively stable during the last three-quarters of 1924 at about 90 to the £ and 20 to the dollar. During 1925 the exchange rose to 96·19 in May and 111·15 in September, when the first stabilisation effort was promulgated.

The scheme of M. Janssen, who was then Finance Minister, involved the stabilisation of the franc with the aid of foreign credits, and the devaluation of the franc on the basis of the stabilised exchange. For that purpose it was proposed to raise \$150 million, with which the State would repay some 3 milliard francs of its debt to the National Bank. The franc, which was stabilised at 22 to the dollar and 107 to the £, would enable the metallic reserve of the Bank to be revalued, and since one gold franc would be equivalent to $4\frac{1}{2}$ paper francs, a gold reserve of 360 millions would on revaluation become 1530 millions as against a note circulation of 7630 million francs.

Any scheme which involved devaluation necessarily outraged the sentiments of those who looked forward to a gradual restoration of the franc to its pre-war parity, and this notion had in fact been held by the author of the stabilisation plan. More important, however, were the conditions upon which the success of the scheme depended. In November 600 million francs of new taxation was demanded by the Government to ensure the equilibrium of the budget. Meanwhile provisional foreign credits had been arranged and the franc was, in fact, successfully stabilised. By the end of the year the requisite fiscal laws had been voted by Parliament, and at the beginning of the following year the Bills relative to the Bank and stabilisation had been passed. It remained only to conclude the arrangements in respect of the foreign loans. As it happened, these negotiations were at first delayed, and when they were, in fact, opened, the prospect of a complete agreement appeared to be doubtful. A final conference in London on March 15 failed to produce an agreement on terms which the

Belgian Government would accept, and on the same day the National Bank ceased to interfere on the exchange market and sterling rose to 122 francs. The breakdown of the negotiations was reported to have developed from the conditions required by the foreign bankers, who stipulated that the loan should not exceed \$100 million, that its duration should not exceed three years, and that it should be accompanied by a partial consolidation of the floating debt, and the adoption of measures for the "industrialisation" of the State railways for this purpose.¹

Meanwhile the period of stabilisation had proved a costly experiment. In the last three or four days of the stabilisation the Bank had spent \$20 million, and the total cost from September 15, 1925, amounted to \$107 million.² Moreover, the Bank had applied a severe discount policy, and those who required foreign exchange had to obtain the necessary payment by drawing against their bank deposits. This in turn led the commercial banks to dispose of Treasury Bonds by presenting them for payment. Thus "les grosses coupures," or bonds of 100,000 francs and upwards, mainly held by the banks, declined from 1800 million in September 1925 to 500 million in May 1926.³

An important criticism concerns the rate at which stabilisation was effected. The fact that the foreign credits employed for the purpose had, in fact, to be employed on a large scale may be interpreted as indicating that the franc was pegged at too high a value. To some extent the problem would have been simplified had it been possible to have stabilised the French franc concurrently with the stabilisation of the Belgian franc, since the industries of the two countries are largely competitors in the same market, and the fall in the level of French gold prices would react upon competing

¹ It was not proposed, as was suggested in various quarters, that this last item was to involve foreign control of the railways, or that the plan should involve more than an element in the consolidation of the floating debt. Cf. Franck, *op. cit.*, p. 48.

² *Ibid.*, p. 158.

³ Cf. *Revue d'Économie Politique*, *op. cit.*, p. 23.

Belgian industries. The following table indicates the movements in gold prices in the two countries :

	Wholesale Prices (Gold).*		Cost of Living (Gold).		Ratio of (3) to (1).	Ratio of (4) to (2).
	Belgium (1).	France (2).	Belgium (3).	France (4).		
June 1925 .	137	136	128	96	93	71
Sept. " .	128	138	124	98	97	71
Dec. " .	132	125	126	82	95	66
March 1926	128	120	114	84	89	70
May " .	112	115	90	74†	80	—

* Taken from French Experts' Report, p. 168.

† June.

It appears, therefore, that while the level of gold wholesale prices was practically identical in June 1925 prior to the Belgian stabilisation, the ratio of gold cost of living to gold wholesale prices was favourable to France even before the Belgian stabilisation was effected. In any case there is no reason why the Belgian effort should have been impossible if accomplished independently and not in collaboration with France. Stabilisation in Belgium unaccompanied by similar action in France might be expected merely to remove a relative and abnormal advantage which Belgium had formerly enjoyed along with France from exchange movements.

At the end of March the sterling rate rose to 130, and at the end of April to 143. In two months 600 millions of Treasury Bonds had been presented for repayment, and on May 18 the Government demanded the immediate passing of a law authorising the National Bank to discount Treasury Bonds up to 1500 millions. The sterling exchange reacted to 174, and after a certain recovery on the selection of a new Government rose to 240 in July, recovering to 192 at the end of the month. The note circulation expanded from 7.42 milliards in February to 8.98 milliards in July and 9.51 milliards in September. Wholesale prices stood at 556 in February, 876 in July and 859 in September, and the cost-of-living indices

for the same months were 526, 637 and 684. Between February and July the gold cost of living fell from 124 to 80, and gold wholesale prices from 131 to 109.

The measures adopted by M. Francqui ranged themselves under several heads. The law of 7th June authorised the creation with assigned revenues of le Fonds d'Amortissement de la Dette Publique. New taxation to the extent of 1500 million francs was simultaneously imposed, and the proceeds of these, together with other specified revenues, were to be allocated to the Sinking Fund. In July, financial power was delegated to the Crown for a period of six months. The task remained of consolidating some important part of the floating debt. For this purpose the "industrialisation" of the State railways was voted on July 23, and on July 31 it was decided to effect a compulsory consolidation of six months Treasury Bonds, and of the 1500 million five-year Bonds which matured at the end of the year, by conversion into Preference Shares in the new railway undertaking.¹

Between July and October the dollar value of the franc in Brussels rose from 41·185 to 36·05. At the latter date the purchasing-power parity on the basis of wholesale prices was 29·53 francs. Gold wholesale prices, in other words, were 122 in Belgium, and gold cost of living 101, having risen from 109 and 80 respectively in the former month. The technique of stabilisation involved the selection of an appropriate rate and the provision of sufficient resources to enable the National Bank to maintain the determined rate. External conditions in general were favourable to a second stabilisation.

¹ A partial modification of this compulsory consolidation gave to bondholders the right to have the character of their bonds maintained, in which case they would only be repayable at the discretion of le Fonds d'Amortissement. Out of a total of 5840 millions of bonds, 4192 millions were converted into Preference Railway Shares, and of the unconverted balance, more than three-fourths were held by the banks. The capital of the new railway company was fixed at 11 milliards, of which 1 milliard in Ordinary Shares was held by the State. The 10 milliard Preference Shares were issued by the Fonds d'Amortissement to consolidated bondholders. Cf. Francq, *op. cit.*, pp. 72, 80 and 161.

The internal dislocation in the United Kingdom was perhaps partly responsible for an important increase in Belgian exports and an improvement in the commercial position during the last six months of the year. Internally the partial consolidation of the floating debt relieved the Bank of an important potential drain on its resources, but there remained a large volume of external floating indebtedness which was unaffected by these compulsory measures. Early in October negotiations were developed with foreign central banks for the purpose of securing the necessary loan. The Bank of England and the Federal Reserve Bank of New York had agreed to the principle of the loan, and offered important credit facilities subject to the conditions that the Belgian currency was stabilised within a period of thirty days and that a loan of £15,000,000 was arranged with the private banks. On October 23 a \$100 million loan was arranged, and on the following day the National Bank proceeded to peg the exchange. The rate of stabilisation was 175 francs to the £, but the "belga," equivalent to 0.20911 gramme of gold and five paper francs, was adopted as a new unit of account for exchange transactions. Thus the rate of stabilisation corresponded to 35 "belgas" to the £, and = 7.919 to the dollar.

Since the end of October the "belga" has been quoted at a slight premium, and till the end of the year the gold import point was exceeded. This was partly the result of the repatriation of funds formerly deposited abroad, and partly the result of the favourable interest rates ruling in Brussels. The effect on market discount rates, which rose towards the end of the year, was to bring about a reduction from $7\frac{1}{2}$ per cent. to $3\frac{1}{2}$ per cent.¹ The official discount rate was reduced from 7 per cent. to 6 per cent. in February 1927. Wholesale prices meanwhile remained stable, but the cost of living continued to increase, so that the relative position of the two price levels became less abnormal. In September the ratio was 80 per cent. (*i.e.* ratio of cost of living to wholesale prices); in December the ratio was 86 per cent.

¹ *Times*: Annual Financial and Commercial Review, 1.2.27.

CHAPTER IX

ITALY

THE pre-war circulation of Italy amounted to 2.8 milliard lire, of which approximately 500 million consisted of State notes of small denominations. The remaining 2.3 milliards represented the notes issued by the Banca d'Italia, the Banco di Napoli, and the Banco di Sicilia. For these three issue banks there was a normal maximum circulation of 908 millions, and notes issued in excess of this amount had either to be fully covered by metallic reserves or else were subject in respect of the deficiency to a graduated rate of tax. A minimum metallic reserve of 548 millions was prescribed, and the total reserve including foreign credits was required to represent at least 40 per cent. of the normal circulation. After the outbreak of war the maximum normal circulation of the issue banks was raised to 1816 millions, and the limit of the State note circulation was raised to 2300 millions.

By the end of 1918 the aggregate note circulation had increased to 13.9 milliards, of which 2.1 milliards consisted of State currency notes, and of the total of 11.75 milliards of banknotes, 7.17 milliards had been issued "on behalf of the State." The public finances during the war years revealed large deficits. For the three financial years from 1916 to 1919 the public tax revenue represented only 30 per cent. of the public expenditure for the same period. The public debt increased from 15.7 milliards before the war to 112 milliards at the end of 1921, including fully 21 milliards of Treasury Bonds held abroad and calculated at par. As regards the trade position of the country, there was an excess of imports in 1913 of 1.1 milliards, against which were important

items of invisible income in respect of remittances from Italians resident abroad and from the proceeds of the tourist traffic. From 1914 to 1920 the excess of imports aggregated 58.5 milliards, against which there were no corresponding items of invisible income from the sources already mentioned. The balance was, in fact, made good out of foreign loans. The exchanges, however, were only pegged during the latter half of 1918, and the external value of the currency showed an appreciable depreciation up to that time.¹ In 1921 the adverse visible trade balance was 7 milliards, while remittances from Italians abroad were estimated at only 711 millions as compared with 981 millions in 1920.²

The following table shows the changes in the note circulation in the post-war period.

(In milliard lire.)

	Bank Notes.	State Notes.	Total.
Dec. 1920 . . .	19'73	2'27	22'00
" 1921 . . .	19'21	2'27	21'48
" 1923 . . .	17'25	2'43	19'68
" 1924 . . .	18'11	2'40	20'51
" 1925 . . .	19'35	2'10	21'45
" 1926 . . .	18'34	1'79	20'23
June 1927 . . .	16'67	1'29	18'96

The total circulation reached its maximum in December 1920, after which it declined to 19.2 milliards in January 1924, rising again to 21.6 milliards in October 1925, and falling to 19.8 milliards in January 1927. In the financial year 1924-5 the budget was successfully balanced and yielded a surplus revenue of 417 million lire, as compared with deficits of 3029 million in 1922-3 and 418 million in 1923-4. The total internal indebtedness was reduced during 1925 to 91.5 milliards, and

¹ Cf. Jack, *Economics of the Gold Standard*, p. 44.

² Brussels Financial Conference: "The Recommendations and their Application after Two Years," December 1922, p. 88.

exceptionally favourable settlements of the external debt to the United States and the United Kingdom were afterwards secured, reducing the volume of that debt from 24.1 milliard gold lire at the end of 1924 to 17.7 milliard at the end of 1925, and the annual payments in respect of that foreign debt were fully covered by the receipts due to Italy from Germany under the Dawes Plan. Thus the financial position was favourable to any attempt at monetary stabilisation. The 18 milliards of Exchequer bills were easily renewed and presented no serious problem.

The next table summarises the relevant price movements during the four years ending in 1926:

	Wholesale Prices.	Cost of Living.	Ratio of (2) to (1).	Cost of Dollar.*	Unemployment.†	P.P.P.‡	P.P.P.§
1923. March	587	493	84	397.4	281	291.7	385.0
June	569	491	86	421.8	216	289.0	371.8
Sept.	569	487	86	434.8	181	283.1	369.5
Dec.	577	499	86	444.9	259	288.5	382.1
1924. March	579	521	90	451.1	219	306.5	386.0
June	566	518	92	445.3	131	306.5	390.3
Sept.	580	516	89	440.3	116	301.7	389.2
Dec.	640	573	90	448.5	150	331.3	407.7
1925. March	659	624	95	473.9	143	—	410.3
June	683	599	88	504.1	86	344.3	435.0
Sept.	721	643	89	474.8	83	—	450.6
Dec.	715	660	92	478.6	122	370.8	458.3
1926. March	693	647	93	480.5	109	—	455.9
June	708	650	92	526.5	93	371.5	465.8
Sept.	731	647	89	525.9	89	—	484.1
Dec.	681	657	96	435.1	181	373.4	463.3
1927. March	646	663	103	428.2	228	—	445.5
June	567	586	103	345.7	215	338.8	393.7

* Per cent. of cost at par.

† 000's omitted.

‡ On cost of living basis; per cent. of par.

§ On basis of wholesale prices.

On the basis of comparative cost-of-living indices the Italian currency has remained heavily under-valued

throughout the period,¹ but the degree of under-valuation is greatly reduced on the basis of comparative wholesale prices, and in December 1926 there appeared to be a certain degree of over-valuation. The sudden fluctuations in exchange rates which occurred during the period were closely related to psychological influences. During the first quarter of 1925 the sterling rate remained relatively stable at 115, but importers, working on the expectation that some appreciation was probable, preferred to borrow exchange from month to month and failed to cover themselves by definite purchases.² By June the expectation of appreciation had disappeared and the general rush to cover drove the sterling rate to as high a figure as 150 in the beginning of July, though the rate recovered quickly to 133, and by the autumn had returned to 115. There was, however, no internal fall in prices, and with the exchange appreciation the level of Italian gold prices rose quickly towards the world level. In June the level of gold prices in Italy was 135; in September it was 156.

In November a loan of \$100 million was raised in New York for the purpose of maintaining a policy of exchange stabilisation, but by July 1926 the sterling rate had risen to 140. The general monetary position at this stage presented certain unique features. The budget had been balanced and substantial revenue surpluses had been attained, while the adverse visible trade balance appeared to be covered by invisible forms of income. This cash surplus of the Treasury was reflected in the funds deposited by the State with the Bank of Italy, and these increased from 236 millions at the end of June 1925 to 2689 millions at the end of February 1926, declining to 2471 millions at the end of May. Commercial discounts, however, continued to increase despite a contracting note issue, and the former expansion was supported out of public deposits.³ The problem which presented itself was how to prevent an

¹ The index for Italy refers only to Milan.

² Cf. *Economist*, July 18, 1925.

³ *Economist*, July 10, 1926.

expansion of the note issue in the event of a large reduction in the public deposits held by the Bank of Italy. "As it is, public deposits are note issues in being. For, if the Treasury were to diminish its deposits to 236 million lire as at June 30, 1925, then the total note issue would be forced to jump up by about 2 billion¹ lire."² Nevertheless, by September the item of public deposits had been reduced to 632 million.

By the decree of May³ 1926 the issue rights of the Banco di Napoli and the Banco di Sicilia were transferred to the Banca d'Italia, together with their gold assets, and in September the proceeds of the Morgan loan arranged in November 1925 were transferred from the Treasury to the central bank, thereby cancelling 2.5 milliards of lire of the State's indebtedness to the Bank. From August a policy of deflation was initiated, and the total note circulation was contracted from 20.4 milliards at the end of July to 19.6 milliards at the end of February 1927.⁴ But the credit restriction was found to give rise to an unusual demand for repayment of Treasury bills, of which there were 15.5 milliards⁵ outstanding at the end of October, and in November a special scheme of voluntary and compulsory consolidation was decreed.

Wholesale prices reached their maximum in August 1926, when the index-number (Bachi) stood at 740. From that date the decline was rapid, and by March 1927 the index had fallen to 646. Between August and December the dollar value of the lire rose from 17.07 per cent. of parity to 22.98 per cent.⁶ and gold prices in Italy rose from 127 to 157, the latter figure being considerably above the world level. In short, the rapid appreciation of the Italian currency had led to its overvaluation, and though the unemployment figures reflect

¹ Milliard in the terminology used in the present text.

² *Economist*, July 10, 1926.

³ For decree see Federal Reserve Bulletin, September 1926.

⁴ The reduction in the issue of State notes by 400 million lire was accompanied by a new issue of silver coins.

⁵ Ordinary bills for less than twelve months.

⁶ Monthly averages.

definite seasonal influences, the returns show a considerable increase over previous years. The following table illustrates the relevant price movements since the commencement of the deflation policy:

	Wholesale Prices (Gold).	Dollar Exchange, % of par.	Ratio of Cost of Living to Wholesale Prices.	Wholly Unemployed.*
1926. Aug. . .	127	17'07	88%	83
Sept. . .	140	19'01	88%	89
Oct. . .	152	21'35	94%	113
Nov. . .	155	21'84	93%	149
Dec. . .	157	22'98	96%	181
1927. Jan. . .	149	22'51	99%	225
Feb. . .	147	22'37	101%	259
June . .	165	29'15	103%	215

* 000's omitted.

Thus by the beginning of 1927, gold prices in Italy were closely adjusted to the world level, and cost-of-living and wholesale-price indices appeared to be in harmony. It might therefore be suggested that the necessary readjustments had been affected prior to formal stabilisation. The official policy, however, has remained undisclosed, but the evidence points to a continued effort towards the appreciation of the lire. It has yet to be seen whether this effort may not be pushed too far, with resulting dislocation to Italian industry. By the middle of the year the level of gold wholesale prices was considerably in excess of the world level, unemployment remained heavy and the number of bankruptcies had rapidly increased. These indications therefore suggest that the rise in the external value of the lire had been carried to excess and that further price readjustments would be necessary even if the currency was officially stabilised at its present level.

CHAPTER X

AUSTRIA

THE peculiar nature of the monetary situation in Austria should be examined in the light of certain general considerations. Of the several secession states into which the former Austro-Hungarian Empire was divided, the new Austria was in many respects least favourably situated. Her natural resources were not great, and her activities were still moulded for the administration of an Empire which no longer existed. Before the Revolution and the general secession, the administrative machinery of the Empire had been centred in Vienna. After the partition the same machinery was preserved, and was extended in other directions with the development of additional functions for the new state. Of the total population of the new Republic—six and a half millions—about one-third represented the population of the capital. A considerable proportion of that number, moreover, was engaged in the administration of public functions, and while the real importance of the administration was reduced, the number of officials actually increased. When the first outburst of national sentiment in the other secession states expelled large numbers of State employees of German-Austrian extraction, these forced their way back to the young Republic, and were conveniently absorbed into the public service.

The natural poverty of the country as regards resources must also be considered. The former Empire had constituted an economic unity of a unique type. Its resources were varied and plentiful, and these were subject to an economic organisation under a single customs barrier and a uniform currency system. Under these conditions

a complex form of territorial division of labour had been evolved, but with the emergence of the secession states that complex unity was dissolved. The industrial regions of the north were consolidated in the Czechoslovak Republic; the agricultural districts of the south and east were included in Jugo-Slavia and Hungary; and the new Austria remained a relatively barren territory with an enormous administrative machinery and an impoverished cultural organisation. The growth of nationalist sentiment in the other states intensified the problem of reconstruction by erecting high tariff barriers, by imposing prohibitions and by a series of measures which dislocated the free intercourse and movement upon which the former unity had depended.

These general considerations, which might be developed, may serve to indicate the inevitable difficulties which confronted the Austrian finances after 1917. But the war in addition had produced a degree of inflation which was especially high in comparison with the inflation which occurred in other countries. The bulk of the gold reserve of the Austro-Hungarian Bank had been transferred to the Reichsbank after the outbreak of war, and all restrictions governing the fiduciary circulation were removed. Direct advances were made by the Bank to the State and these increased from 625 million crowns at the end of 1915 to 42.3 milliard at the end of 1919. In that way the State borrowed by means of Treasury bills both from the bank of issue and from the other banks which re-discounted their bills at the central bank for cash. Public borrowings against war stock also played a rôle in Austria similar to that described in the chapter on Germany.

The pre-war circulation of the Empire averaged 2300 million crowns, and the total circulation, including gold and silver, was estimated at approximately 2500 million. On that basis the circulation had increased by more than seven times up to January 1918, and by about fourteen times up to the end of the same year. The cost-of-living index in January 1918 was 6.82 including housing, and

8.31 excluding housing, while at the beginning of 1918 the corresponding indices were 22.58 and 28.37¹ (1914 = 1). Foreign exchange transactions had been centralised first by voluntary agreement between the leading banks in February 1916 and from December of the same year by official control. The value of the crown in terms of dollars did not at first fall to so great an extent as its domestic purchasing power. The dollar rate in Vienna averaged 8.1675 crowns in January 1918 and 16.16 crowns in December, the latter figure being 3.27 times the quotation at par.

After the Armistice and the dissolution of the Empire, financial difficulties increased and inflation became more rapid. The distress prevailing within the country necessitated important relief missions, and relief credits amounting to fully £25 million were provided during 1919, 1920 and 1921 by the countries of Europe and the United States,² excluding sums expended by private and charitable organisations. From 1919 to 1922 inclusive the State expenditure of Austria aggregated 488.5 milliard crowns, while the aggregate deficits for the same period amounted to 217.6 milliard. The Finance Ministry possessed no control over the departments and was reduced to a mechanism for the provision of the necessary money instruments. From the end of 1919 the Austro-Hungarian Bank was liquidated and replaced by an "Austrian section" which continued the note-issuing functions for the new Republic. The other secession states had in the meantime introduced independent currency systems. The pre-war circulation of the territory included in the post-war Austria has been estimated at 500 million crowns. By the end of 1919 the corresponding figure amounted to 12.13 milliards, representing a circulation increased by twenty-four times. The following table indicates the expansion of the circulation and the cost-of-living index-number up to the end of 1924 :

¹ Bordes, *The Austrian Crown*, p. 82.

² *The Financial Reconstruction of Austria*, Geneva, 1926, p. 11.

End of	Circulation (milliards).	Index-number of Circulation (500 m. = 1).	Cost-of-living Index (Pre-war = 1).*
Dec. 1919 . .	12'12	24	39 (Jan. 1920)
„ 1920 . .	30'65	61	74 (Jan. 1921)
„ 1921 . .	174'12	348	527
„ 1922 . .	4080'18	8,160	8,375
June 1923 . .	5432'62	10,866	11,249
Dec. 1924 . .	7125'76	14,251	13,650

* Index of the Mixed Commission. The indices cited are those which include housing.

Within this period, the sterling value of the crown passed from 137 crowns to the £ at the beginning of July 1919 to 22,290 at the beginning of 1922, and to 375,400 in August. This rate of depreciation exceeded the rate at which the note circulation expanded, and the sterling value of the note issue fell from £54 million at the first of the dates cited to £7·8 million at the second and to £3·1 million at the third. Three main periods have, in fact, to be distinguished. In the first of these, which extended into 1916, the circulation increased more rapidly than either the rise in domestic prices or the rise in the dollar exchange quotation. In the second period, which extended up to 1920, internal prices rose more rapidly than the note circulation or the dollar exchange, while in the third period, which covered the interval up to September 1922, "the pace was set by the foreign exchanges."¹

The peculiar difficulties which confronted Austria produced chaos and famine from the beginning of its existence. Budget deficits increased rapidly until by the middle of 1922 they reached half a billion crowns per month, and the bulk of the increasing note-issue was made to cover Government expenditure. With rising prices, public expenditure also increased, particularly on the railways, where wages were governed by the purchasing

¹ Bordes, *op. cit.*, p. 152.

power of the crown. On the other hand, railway rates were only about one-half of what they should have been on the same basis. Most forms of direct taxation were ineffective, and the yield of general taxation became inadequate from the dates on which the taxes were imposed, even without the economic dislocation of the country. Food-stuffs, again, were distributed at less than cost price in order to cope with the scarcity which prevailed and the general impoverishment. In February 1919 the Allied Governments had granted large credits, which were employed in the purchase of these food-stuffs, but these credits were exhausted by the end of the following year. These credits, moreover, constituted the largest item in the public indebtedness of the country at that time,¹ but when they were exhausted the country was thrown back upon its own resources, supplemented by charitable contributions from abroad. Whatever assets might have been employed to serve as the security for further foreign assistance were already pledged for the loans which had been exhausted.

An attempt at reconstruction was made in March 1921, and the Allied Powers agreed to release these pledged assets and invited the League of Nations to devise a comprehensive scheme for the financial reorganisation of the country. The conditions relating to the release of these assets, however, created difficulties which led to the postponement of the application of the scheme which was devised. In particular, the Reparation clauses in the Peace Treaty assigned the national assets exclusively for the purpose of reparations. In February 1922, certain temporary loans were promised by the United Kingdom, France, Italy and Czechoslovakia, and in July a number of modifications of the restrictive clauses were permitted by the Reparations Commission. The British credit, which amounted to £2½ million (£250,000 of which was earmarked for the liquidation of an earlier debt), enabled a certain exchange stability to be secured up to May, when the credit was exhausted and the

¹ Cf. Dept. of Overseas Trade, *Report on Austria, 1921*, App.-IV.

exchange continued on its rapid depreciation. The underlying disorganisation remained unimproved. In August the Allied Governments rejected the appeal of the Austrian Government that they should guarantee a foreign loan of £15 million, but suggested a further reference of the problem to the League of Nations, subject to the condition that "there is no prospect of further financial assistance to Austria from the Allied Powers unless the League were able to propose such a programme of reconstruction, containing definite guarantees that further subscriptions would produce substantial improvement, and not be thrown away like those made in the past, as would induce financiers in our respective countries to come to the rescue of Austria."¹

On this occasion the appeal to the League of Nations was definitely successful. A new financial committee was appointed, and the recommendations of that body were incorporated in three protocols which were signed in October. The first of these guaranteed the political and economic independence of the country, while the second embodied the principles of a guaranteed loan of 650 million gold crowns by Great Britain, France, Italy and Czechoslovakia. In the third protocol the Austrian Government undertook to effect important financial reforms, including the stabilisation of the currency with the aid of a new bank of issue.²

The use to which the guaranteed loan was to be put was in the main twofold. A sum of 130 million gold crowns was calculated as necessary for the repayment of earlier loans, while it was estimated that a sum of 520 million would serve to enable the Austrian budgets to be balanced during the succeeding two years. But the granting of the loan was made conditional upon the execution of the requisite financial reforms within the country itself, and a Commissioner-General was appointed by the Council of the League to supervise the fulfilment of this

¹ Quoted, *Financial Reconstruction of Austria*, Geneva, 1926, p. 15.

² Reference may be made to these documents, which are reproduced, *ibid.*, pp. 129-50.

condition, together with the spending of the proceeds of the loan.

The first instalment of the loan was not available till February 1923, but the monetary position revealed an earlier improvement. Confidence revived, and though the note circulation increased still further, internal prices reached a maximum in September, while the external value of the crown touched bottom on August 25.

Circulation.		Dollar Rate in Vienna.		Cost of Living.	
31. 3.22	398 milliards	1.6.22	11,175 crs.	March 22	790
31. 8.22	1353 "	25.8.22	83,600 "	Sept. "	11,271
31.12.22	4080 "	2.1.23	70,025 "	Dec. "	9,375

By December 15 the capital of the new issue bank was fully subscribed, and the Bank of Austria started operations from the beginning of 1923 as a private corporation with the sole right of issue for twenty-five years. The Bank Act, moreover, specifically precluded the State from borrowing from the Bank "without supplying the exchange value of the bank-notes withdrawn either in gold or foreign exchange." At the same time the entire note circulation and current account liabilities of the Austrian section of the former Austro-Hungarian Bank were to be taken over together with proportionate assets. To the new Bank was assigned the task of maintaining a stable exchange. "The bank of issue is bound by all means at its disposal to take care that until the fixing of a new legal ratio at which paper money is to be redeemed in metal, the value of its notes as expressed at the rate of exchange shall at least undergo no decrease." A statutory minimum cover was prescribed for the first five years at 20 per cent.¹ in gold and stable foreign exchange, to be calculated on the basis of the note issue plus current account liabilities and after deduction of

¹ That proportion was to be raised to 24 and 28 per cent. in the next two quinquennial periods, and thereafter to 33½ per cent.

the State debt. The following table summarises the position during the first four years of the bank's working :

(In million schillings.)

End of	(1) Note Issue.	(2) Current Account.	(3) Advances to Treasury.	(4) Reserve in Gold and Foreign Currencies.	Ratio of (4) to (1)+(2) - (3).
1923. March .	446	32.9	255.2	142.2	63.56%
June .	543	36.2	254.7	260.6	80.23%
Sept. .	622	37.4	253.8	320.0	78.80%
Dec. .	713	64.9	253.4	391.5	74.71%
1924. March .	714	75.3	229.5	406.1	72.48%
June .	777	74.1	223.8	328.6	52.34%
Sept. .	800	89.1	221.1	383.4	57.41%
Dec. .	834	55.3	217.8	488.1	72.18%
1925. March .	790	29.6	210.8	331.4	54.47%
June .	828	33.3	203.7	438.6	66.70%
Sept. .	841	29.5	196.6	518.2	76.93%
Dec. .	890	55.0	187.9	513.9	67.87%
1926. March .	816	26.0	183.5	506.5	76.88%
June .	836	61.9	182.7	532.9	74.46%
Sept. .	865	69.8	178.4	527.6	69.70%
Dec. .	947	37.3	177.3	537.1	65.31%
1927. March .	883	21.0	174.0	497.0	68.09%
June .	917	36.0	174.0	493.0	60.72%

It will be seen that the item of "Advances to the Treasury" has been subject to a steady decline during the period under review. The note issue was rapidly increased on the basis of the expanding foreign currency reserves, and at no time since the Bank was founded has the actual reserve been near to the prescribed minimum. During 1923 that cash reserve increased from 120 million schillings to 392 million. Under the influence of the foreign loan, the speculative purchase of Austrian securities by foreigners and the repatriation of Austrian funds, the external demand for Austrian currency increased and while increasing its reserve in foreign currencies, the Bank was able to stabilise the exchange at between 70,000 and 71,000 crowns to the dollar.

The following table indicates the course of gold prices and the level of unemployment :

	Wholesale Gold Prices.	Number of Unemployed in Receipt of Relief.*
1922. 1st Qr.	87	31,600
2nd "	92	41,700
3rd "	104	31,800
4th "	114	59,600
1923. 1st "	123	148,600
2nd "	130	131,000†
3rd "	121	87,900
4th "	124	77,900
1924. 1st "	132	114,500
2nd "	132	86,800
3rd "	136	68,100
4th "	142	93,300
1925. 1st "	145	176,800
2nd "	139	151,600
3rd "	132	117,300
4th "	126	136,400
1926. 1st "	120	229,300
2nd "	120	176,800
3rd "	125	151,500
4th "	127	175,100
1927. 1st "	131	229,400
2nd "	138	161,500

* Average of figures for beginning of each month.

† Between October 1922 and July 1923 some 45,000 State officials had been dismissed. Cf. *Financial Reconstruction of Austria*, p. 52.

The rapid initial increase in the circulation was a natural consequence of the previous disorganisation when there was a general unwillingness to hold depreciating currency units. Equally natural was the rapid rise in the level of gold prices as indicated by the movement in the quarterly index from 87 in the first quarter of 1922 to 130 in the second quarter of 1923, and, after a certain fall, a further upward movement to 147 in January 1925. The sudden increase in the unemployment figures from 31,000 at the beginning of September 1922 to fully

167,000 at the end of February 1923 reflects the difficulties of readjustment occasioned by a stable exchange and a rising level of domestic gold prices,¹ while the improvement in employment during the remainder of 1923 was partly occasioned by the dislocation in the Ruhr and the greater German demand for Austrian products. The crisis which occurred at the beginning of 1924 was financial, and was the result of over-speculation in what were apparently greatly under-valued securities. The index of the shares of 77 pre-war joint-stock companies rose from 56 in January 1922 to 893 in January 1923, and 2680 in January 1924, when the highest point was reached.² In this movement there were important foreign influences, but the large-scale selling-out by foreign speculators in the summer of 1923 was not sufficient to check the rise in the market. During the first quarter of 1924 the index fell slightly, but panic sales occurred in April, when the index dropped to 1724, falling further to 975 in October. A rush on the banks followed, during which the National Bank rendered valuable support which probably prevented the panic from developing to a still greater extent. One aspect of this movement is reflected in the decline in the foreign currency reserve of the National Bank from 392 million schillings at the end of 1923 to 326 million on August 23, 1924.

To meet this rapid drain, precautionary measures were adopted by the rise in bank rate from 9 to 12 per cent. in June 1924, and later to 15 per cent. in August, reinforced by a rationing of credits in September. Bills discounted by the Bank fell from 323 million schillings³ at the end

¹ Cf. Layton and Rist, *The Economic Situation of Austria*, p. 120 n., where it is pointed out that the "Austrian wholesale index has a downward bias, so that the full extent to which prices have risen in Austria does not appear from it."

² The figures relate to quotations in paper crowns. Cf. *The Financial Reconstruction of Austria*, p. 88.

³ As compared with 77 million for the first six months of 1923. The great increase in "bills discounted" occurred from the beginning of 1924, when the Stock Exchange boom showed signs of collapse.

of August to 96 million on April 23, 1925, and notes in circulation were contracted during the same two dates from 800 millions to 707 millions. The decline in discounted bills, however, continued under other influences. Short-term foreign credits became available and replaced inland bills which were not renewed, and the proceeds of these credits augmented the foreign currency holding of the Bank.¹

The influence of these measures was soon reflected in the condition of the national finances, where a balance on the ordinary accounts was reached in November 1923. For 1923 as a whole, expenditure exceeded revenue by 8·22 million schillings; in 1924 there was a revenue surplus of 90·93 million, and in 1925 a surplus of 167·09 million. Allowing, however, for capital expenditure in respect of the railways and other public undertakings, the budget deficits amounted to 158·28 millions in 1923, 13·04 millions in 1924, while in 1925 there was a net balance of 76·45 millions.² By the middle of 1926 the unused portion of the international loan, with accumulated interest, amounted to 217·60 million schillings out of a net yield of 879·8 million.³

The general commercial position of the country during 1924 indicated a more unfavourable position, but though exports have since declined, the relative position revealed a definite improvement.

MONTHLY AVERAGES * (SCHILLINGS).

	1920.	1921.	1922.	1923.	1924.	1925.	1926.
Value of imports .	204 m.	203·9 m.	210·7 m.	230·4 m.	287·3 m.	234·9 m.	227·4 m.
Value of exports .	111·9 m.	108·4 m.	132·3 m.	134·6 m.	164·2 m.	157·6 m.	140·7 m.
Trade deficit .	92·1 m.	95·5 m.	78·4 m.	95·8 m.	123·1 m.	73·3 m.	86·7 m.

* League of Nations Monthly Bulletin of Statistics.

¹ Cf. Layton and Rist, *op. cit.*, p. 117.

² *Financial Reconstruction of Austria*, p. 72.

³ *Ibid.*, p. 74.

The 1924 returns represented a set of abnormal influences. Assuming no important change in price levels to occur, the normal trade deficit of the country has been estimated at from 1000 million to 1100 million schillings,¹ against which there are certain invisible items of income conservatively estimated at roughly 860 million schillings.² Allowance should also be made for invisible debits, but whatever adverse balance of indebtedness has existed has been made good by external loans. To that extent it cannot be said that the process of adjustment has been finally completed. The increase in the adverse visible trade balance in 1926 is an index of this conclusion, and the real strain must develop when foreign loans are no longer available to make good the gap in the statement of indebtedness. Much must depend upon the future invisible income of the country, and in particular from the tourist traffic. Commercially, recovery is handicapped by the trade barriers between the different secession states, which normally provide a market for approximately 60 per cent. of Austria's exports. The problem remains one as to the possibility which the country possesses of remaining as an independent economic unit without a contraction in population or a lowering of the general standard of life.

When the crown was stabilised at between 70,000 and 71,000 to the dollar, the rate corresponded roughly to 14,400 paper crowns to the gold crown. In September 1924 a further change was introduced by the adoption of the schilling as the new unit of account. No actual schilling currency was introduced till March 1925. This new unit was equivalent to 10,000 paper crowns, and was fixed in respect of its gold value at 0.21172086 gramme of fine gold. New gold pars of exchange resulted. Thus the sterling parity became 34.586 schillings as compared with the pre-war parity of 24.02 crowns. In 1925 a new schilling currency was put into

¹ Layton and Rist, *op. cit.*, p. 125. \$1 = 4.935 gold crowns = 7.107 schillings.

² *Ibid.*, p. 126.

circulation, and in August of that year the dollar rate of exchange was decontrolled. The subsequent inflow of gold reflected the rise of the schilling to a premium over the dollar. From December 1925 control of the Austrian budget came to an end, so that the process of financial and monetary reconstruction may be regarded as completed. The future of the country depends upon a number of more fundamental economic conditions, most of which are uncertain and are surrounded with difficulty.

CHAPTER XI

CZECHOSLOVAKIA

THE monetary history of Czechoslovakia illustrates the attempt of a new state to introduce an independent currency system, and provides an important example of the effects of deflation and stabilisation which became the successive features of the official policy. The secession from the Austro-Hungarian Empire was effected by proclamation in October 1918, and four months later the new National Assembly decided upon the adoption of an independent monetary system. First the supply of currency was reduced by means of a forced loan. The method adopted for this purpose consisted in stamping all bank-notes except those for very small amounts "by means of a stamp representing a percentage of the nominal value of the notes, and further to withdraw from circulation 50 per cent. of the bank-notes presented, and to declare those a forced loan, irredeemable by the creditor but repayable on the part of the State at any time and carrying 1 per cent. interest."¹ On the same principle reductions were made from current accounts. To ensure the success of this method it was necessary to effect a complete isolation of the country for a period of ten days, during which the stamping could be carried through, and at the same time to preserve absolute secrecy as to the nature of the official policy, so that all possible evasion might be avoided.

The next step was to issue new State notes to be exchanged for Austro-Hungarian bank-notes already stamped. In so doing the Czechoslovak Republic became the sole debtor of those who held the new notes and the sole creditor of the Austro-Hungarian Bank in respect of the notes withdrawn and replaced. In April

¹ Rasin, *Financial Policy of Czechoslovakia*, pp. 25-6. This volume provides a detailed narrative of the early monetary history of the Republic.

a special banking office with a monopoly of note issue was established under the Ministry of Finance, and only stamped notes were allowed to serve as legal tender until the new notes were issued.

Throughout this early period precautions were taken to prevent the development of inflationary tendencies. At the time of the stamping 7436 million of bank-notes were in circulation within the country, or one-fifth of the total circulation of the Austro-Hungarian Bank at that time. The total of notes and current accounts withdrawn amounted to 2781 millions, of which 2134 millions represented notes. The active note circulation was therefore reduced to 5302 millions. Banking accounts and Treasury accounts received from the public amounted to 2084 millions, of which 647 millions were withheld. The new circulation, therefore, amounted to 6739 millions. By the Act of April 1919 this became the maximum uncovered circulation of the new issue, and any increase in the total was to be covered by gold, silver and bills.

In April 1920 a capital levy was imposed as a deflationary measure for reducing the quantity of uncovered notes in circulation, and a reserve in gold, silver and foreign currencies was accumulated out of the proceeds of an internal loan, supplemented by gifts and purchases. Payments under the levy were gradual, and some modifications were afterwards made in favour of those whose quotas were small. But during this period, and up to the middle of 1921, the value of the Czechoslovak crown continued to follow the vagaries of the German and Austrian units. The following data illustrate the current movements of the crown and mark in terms of Swiss prices in Zurich :

	Crown.	Mark.
May 1919	34 centimes	36 centimes
Dec. "	9 "	10 "
Feb. 1920	6 "	7 "
June "	13 "	15 "

From the middle of 1921 the new Czechoslovak crown followed an independent course, and in the following year Dr. Rasin, who became Finance Minister for the second time, adopted a policy of hastening the rise in the external value of the currency by arranging and utilising certain foreign credits. In this respect Czechoslovakia was the first of the European states to succeed in securing foreign financial assistance for its monetary policy. Two loans amounting to \$21.5 million were floated in New York, one of £2.5 million in London and one of £0.5 million in Amsterdam. In January 1922 the crown was quoted in Zurich at 8.30 centimes; on August 24 at 19.60 centimes. Thus in eight months the value of the crown abroad had risen by 136 per cent. The immediate effect was a severe crisis, followed by intense depression, for while prices fell rapidly during the year, the internal value of the crown did not rise by more than 40 per cent. Wholesale prices fell from 1675 in January to 1003 in December, and retail prices from 1476 to 962. With an external appreciation out of all relation to the fall in Czech prices, production costs in the exporting trades became too high. Unemployment increased four times between June and December.

In 1923 the official policy aimed at stabilising the crown on the basis of the dollar at between 2.96 and 3.03 cents, and this end has, in fact, been achieved. No attempt, however, was made to introduce a gold standard on the basis of devaluation. Since April 1926 the Banking Office of the Ministry of Finance has been replaced by the newly-constituted National Bank. Notes remain inconvertible, but a minimum legal cover is prescribed of 20 per cent. of the note issue, plus sight obligations, and less the State debt, and the 20 per cent. proportion is to be raised by 1 per cent. per annum over a period of fifteen years.

The table on p. 165 summarises the main statistical data over the period from 1922 to 1926.

It would, of course, be unwise to draw precise conclusions from the last column. The margin of error

	Wholesale Prices.	Retail Prices.	Cost of Dollar. Per cent. of par.*	Unemployment. †	Ratio of Col. 1 to U.S. Wholesale Prices.
1922. 1st Qr.	1521	1447	1144%	128,000	1086
2nd "	1469	1433	1047%	108,000	1000
3rd "	1200	1275	758%	232,000	779
4th "	1006	987	634%	438,000	649
1923. 1st "	1026	937	602%	369,000	654
2nd "	999	929	679%	247,000	640
3rd "	962	905	681%	211,000	633
4th "	979	902	691%	192,000	644
1924. 1st "	1009	914	698%	180,000	668
2nd "	974	915	688%	86,000	663
3rd "	989	905	681%	73,000	664
4th "	1027	922	676%	81,000	666
1925. 1st "	1034	905	681%	61,000	642
2nd "	1004	903	684%	40,000	644
3rd "	993	898	684%	42,000	621
4th "	973	868	684%	48,000	619
1926. 1st "	937	844	684%	27,000	609
2nd "	934	843	684%	40,000	614
3rd "	969	877	684%	43,000	646
4th "	978	901	684%	29,000	661
1927. 1st "	977	914	684%	27,000	669
2nd "	990	934	684%	—	687

* Par, 20'26 cents = 1.

† End-of-quarter figures.

which arises when prices have risen to enormous heights is large. But in the evidence which the figures do afford, a certain over-valuation of the Czechoslovak crown would appear to have occurred during the last half of 1922, when the rapid appreciation occurred. Since then the figures in the last column have remained below those in column (3), and in the first half of 1926 the gap became appreciably greater. In short, on the basis of the evidence cited, Czechoslovak gold prices were probably below the world level according to the stabilised exchange. By the end of the year, however, the disparity, if any, had been materially reduced.

CHAPTER XII

RUSSIA

A PECULIAR significance attaches to the problem of monetary reconstruction in Russia from the conditions under which the problem was set. Apart from the revolutions and the reactions which followed, the task would have presented difficulties in view of the extent to which the currency had been depreciated up to the beginning of 1917. But the problem was complicated under Bolshevik control by the deliberate depreciation which was effected as part of the general machinery which was to prepare the way for a general reorganisation of the social order. From that point of view, currency reform in Russia—and especially a reform which aimed at the linking of the currency to a gold basis—must be interpreted as a definite departure from the earlier policy which aimed at the creation of a moneyless economy. It will not be necessary to examine in detail the course of depreciation before the reform period was initiated. A brief outline will indicate the main features of the problem. Moreover, the statistical data which are available cannot be taken as fulfilling normal requirements of accuracy, so that precise conclusions from them should not be drawn. They will be cited when necessary merely as indications of the general movements which occurred.

The Russian monetary system had been based on the gold standard since 1897. Prior to that time there had been numerous periods of monetary disorganisation and development had been slow. Banking in its wide sense, for example, had not been highly organised, though it had shown some development during the first decade of the present century. As regards the note issue, that was confined to the State Bank and was subject to certain

regulations. The gold cover requirements were inelastic. A minimum cover of 50 per cent. of the notes issued was prescribed, but there was a fixed fiduciary issue of 600 million roubles, and notes issued in excess of this amount had to be covered by gold. At the beginning of 1914 the gold holding of the Bank was 1528 millions¹ as compared with a note issue of 1665 millions, so that notes were covered by gold to the extent of 92 per cent. In July 1914 the ratio was 98 per cent., and that proportion may be compared with the corresponding figure of 68 per cent., which represented the actual cover for Bank of England notes.

In addition there was a certain gold circulation with free mintage and full convertibility as regards notes. At the beginning of 1914 the total circulation amounted to 2405 million roubles, of which 1665 million consisted of notes of the State Bank, 494 million of gold coins,² and the remainder in silver and copper pieces. At the outbreak of war, as in other countries, convertibility was suspended and the law relating to the regulation of the note issue was repealed. By the end of 1916 a series of decrees had increased the maximum fiduciary note issue to 6½ milliards.

The national finances were quickly disorganised, and the war budgets showed large deficits which led to direct inflation. For the four years 1914-17 these deficits aggregated 47 milliards, or 75 per cent. of the total public expenditure for the same period. The national debt, which was 9.3 milliards in 1914, increased to 33.6 milliards at the beginning of 1917, and a considerable proportion of that increase represented external indebtedness. The volume of Treasury bills discounted by the Central Bank showed a rapid expansion.³ (See table on p. 168.)

In the later years from 1918 there was a close correspondence between the amount of the budget deficit

¹ Excluding gold held abroad, which amounted to 141 millions in July 1914.

² Probably an over-estimate.

³ Introduced in August 1914.

	Treasury Bills Discounted.	Note Circulation.
July 1, 1915	'1,589 millions	3,756 millions
July 1, 1916	3,824 "	6,628 "
March 1, 1917	7,882 "	9,950 "
Oct. 23, 1917	15,507 "	18,917 "

and the increase in the note issue; thus in 1919 the deficit amounted to 166 milliards, while the note issue increased by 164 milliards.

Taking now the pre-revolution period from July 1914 to March 1917, the note circulation of the State Bank increased from 1630 million roubles to 9950 million, while prices rose from an index of 1 in 1913 to 3.30 in March 1917. (The index for prices in Moscow was 3.72.¹) During the same period the external value of the rouble fell, but not to the same extent, despite the great increase in the adverse trade balance during the war years. In September 1914 the rate of exchange in London ranged from 11.25 to 12.25 (roubles to £) and remained stable till July 1915, when it ranged from 13.5 to 14.8. In March 1917 the range was 16.4 to 17.15. Large foreign credits had been arranged, and these enabled a relatively high external value to be maintained.

In the period from the 1917 revolutions the note circulation increased with growing rapidity, and, as will be seen from the following table, there is no close correspondence between the increase in the circulation and the rise in prices. No particular reliance, however, can be placed upon the indices of prices, and the figures relating to the circulation exclude the issues of local currency, of which no data are available.² But apart

¹ Index of the Gosplan—the State Planning Commission of the Soviet of Labour and Defence.

² Turkestan, Buchara and the Far East and Caucasian Republics had independent currencies. In 1922 the Turkestan currency was replaced by notes of the Russian Republic, and in 1923 a similar change occurred in Buchara and Khiva.

from these limitations it is to be expected that the value of the rouble would diminish at a rate which was more than in proportion to the increase in currency. There was the factor of rapidity of circulation, and in particular the diminished demand for currency during the first phase of the Bolshevik régime, when the attempt was made to create a moneyless currency.¹

The note circulation at the time of the first revolution in March 1917 is given by Yurovsky as 11,786 millions, and by Katzenellenbaum as 9,950 millions. (The subsequent figures cited by these writers agree.) By November, the month of the Bolshevik coup, it had risen to 22,400 millions, and by January to 60,800 millions. The following table gives the estimated note circulation up to the beginning of 1923, together with the indices of prices for Moscow and Russia respectively.² The last column gives an index of the *real* value of the increasing circulation, taking the pre-war note circulation of 1.63 milliards as 100.

	Circulation (milliards).	Prices 1913 = 1.		Real Value of Note Circulation. (1) ÷ (3). 1914 = 100. (4)
		Moscow. (2)	Russia. (3)	
Jan. 1, 1917	9.1	3.15	3.00	184
" 1918	27.3	43.30	35.60	49
" 1919	60.8	278	164	23
" 1920	225.0	4,180	2,420	5.5
" 1921	1,168.6	24,600	16,800	4.3
" 1922	17,543.9	244,000	288,000	3.8
" 1923	1,994,500.0	20,750,000	21,015,000	5.8
Oct. 1, 1923	22,702,000.0	638,000,000	648,230,000	2.1

The official policy, moreover, did not attempt to obscure the fact that currency inflation was a means of

¹ Cf. Yurovsky, *Currency Problems and Policy of the Soviet Union*, pp. 21-3.

² Katzenellenbaum, *Russian Currency and Banking, 1914-24*, pp. 56 ff. and 74 ff.

securing effective purchasing power to the State independently of the normal method of taxation. As the depreciation became more rapid, however, this method became less effective, and the decrees which prohibited the holding of stocks of currency merely hastened the rate of depreciation. It is idle to speculate what later developments would have occurred had there been no change in the official policy. Experience in other cases might suggest that foreign currencies, together with the precious metals, would have forced their way into circulation in order to provide some circulating medium upon which reliance could be placed. In fact, in some districts gold coins seem to have come back into use.¹

The period of reform has been prolonged, and particular difficulties have arisen as a legacy from the earlier Bolshevik experiments. The New Economic Policy, which dates from the end of 1921, could not be easily effected even had it been officially acceptable. It implied a definite abandonment of monetary and financial practices which had become inseparable from the policy of the earlier years. Restrictions in the way of ordinary trading were relaxed first in the case of coin and later in other directions, and the practices of compulsory labour were abolished. These in themselves implied a greater use of money payments instead of payments in kind, and therefore a greater need for a stable standard of value. For similar reasons the State's money expenditure also increased, and many of the State activities which had been included in the annual budget were placed on an independent footing.² It is therefore significant that the Ninth All Russian Congress of Soviets decided at the end of 1921 in favour of "a sound monetary system on a gold basis"; the task of achieving this was relegated to the Commissariat of Finance.

The subsequent changes may, for present purposes, be grouped under two heads—financial and monetary. The financial changes involved a complete alteration of

¹ Yurovsky, *op. cit.*, p. 86.

² Any profits accruing were still to be transferred to the State.

existing budgetary practices. State and local budgets were separated, and the expenditure of the central government was restricted to primary activities unhampered by subsidiary enterprises. Departmental expenditures were cut down, and the general aim became one of apportioning the tax revenue as between the several departments and the attainment of a proper balance. These changes, however, were not readily achieved. A new mechanism of taxation had to be devised to replace the machinery which had been destroyed. The requisition system, which sought to take from the peasants all their produce over what was regarded as necessary for personal consumption, had to be replaced by a tax on agriculture. But this required time for its achievement. Meanwhile estimates of revenue and expenditure were continually falsified by the continued depreciation of the currency. Thus while the first step towards reform was taken in 1921, no real approach to normal budgetary requirements was apparent before 1924.

With the new economic policy an attempt was made to restore the pre-war or gold rouble as the unit of account, but with little success. In November 1921 it was decreed that the budget should be fixed in terms of this unit, and for purposes of calculation, 1 pre-war rouble was taken as equivalent to 60,000 current roubles, the latter figure being the multiple by which prices had risen in the interval. Taxes were to be fixed in terms of this new standard, and at the same time the use of the gold rouble was made to apply to lease contracts and other transactions, and on December 15 agreements previously concluded were to be revised in terms of the same principle.¹ With the continued depreciation of the current circulation the index for calculating pre-war roubles was subject to monthly alterations, and rose from 60,000 in November to 200,000 in March 1922, when the attempt was abandoned. This abandonment has been interpreted as a recognition of the fact that the new method was not employed in market transactions

¹ Yurovsky, p. 72.

where Soviet currency units were still accepted, but it would also appear that the indices cited over-valued the Soviet currency, which was depreciating rapidly at this stage. The real problem, therefore, remained unsolved until, along with financial reform, a stable unit of account was achieved.

The approach to this second aspect of the problem was associated with the foundation of the new State Bank in October 1921, though the new bank was not vested with powers of issue till October 1922. Like its predecessor, the new Bank was a State institution under Treasury control, and its capital of 2000 million Soviet roubles¹ was fully paid by the central exchequer. Its functions were to grant loans on the security of goods in warehouse, shipping documents and promissory notes up to 75 per cent. of the security pledged; to grant loans on the security of precious metals; to grant unsecured loans if satisfied by the plans of the borrowers; to discount bills with not more than six months to run; to receive deposits; and to trade on its own account in the precious metals, bills, foreign securities and goods on commission.

Later, certain relaxations were legalised to apply to the former prohibitions which prevented persons from holding large quantities of paper money or of the precious metals and stones. In April 1922 the holding of precious stones, metals and foreign currencies was freed from restriction, and at the end of May a certain freedom to hold paper money was permitted. A further feature of the new policy enabled private banks to reappear, though the operations of these were restricted by the control of trade which was still maintained. But despite these restricting factors, the credit facilities of the private banks were developed, while the State Bank tended more and more to be a bank for governmental operations. Thus while private banks' loans represented only 8.4 per cent. of State Bank loans at the beginning of 1923, by

¹ Equivalent at that time to about 15 million gold roubles. Its present capital is 10 million chervontzi, *i.e.* 100 million gold roubles.

September of the following year they represented 42.5 per cent.¹

In October 1922 the new State Bank became a bank of issue, with powers to issue notes in terms of a new unit, called the chervonetz. This new unit was related to the pre-war gold rouble, but no rate of exchange was fixed in terms of the current Soviet money. It was equal to 10 pre-war gold roubles. Theoretically the new notes were to be redeemable in gold, but actual convertibility was left for later determination. The cover provisions required that the new notes should be secured up to 25 per cent. by gold, silver, platinum and stable currencies, the remaining 75 per cent. to be in liquid bills and readily marketable goods. Bank advances in notes to the Commissariat of Finance were not prohibited, but had to be secured by precious metals up to at least 50 per cent.

At first a certain pressure was required to place the new notes in circulation, but later they were regarded as suitable instruments for the investment of spare cash, and were therefore held for that purpose. Naturally time would be required before they could permeate into remote districts, while their high denominations may also have proved a deterrent factor. By the beginning of 1923, chervontzi in circulation only amounted to 3.46 million gold roubles; a year later they totalled 249.17 million. During this period a difficult situation was created by the co-existence of two paper currencies, the chervonetz and the Soviet rouble, the one being relatively stable while the other was depreciating rapidly. Both issues, moreover, were ultimately controlled by the Commissariat of Finance, though the one proceeded from the State Bank and the other from the Treasury. The difficulty arose because the two issues were interchangeable, but not in any fixed ratio, and during 1923 the

¹ *Economic Review*, September 18, 1925. Cf. *Financial Times Banking Supplement*, March 21, 1927. Loans and discounts of the State Bank amounted to 1918 million roubles on October 1, 1926, while other banks and credit institutions showed a total of 1914 million.

value of the Soviet rouble in terms of chervontzi depreciated by 171 times.¹ Prices rose by 23 per cent. per month in the first quarter of the year; by 43 per cent. per month in the second quarter; and by 78 and 104 per cent. per month in the last two quarters respectively.² The increased issue of Soviet roubles was partly the result of the continued inability to realise a balanced budget, and 20 per cent. of the State expenditure for the year was covered by the issue of paper money.³

The rate of exchange between chervontzi and Soviet roubles was determined locally till October 1923, when it was enacted that the official rate would be that issued daily by the Stock Section of the Moscow Goods Exchange. This daily rate, however, became inadequate at a time when depreciation was proceeding hourly, and market rates differing from official quotations came into use. A wave of speculation was therefore forced upon those who sought to avoid the loss involved in holding Soviet roubles. The position is described by Yurovsky as follows: ⁴ "As payments could be effected in Soviet money tokens at the official rate of exchange, everyone was anxious to pay in these tokens and not in bank-notes. Those who had bank-notes would sell them first for Soviet tokens before paying for their purchases or settling their debts. An industrial or trading concern which had received payment in Soviet money tokens, anxious to avoid the losses consequent upon their depreciation, would hasten to buy Tchervontzi even at the higher rate likely to rule on the morrow, rather than keep the money tokens in the safe over-night. Such a state of affairs made it impossible for the official rate of exchange to keep pace with the open market rate, and had the effect of driving the Tchervontzi from circulation. The bank-notes, on the one hand, began to be hoarded, and, on the other, became objects of speculative investment and

¹ Katzenellenbaum, *op. cit.*, p. 117.

² Yurovsky, *op. cit.*, p. 107.

³ *Ibid.*, p. 124. The proportion, however, fell from 30·8 per cent. in the first quarter to 9·6 per cent. in the last quarter.

⁴ *Ibid.*, p. 114.

were gambled in freely by nearly the whole of the town population, and even by large sections of the peasantry."

A final stage in the reform had therefore still to be accomplished, and that was undertaken by a series of decrees in February and March 1924. By the first of these the Commissariat of Finance was authorised to issue currency notes of 1, 3 and 5 roubles, but the total issue of these legal tender notes was not to exceed one-half of the chervontzi circulation. This was followed by a decree which stopped the further issue of Soviet roubles, and by an authorisation to mint silver coins of 10, 15, 20 and 50 copecks and 1 rouble, and copper coins of 1, 2, 3 and 5 copecks. The demonetisation of Soviet roubles was authorised in March. From June they were to be deprived of legal tender status, but in the interval they might be redeemed at the rate of one gold rouble for 50,000,000 old roubles.¹ Since the middle of 1924, therefore, the country has possessed a unified currency system.

The table on p. 176 indicates the growth of the circulation in gold roubles, account being taken of the issue of Treasury notes and silver and copper coin.

The circulation of 1490 million roubles at the beginning of 1927 may be compared with the estimate of the pre-war circulation of the territory of present-day Russia at 1700 million, but no comparisons can be made in view of changes which had occurred in the velocity of circulation and the volume of trade. The very rapid increase in the total circulation has also to be considered in relation to the improvement in the volume of trade since the reforms were accomplished and to the greater use of money payments as the alternative to commercial

¹ Devalorisations had occurred in 1921 and 1922. In November 1921 a new note had been authorised to replace existing roubles at the rate of one new rouble for 10,000 old roubles. In November 1922 the so-called 1923 rouble was issued to replace current roubles at the rate of one new rouble for 100 1922 roubles. These changes merely affected the number of noughts employed in making estimates and prices. The final substitution in March 1924 fixed the rate of conversion at one gold rouble for 50,000 (1923) roubles: *i.e.* at 50 milliard old roubles.

EUROPEAN CURRENCIES

	(1) Bank-notes.	(2) Treasury Notes and Silver and Copper Coin.	(3) Total.	(4) Metal and Exchange Reserve of Bank.	(5) Ratio of (4) to (1).
Jan. 1, 1923 .	4 m.	114 m.	118 m.	31 m.	775.0%
Jan. 1, 1924 .	249 m.	69 m.	318 m.	214 m.	85.9%
Oct. 1, 1924 .	346 m.	281 m.	627 m.	239 m.	69.1%
Dec. 1, 1925 .	738 m.	598 m.	1287 m.	265 m.	35.9%
April 1, 1926 .	693 m.	511 m.	1204 m.	228 m.	32.9%
Jan. 1, 1927 .	885 m.	605 m.	1490 m.	225 m.	28.8%
Feb. 1, 1927 .	857 m.	579 m.	1436 m.	271 m.	31.6%

(The figures in the second column for the first two dates do not, of course, refer to the new issues which were made from March 1924, but refer to the value of Soviet roubles expressed in gold roubles.)

barter and payments in kind. The rapid decline in the metal and exchange reserve is conspicuous, but it is not apparent that the legal minimum has been reached, though it has been stated that gold held abroad and included in this item has been on several occasions employed as security for foreign credits.¹ The increased cover built up during 1923 may be interpreted in the light of the generally favourable trade position in that year, although the volume of that trade has not even yet recovered to one-half of its pre-war level. As regards that external trade the State monopoly has been maintained, and relaxations of that monopoly have been less important than in the case of internal trade. The primary considerations throughout have been related to the maintenance of stable exchange rates, and when complete regulation of that foreign trade has not been possible, the fluctuations in the foreign currency reserve have been marked. Thus in 1925 heavy food imports became necessary, while exports could not be increased to pay for these additional purchases, and the foreign currency reserve dropped from 101.4 millions on December 1, 1924, to 46.9 millions on May 1, 1925.

¹ Cf. *Economist*, Russian Supplement, March 19, 1927.

Since currency reorganisation has been achieved, budget equilibrium has also been secured, although certain extraordinary revenue in the form of loans was required. For the financial year 1924-5 the ordinary and extraordinary budgets totalled 2876 million roubles, of which 113.5 million was covered by loans. In the following year the budget total amounted to 4039 million, of which 120 million was covered by loans. The debt of the Union at the beginning of October 1926 was returned at 663 million,¹ so that the burden of debt charges in the absence of any resuscitation of pre-war debt is not heavy. On the other hand, future prospects must depend upon the extent to which the productive resources are effectively organised. In particular, the methods by which financial equilibrium has been secured have been criticised, particularly in relation to the profits of nationalised industries accruing to the State. Thus it has been alleged that these profits have not always been fully earned, but have been obtained through the failure to make adequate allowance for the depreciation of plant and buildings.² It is impossible, in view of the general obscurity of the Russian position, to determine precisely how far this criticism is valid, but if it should be substantiated in fact, important reactions in later years would be inevitable.

As regards the monetary position, the official policy has succeeded in maintaining the external value of the chervonetz close to its parity, but during 1924 and 1925 there was a rapid fall in its internal purchasing power, and no real equilibrium has been obtained. The foreign trade monopoly has had to be controlled with a view to maintaining the apparent external stability, but with rising internal money costs the difficulties of securing this end have increased. It is therefore significant that the relative improvement in the foreign trade position of the country since the initiation of the New Economic

¹ As compared with 366.5 million on the corresponding date in 1925. Cf. *Financial Times Banking Supplement*, March 21, 1927.

² *Economist*, Russian Supplement.

Policy has been much less marked than the improvement in the domestic trade position. It has, in fact, been admitted, moreover, that on the "black" or unofficial bourses foreign currencies have commanded a premium over the chervonetz. The estimated decline in the internal purchasing power of the chervonetz may be indicated by reference to the index-number of the Planning Board (1913 = 100). At the beginning of 1923 the index was 90.2. A year later it had risen to 126.1, by the beginning of 1925 to 172.1, and 194.5 in April. In March it was 193.6. From that month the general index showed a fall to 177.2 in January 1927.

Thus the rapid upward movement in internal prices was continued up to the first half of 1925, and during the following year there was little variation. On the other hand, an important contraction in the circulation had occurred during the early months of 1926, but that was followed by a further rapid expansion towards the end of the year,¹ while prices were falling from about June. Taking the period as a whole, several factors are important. In the summer of 1923, industrial and trading monopolies, aided by bank credits, appear to have pursued a policy of raising the prices of their products until sales became impossible and a crisis ensued.² During 1924 the increase in the total circulation was much more than in proportion to the rise in prices. This apparent expansion was partly the result of the final currency reform which demonetised the Soviet roubles. To some extent an expanding circulation was a necessary feature of the period of transition, but the expansion was carried to excess. The existence of a premium on foreign currencies on the "black" bourses was attributed to a certain "flight from the currency."

¹ In part a seasonal movement connected with the crops.

² Yurovsky, *op. cit.*, p. 95.

CHAPTER XIII

POLAND

THIS chapter deals with an instance of a new country confronted with difficult problems of monetary reconstruction but without the mechanism necessary for their proper treatment. The results obtained were unsatisfactory and the ultimate depreciation of the currency ranks with the extreme instances of Russia, Germany and Austria. This failure in Poland must also be considered in relation to the inexperience of the country in the matter of internal management and the political and social instability of the transition period. When the Republic was formally constituted in 1918 the monetary position was one of complete confusion. Five different main currencies circulated side by side, in addition to the notes of a number of subordinate states. These main currencies included German marks, Russian roubles, Lithuanian marks, Austro-Hungarian crowns and Polish marks or "Kreis" notes issued by the Darlehnskasse or Polish Loan Bank, which was established in 1917 during the German occupation. On the financial side, political inefficiency made it impossible to formulate a system of national finance adequate to the new conditions, and the instability of successive Governments postponed the date when a uniform system of accounts could be achieved. New states are always subject to the temptation to develop their governmental activities beyond either their immediate requirements or their financial resources. In the case of Poland the army and the railways absorbed the bulk of the State expenditure, and both were overstuffed. Psychological difficulties also prevailed which were not easily surmounted. Before the war it was natural that tax-collectors should have been regarded as

the agents of a foreign Power, and for that reason the maximum of evasion would be practised. But it is difficult to alter the attitude of the taxable community from one of resistance to one of complacent or willing acceptance, and unstable Governments, as in Poland, can seldom afford to incur public disfavour either by adding to the tax burden or by the more rigorous enforcement of the collection of receipts. Prior to 1921 there was no general State budget, and financial administration was conducted without parliamentary authority and without responsibility.¹ Inflationary measures became necessary to cover the public expenditure. The same confusion prevailed throughout the country generally. Towns raised taxes which were intended for the central Government, and granted monopolies which the State alone had the right to authorise.

The circulation of Polish Loan Bank notes when the Republic was constituted amounted to 880 million Polish marks. This was subsequently increased on account of excessive State expenditure and by the withdrawal from circulation of other foreign currencies. At the end of 1919 these foreign currencies were deprived of legal tender status and were exchanged at fixed rates for Polish marks. Thus some 3 milliards of Austro-Hungarian crowns were converted into Polish marks at the rate of 100 : 70. Between November 1918 and the end of 1919 the note circulation of the Polish Loan Bank had increased by roughly 4 milliard Polish marks. No attempt to check this expanding issue was made prior to 1922, but the hope was entertained that ultimately the Polish mark would be given the value of a gold franc. From 1919 Loan Bank notes carried the following inscription: "The Polish State assumes the obligation to redeem this bank-note in the future Polish currency at a rate to be fixed by the Legislative Assembly."

External debts apart, budget deficits for the first three

¹ Cf. Dr. W. Guido, "The Exchanges and Finances of Poland," *Manchester Guardian Commercial*, Reconstruction Number, April 20, 1922.

years from November 1919 to November 1921 amounted to 222 milliard marks out of a total expenditure of 324 milliards. In 1922 the cost of the army was 319·7 million gold francs, while the railway deficit amounted to 175·6 million. This latter represented 48·5 per cent. of the total deficit, while the cost of the army and the railway deficit amounted to 55·6 per cent. of the total expenditure. The following year, though it witnessed two attempts to improve the position, was little better. The cost of the army increased to 369 million gold francs, and the railway deficit amounted to 365·4 million, or fully twice the deficit of 1922. Taken together, these two items represented 65·6 per cent. of the total expenditure, and the railway deficit amounted to 52·8 per cent. of the total deficit.¹

The following table ² indicates the extent of the inflation up to the projected reform of April 1924.

(Polish Marks.)

End of	State's Debt to Bank (milliards).	Notes in Circulation (milliards).	Dollar Rate.	Dollar Value of Note Issue.*
1919 . . .	6·8	5·3	110	\$48 m.
1920 . . .	59·6	49·4	590	84 m.
1922 . . .	675·6	793·4	17,800	45 m.
1923 . . .	111,320·0	123,372·0	6,375,000	20 m.
1924 (Feb.) .	291,700·0	528,913·4	9,250,000	57 m.
1924 (April) .	291,700·0	570,697·6	9,250,000	62 m.

* The pre-war circulation of the present Poland was estimated at 1500 million zlots, or \$290 million.

Up to the reform of 1924 there had been two attempts to check the depreciation. In 1921 there was a capital levy, part of the proceeds of which were used early in 1922 to reduce the State's indebtedness to the Bank, and a reduction was effected from 232 milliards at the end of

¹ E. Hilton Young, *Financial Report on Poland*, p. 14.

² Zdziechowski, *The Finances of Poland*, 1924-5, p. 6.

March to 217 milliards at the end of May. But the necessary checks to governmental expenditure were not achieved, and by June the Government had once more lost control, so that a rapid depreciation reduced the dollar value of the circulation at the end of the year to about 56 per cent. of its value at the end of 1921.

A fresh attempt was made by M. Grabski early in 1923, and in February of that year an elaborate scheme was constructed for the purpose of reducing the budget deficits. The problem was to eliminate the gap which rapidly rising prices inserted between revenue and expenditure, and that gap would persist so long as receipts were collected in depreciating marks, and so long as estimates of future expenditure were continually falsified by progressive depreciation. On the revenue side, therefore, it was proposed to relate taxation to the level of wholesale prices, while a new unit—called the zloty—would be substituted for the Polish mark as the unit of account. This new unit was equal to a gold franc. Taxation and expenditure would then be expressed in terms of the zloty to be fixed by the Minister of Finance. On the side of expenditure, the budget would be separated into an administrative section and a section which included public undertakings. Each of the latter would have its own budget and would be conducted on the basis of an independent commercial concern which had to rely upon its own resources. Thus, if the railway system required loans, it would require to raise those loans on the security of its own property and receipts. The administrative budget, moreover, was to be limited, and was not to exceed 90 per cent. of the 1923 estimates, except in the case of expenditure upon education. On this basis, estimates of expenditure were prepared for the next three years, while the equilibrium of the ordinary budget was expected to be realised in 1924.

This programme involved drastic economies on the side of expenditure, and it implied the abandonment of the use of the printing press for inflation. A capital levy payable in instalments and an issue of Treasury Bonds expressed in zloty were proposed to provide the resources

to cover the deficits incurred during the interval before complete equilibrium was secured. Taken together, the adoption of these proposals enabled the Government to slacken the rate of inflation, and a certain appreciation of the mark occurred in March. The dollar rate showed an improvement from 44,750 marks at the end of February to 42,300 at the end of March, after which it fell to 52,875 at the end of May. Between January and May the dollar value of the entire circulation rose from \$25.5 million to \$51.7 million, or by fully 100 per cent. The improvement, however, was short-lived, and a political crisis resulted in the downfall of the Government in June. The dollar rate immediately reacted and rose to 104,000 at the end of the month and to 196,750 at the end of July. The succeeding Government reverted to the former method of direct inflation, and the dollar value of the expanding circulation fell to its lowest point at \$14.3 million in October. The general position of the public finances became steadily worse, and whereas in 1922 actual revenue amounted to 74.2 per cent. of the estimated revenue, in 1923 the corresponding proportion had fallen to 47.5 per cent.

At the end of 1923, M. Grabski returned to the Ministry of Finance, but on this occasion vested with extraordinary powers to adopt without parliamentary authority whatever financial measures were considered to be necessary to redeem the position.¹ These special powers, which were to extend for a period of six months, included the right to revise taxation and Customs rates, to effect administrative economies, to raise funds by loans up to a maximum of 500 million gold francs, and, if necessary, to sell certain State enterprises to the value of an additional 100 million gold francs. The reforms which were initiated during this period had necessarily to cover both the fiscal and the monetary problems, and it may be worth while to examine these two groups of measures in some detail.

Under the first head the financial position of the

¹ In July 1924 these special powers were extended for a further period of six months.

railways called for immediate attention, and the earlier scheme for separating the railway accounts from the general administrative budget was put into effect. But the change could not be made without some initial delay, and Treasury grants up to 4 million zloté were made up to March. In addition, 10 per cent. Railway Bonds were issued in January and guaranteed by the assets of the railways, while receipts were increased by the imposition of higher rates. In this manner the chief drain on the national finances was removed, but it was equally necessary to revise the administrative budget, and that involved the retrenchment of expenditure and the increase of revenue both out of ordinary sources and by the imposition of a third levy on capital. By these means receipts were raised from 34.6 millions in January to 76 millions in February, and 114 millions in March, the monthly deficits being reduced and converted into a surplus of 5 millions in March.

On the basis of these fiscal improvements the necessary monetary reforms could be undertaken. In January a special effort had been made to check the continued depreciation of the exchange by placing the entire gold reserve of the Treasury, which only amounted to \$2.5 million, at the disposal of the market, and by February a stable dollar rate of 9,250,000 marks was achieved. At the beginning of that month an official decree declared that the use of the printing-press for the purpose of covering budget deficits would be discontinued, and the Bank's advances to the State reached their maximum of 291,700 milliard marks. Further assistance was obtained in March in the form of a loan of 400 million lire arranged by the Commercial Bank of Italy and secured by the Polish Tobacco Monopoly. Inflation, which as a depreciation tax had been estimated to yield \$549 million up to the beginning of 1924, was thus brought to an end and a new period of reconstruction was introduced.

The New Bank of Poland commenced operations on April 28, as a central bank with the sole right to issue legal tender bank-notes up to 1944, and with certain provisions for the renewal of that monopoly on the expiry

of its charter. The new zloty issue was to replace the issue of Polish marks at the rate of one zloty for 1,800,000 Polish marks, that figure corresponding to the rate at which the exchange had been stabilised. The dollar and sterling parities thus became 5.18 and 25.2215 respectively. The capital of the Bank—100 million zloty—was quickly raised within the country itself, and the new institution, though subject to Treasury control, remained a private concern.

Notes issued were to be covered up to 30 per cent. in gold, foreign currencies and exchange in stable currencies, and the remainder in commercial bills, silver, etc., but the Bank was not obliged to maintain full convertibility for its notes. Its immediate task was to maintain the stability of the new unit in terms of the dollar, and during 1924 that result was successfully attained. Provision was also made for the distribution of profits. A reserve was to be built up by the allocation of 10 per cent. of the net divisible profits until that reserve amounted to one-fifth of the Bank's capital, after which a 5 per cent. allocation was to be made until a proportion of one-half of the Bank's capital had been reached. The maximum initial dividend to stock-holders was fixed at 8 per cent., and the State was to participate in any balance which remained. Finally, the power of the State to borrow from the Bank was limited to short-term loans for the purpose of covering temporary deficits, and the maximum of advances under this head was fixed at 50 million zloty.

The State, however, was to provide a metallic circulation, and an issue of Treasury notes of small denominations. The maximum issue of Treasury notes was fixed at 150 millions and the quantity of subsidiary coin was not to exceed eight zloty per head of population for silver pieces and four zloty per head for coins of inferior metals; *i.e.* twelve zloty per head for subsidiary coins, or about 326 millions for the entire population. This issue of token money was soon to prove a definite menace to the power of the Bank to control the value of the zloty, more particularly when there existed another State Bank (the Bank Gospodartstwa Krajowego, or Bank of National Economy),

which not merely held part of the State's funds, but which also pursued an independent policy in the granting of advances to industry.

In June 1924 the circulation of zloté amounted to 334 millions plus the equivalent of 79 millions in Polish marks not yet withdrawn. The pre-war circulation has been estimated at from 1500 million to 1850 million zloté. At the end of 1924 the circulation, including Treasury notes and coin, was 647 millions, increasing to 787 millions in July 1925. Again, before the war, bank deposits aggregated 3000 million zloté. At the beginning of 1924, when stabilisation was effected, they represented only 22 millions, but increased to 201 millions at the end of the year and reached 650 millions in July 1925.

The following table summarises the main statistical data during 1925 and 1926 :¹

Average.	(1) Total Cir- culation.*	(2) Cost of Living.	(3) Wholesale Prices.	(4) Un- employed.	(5) Ratio of (2) to (3).
1924. 1st Qr. .	—	124·7	111	110,300	112%
2nd " .	381 m.	125·3	105	118,900	119%
3rd " .	463 m.	134·7	108	156,000	125%
4th " .	520 m.	151·6	117	152,300	129%
1925. 1st " .	701 m.	145·8	121	181,600	120%
2nd " .	778 m.	144·5	119	174,300	121%
3rd " .	787 m.	147·7	124	184,900	119%
4th " .	795 m.	160·7	113	258,100	120%
1926. 1st " .	796 m.	169·7	145	354,000	117%
2nd " .	864 m.	180·5	174	304,200	104%
3rd " .	998 m.	181·9	172	239,700	106%
4th " .	1013 m.	194·1	178	211,000	109%
1927. 1st " .	1043 m.	201·2	197†	209,300	—
2nd " .	1118 m.	204·2	207†	174,800	—

* Including token notes and coin, except for 1924. The figures for 1924 include Polish marks, but not token notes and coin.

† New series since January 1927.

¹ The price index numbers are defective for close analyses. The wholesale index tends to under-estimate the increase over pre-war, while the cost-of-living index tends to over-state the position for the whole country. Cf. Zdziechowski, *op. cit.*, p. 9; and Gregory, *First Year of the Gold Standard*, p. 112 n.

It will be seen that the rise in prices after stabilisation was not proportionate to the increase in the circulation—a phenomenon common to all countries whose currency systems were greatly disorganised. But the rise in the cost-of-living index during 1924 proceeded more rapidly than the rise in the wholesale price-index, and it is perhaps significant that during that year the unemployment figure, after a temporary decline in May, increased fairly rapidly.

The policy of the Bank of Poland was to maintain intact the dollar parity of the zloty. Throughout the year that object was fully realised without involving any serious drain on its resources in gold and foreign currencies, which actually increased from 247 million zloty at the end of May to 369 million at the end of December. A more serious position developed in 1925 which revealed the difficulties which had to be faced. The rise in prices which became marked towards the end of the previous year was continued. The visible trade balance showed an excess of imports of 267 million zloty as compared with 216 million in 1924 and as compared with an excess of exports in 1923 amounting to 71 million. Apart from remittances from Polish emigrants there are no important invisible items of income to be recognised. But the position in 1924 had been favoured by the large volume of foreign credits which were available, although these were in the main short-term credits subject to sudden withdrawal. The movements which occurred in 1925 called for the adoption of definite restrictive measures which the Bank of Poland was unable to enforce.¹ During that year the foreign balances held by the Bank declined from 254 millions at the end of 1924 to 37.4 millions at the end of September 1925, despite the 123 millions available from a Government loan in New York. The metallic cover for the Bank's

¹ In a recent pamphlet, Dr. Mlynarski attributes the subsequent fall in the zloty to the adverse trade balance instead of regarding it as the result of other influences. Cf. *The International Significance of the Depreciation of the Zloty in 1925*. Cf. also the *Polish Economist*, July 1924, p. 4. The trade balance was also unfavourable in 1924.

note circulation, which had fallen from April, declined from 65 to 42 per cent. between the same two dates. But the bank-note circulation represented a diminishing proportion of the total circulation, falling from 82 per cent. at the end of 1924 to 50 per cent. in September, and to 46 per cent. at the end of the year. Between April and September the bank-note circulation declined from 567 millions to 397 millions, while the issue of token notes and coin rose from 212 millions to 395 millions. In November 1924 the Bank had yielded to the popular argument that an increase in the rate of discount reinforced the upward movement of prices,¹ and had effected a reduction from 12 to 10 per cent. Since, therefore, the Bank was deprived of the power to regulate the demand for credit by regulating the rate of discount, it was compelled to resort to a rationing of credit supplies in the manner adopted in Germany in 1924. In that connection it is significant that while this process was in operation the discounts and advances of the Bank of National Economy actually increased.

DISCOUNTS AND ADVANCES.

End of	Bank of Poland.	Joint Stock Banks (44).	Bank of National Economy.
May 1924 . . .	128 m.	82 m.	27 m.
Dec. " . . .	289 m.	265 m.	82 m.
July 1925 . . .	357 m.	456 m.	163 m.
Nov. " . . .	332 m.	372 m.	218 m.

The foreign currencies and balances of the Bank fell rapidly from 254 millions at the end of 1924 to 115 millions in June 1925, and 73 millions in August. At the end of July, the Bank was obliged to abandon the practice of selling dollars at the fixed rate of 5.18 zloté, and the exchange weakened, to develop later into a rapid fall. The too liberal granting of credits by the other

¹ This argument is partially endorsed by Mlynarski, *op. cit.*, pp. 36-7.

banks had engendered a position of great illiquidity, and the credit rationing adopted by the Central Bank in March developed the severe crisis in August, when deposits were withdrawn on a large scale. It was at this point that the danger resulting from the short-term foreign credits became significant, since the first weakening of the exchange led to their rapid withdrawal. Purchasers of dollars in the open market had to offer greater quantities of zloty and banking houses abroad declined to renew short-term loans. The zloty, which averaged 99·4 per cent. of its dollar parity in June, fell to 91·1 per cent. in September and 56·2 per cent. in December.

On August 12, bank rate was raised from 10 to 12 per cent. Special "intervention credits" were arranged abroad in November both by the Bank and by the Government, and these helped to check the depreciation of the zloty for the period during which they were available, but they were soon exhausted and the exchange slumped heavily in December. The large contraction in the bank-note circulation was more than offset by the issue of notes by the State. Wholesale prices rose from an index of 119 in June to 155 in December. Meanwhile the author of the stabilisation scheme had resigned in November and was succeeded at the Ministry of Finance by M. Zdziechowski, who succeeded for the time being in restoring confidence by the assurance that inflation would not be permitted and that fiscal economies would be secured. Indeed the zloty rose from 56·2 per cent. of its dollar parity in December to 68·6 per cent. in February 1926, but receded to 51·2 per cent. in May, when the revolutionary change of government occurred.

The depreciation of the currency reacted immediately upon the commercial position of the country and imports were greatly reduced during 1926. Exports, on the other hand, were increased, and for the year there was an excess of visible exports. The reserves of foreign currencies held by the Bank improved and, in June, bank rate was reduced to 10 per cent.

BANK OF POLAND.

	Bullion.	Foreign Assets after deducting for Obligations in Foreign Currencies.	Total Reserve.	Note Cir- culation.	Ratio.
Dec. 1925 .	133·6 m.	2·8 m.	130·8 m.	344·6 m.	37·96%
June 1926 .	134·7 m.	9·6 m.	144·3 m.	427·8 m.	33·72%
Dec. " .	138·8 m.	125·2 m.	264·0 m.	563·4 m.	46·86%
June 1927 .	161·7 m.	210·9 m.	372·6 m.	727·5 m.	51·22%

Since June the increase in the total circulation was the result of an expanding bank-note circulation. The issue of Treasury notes declined for the first time. The exchanges continued to show improvements, and the zloty rose from 48·2 per cent. of its dollar parity in June to 58·4 per cent. in December 1926. Along with this movement was a rise in the level of gold (wholesale) prices from 84 in June to 104 in November and 103 in December. Even allowing for the probable underestimate of the increase in wholesale prices over pre-war, the level of gold prices would as yet have some distance to rise before the world level was reached. The second legal stabilisation of the currency, therefore, remains to be accomplished. It is possible that the relationship between cost of living and wholesale prices will be more favourable for this occasion than it was during 1924, but no accurate conclusions can be drawn on the basis of the index numbers available.¹

The Kemmerer Report, which was made available in the autumn of 1926, recommended the stabilisation of the zloty at its present value at fully 11 cents, or one-ninth of the dollar, a revaluation of the zloty and an early resumption of payments by the Bank of Poland. These or similar proposals have yet to be put into effect. But short-term open credits have already been arranged by foreign banks and negotiations have been completed for the flotation of a new stabilisation loan of \$60 millions.

¹ The ratio of the two indices rose, however, from 104 in the second quarter of 1926 to 109 in the fourth quarter.

CHAPTER XIV

THE BALTIC STATES

IN this chapter it is proposed to examine the efforts made to secure monetary stability in that group of new states which have arisen on the shores of the Baltic, viz. Latvia, Lithuania, Estonia and Finland. With the exception of Finland, the problem which emerged was similar to that which occurred in Poland. New and independent currency systems had to be devised. War and revolution, moreover, involved expense and disorganisation; the new Governments lacked political and financial experience; and quite new fiscal machineries had to be developed. On the other hand, the economic organisation of each of the countries was mainly agricultural, and to that extent the difficulties of reconstruction were less acute than those which occurred in more complex industrial societies.

Latvia.—The general economic organisation of the new Latvia differs in important respects from the pre-war organisation of the same territory. Before the war the country was subject to Russian domination, and its internal economy was subordinated to the industrial organisation of the Russian Empire. Financially, Latvia was the source of important contributions to the Imperial Treasury, and in 1913 contributed 90 million gold francs out of a revenue of 235 million.¹ Economically, the country had manufactures which were organised for Russian markets, while it also provided one of the main channels for Russian foreign trade, one-quarter of which passed through Latvian territory. The post-war organisation of the country differs from the pre-war conditions

¹ *Latvia: Natural Conditions and Possibilities*, 1922, p. 25.

in the absence of financial tributes to Russia and in the nature of the main industries. Present-day Latvia is predominantly an agricultural state, its rural dwellers representing almost three-fourths of its total population of 1,900,000. Many of its pre-war factories have not been reopened, since its industrial equipment was despoiled during the war years and has not been replaced. One estimate placed the value of the industrial equipment requisitioned by the Russian Government in the period 1915-17 at over 500 million gold francs,¹ and though the Treaty of September 1920 guaranteed the restitution of that material, no steps in that direction have yet been made.

On November 18, 1918, the Latvian National Council proclaimed the independence of the new state, and this received immediate official recognition by France, Great Britain and Japan. A new regime was temporarily introduced by a German *coup d'état* in March 1919, but this was subsequently suppressed, and in April 1920 a Constituent Assembly was elected from which the present constitution of the country emerged. Up to 1918 the currency of the country consisted of German marks, but one of the first acts of the newly-constituted government of the country was to effect its own issue of Latvian roubles to replace the current circulation of marks and Russian currency. The official rates of exchange,² however, did not correspond to the real relationship of the currencies. The subsequent conflicts with Russia and Germany involved expenditure which was covered by direct inflation. Expenditure on defence absorbed 57 per cent. of the total public expenditure in 1919, and 24 per cent. in the following year, when peace was concluded with the two countries. The circulation of State notes, which amounted to 106 millions at the end of 1918, rose to 947 millions at the end of 1920 and 2282 millions at the end of 1921. In consequence, the

¹ Cf. *Economic Review*, August 13, 1926.

² One Latvian rouble was declared to be equal to one Russian rouble and to two German marks.

external value of the rouble was subject to rapid depreciation, and dropped from 800 to the £ in March 1921 to 2000 at the end of June.

The method of approach to this problem of depreciation was an attempt to improve the commercial position of the country. This coincided with a certain revival in foreign trade, which was more apparent in the following year: Heavy import and export duties were imposed with a view to increasing the revenue of the State, and these were supplemented by additional taxes on capital and property. During the autumn the rouble appreciated rapidly and remained in the neighbourhood of 1000 to the £ sterling. In August the State Savings and Credit Bank was founded with a paid-up capital of 6 million gold francs, and to this institution was assigned the task of maintaining the value of the rouble at one-fiftieth of a gold franc, representing a stable dollar exchange of 259. During the last quarter of the year the actual rate appreciated from 370 to 237, but fell to 260 in 1922. At the same time the continuous issue of fresh paper money was abandoned.

This scheme of reform was developed in November 1922, with the foundation of the Bank of Latvia as a central bank under State control. This new bank was to take over the note issue of the State, serve as the fiscal agent of the Government, and, in addition, it was intended to develop ordinary commercial banking facilities for the country. At the same time a new unit of account was introduced—the gold lat, divided into 100 santims—equal to 0.2903 gramme of fine gold. The new unit was therefore equivalent to a gold franc, and had a sterling parity of 25.2215. Paper roubles were declared to be exchangeable for new currency at the rate of 50 roubles to one lat.

To the Bank of Latvia was given the right to issue notes in terms of the new unit and redeemable in gold on demand. The reserve proportions which were prescribed depended upon the amount of the issue. For a note issue not exceeding 100 million lats, a 50 per cent.

cover in gold or stable foreign currencies was required; for an issue exceeding 100 million lats and not exceeding 150 million, the proportionate cover was raised to 75 per cent.; while any issue in excess of 150 million had to be fully covered by gold and foreign currencies. The capital of the Bank, which was originally provided by the Government, was fixed at 10 million lats, but was to be increased by the annual allocation of 25 per cent. of the profits for the year until a figure of 25 million was reached. A further 10 per cent. of the profits was to be allocated to a special reserve fund.

Provision was further made to prevent that type of inflation which proceeds from excessive Government borrowing from the Bank, and the law provided that loans to public authorities should not be granted except upon the security of gold or readily marketable commodities. But the State retained the right to issue a metallic currency and a paper currency of limited amounts. No gold coinage has yet been made, but notes of the Bank are convertible into gold or gold exchange. The silver, bronze and nickel circulations must not exceed 40 lats *per capita*, representing a maximum of 76 millions. The State currency notes may be issued up to 48 millions with a gold cover of 25 per cent. This figure represented the rouble circulation—*i.e.* 2269 million roubles—at the time of the foundation of the Bank, so that the new Bank was not burdened by an issue for which it had not been responsible.¹

The table on p. 195 gives the movements in the note circulation since the end of 1923.

The decline in the issue of State notes since the beginning of 1924 has been accomplished by a corresponding increase in the issue of token coins, which has left the combined total unchanged at 45 million lats.

Lithuania.—The general economic structure of Lithuania presents similar features to that described in the cases of Latvia and Estonia, and the task of reconstruc-

¹ The amalgamation of the State and Bank circulations was proposed in the autumn of 1924 but was not approved.

	State Notes.	Bank Notes.	Gold and Foreign Currencies.	
			Government.	Bank.
Dec. 1923 . . .	2,319 m. ¹	21 m.	—	—
" 1924 . . .	2,269 m. ¹	29 m.	28 m.	56 m.
" 1925 . . .	37 m.	29 m.	21 m.	38 m.
" 1926 . . .	35 m.	31 m.	17 m.	40 m.
June 1927 . . .	33 m.	28 m.	15 m.	39 m.

¹ Roubles.

tion which emerged was equally similar. As in the other cases, the pre-war circulation consisted of Russian roubles, but in 1918 several different monetary issues circulated together, including German Reichsmarks and Ostmarks issued during the German occupation, and these constituted the sole legal tender within the country. With the establishment of the new Government in 1918 the position remained unaltered, except for the demonetisation of Russian roubles in April 1919, and the expenses of the Government were covered in the main out of German loans in 1918 and 1919 of 115 million marks, other debts in respect of purchases of stores, materials and food relief supplies being contracted with the United States and France. Thus the German mark continued in circulation as legal tender, and for a time this appeared to provide the country with a currency of greater stability than the new currencies in Latvia and Estonia. But later difficulties emerged when the mark started on its general depreciation, and the instability thus occasioned led to the introduction of the United States dollar on a considerable scale.

It was therefore expedient that an attempt should be made to establish a new currency which should be independent of fluctuations in the value of the mark. This monetary reform took place later than in the neighbouring states and was delayed till the second half of 1922. The general conditions for the establishment of

a new standard were suitable. In 1921 the deficit in the budget amounted to 213 million marks out of an expenditure of 886 million, and this deficit had been entirely made good out of the proceeds of an internal loan. On August 16, 1922, the Bank of Lithuania was founded with the sole right to issue notes of legal tender status, and the litas was established as the new unit of currency on a gold basis.¹ The existing mark currency, which was estimated to amount to 10 milliards at the end of 1922, was to be exchanged for new local currency at rates to be fixed periodically by the Minister of Finance. A minimum gold cover of 33½ per cent. was prescribed for the note circulation of the Bank, the remainder being coverable by easily marketable securities, but full convertibility into gold was not required, a gold-exchange standard being introduced instead which aimed at maintaining a stable dollar rate at 10 litu. The position of the Bank since its foundation is indicated below:

(In Litu.)

End of	Notes.	Gold.	%.	Foreign Bills, Bank-notes and Balances.
1922 . . .	30 m.	15 m.	50	18 m.
1923 . . .	60 m.	16 m.	27	47 m.
1924 . . .	93 m.	31 m.	33	63 m.
1925 . . .	82 m.	32 m.	39	30 m.
1926 . . .	87 m.	31 m.	35	37 m.
1927 (June) . . .	87 m.	31 m.	35	40 m.

Foreign currencies, of which the United States dollar is the chief, have, however, continued to circulate. During this period the dollar rate has remained stable, but the absence of important invisible trade items of income adds to the necessity of securing a favourable visible balance. Thus in 1924 the attainment of a con-

¹ One litas contained 0.150462 of 1 gramme of pure gold, and therefore was equivalent to \$0.1.

siderable trade surplus may be taken as accounting for the increase in foreign balances held by the Bank during that year, and the decline during 1925 followed upon an adverse balance. On the other hand, the liquidation of part of the foreign indebtedness and the funding of the American debt on the basis of annual payments extending over sixty-two years has removed an uncertain factor which might otherwise have been important. The stability of the litas, however, has been maintained only through the high import duties which have restricted imports, many of which were in urgent demand. There remains an uncertain political factor which has weakened confidence abroad, and which has therefore added to the difficulties of securing foreign financial assistance for the development of the country.

Estonia.—The general conditions prevailing in Estonia were similar to those already described in the section on Latvia. Up to the end of 1918 the country remained under German occupation and possessed no independent monetary system. Reichsmarks and Russian roubles of several issues made up the circulation in addition to special issues of the occupation and a heterogeneous assortment of miscellaneous currencies. The new Government was established without resources and at the outset covered its expenditure out of a loan from Finland of 20 million Finnish marks which were added to the circulation. At the end of 1918 steps were taken to provide an independent and uniform issue on the basis of the Finmark. Interest-free Treasury bills were authorised for issue in amounts to be determined at the discretion of the Treasury, and these were to replace all other currencies then in circulation at the rate of one Estonian mark to one Reichsmark, one Finmark, and 50 Russian copecks. Other currencies were deprived of legal tender status by the law of May 2, 1919.

At the outset the new currency was issued by the Treasury and further inflation became inevitable. Certain foreign loans were obtained and a foreign indebtedness of about £4 million was contracted with the United

States and the United Kingdom. Up to 1921 it was necessary to incur heavy expenditure on defence and in the building up of a new administrative machinery, and the revenue obtainable from tax sources and from foreign loans was inadequate to cover that outlay. For the three years ending 1921, public expenditure amounted to 10.7 milliard Estonian marks, or 2.4 milliards in excess of the State's income during the same period, and notes were issued to the extent of 3157 million marks.

The sterling exchange, which was quoted at 750 marks at the beginning of 1920, rose to 1300 in January 1921 and later to 1500 marks, despite an improvement following the peace with Russia. The Eesti Pank, or Bank of Estonia, was founded in February 1919 as a joint-stock institution with an initial capital of 250 million Estonian marks provided by the Treasury. The new bank was not a central bank in the ordinary sense. It was primarily a commercial institution for the financing of trade and industry and exercised no note-issuing function until March 1921. These notes, moreover, were not legal tender, but were convertible into inconvertible State notes. The maximum issue was fixed at 2500 millions, and the cover provision required that they should be secured up to at least 50 per cent. by discounted bills, loans and advances, up to a minimum of 10 per cent. by legal tender State notes, and the remainder in gold, silver, platinum or foreign assets.

The changes in the aggregate note circulation are shown below:

(In Estonian Marks.)

End of	Eesti Pank.	State Notes.	Total.
1919	—	591 m.	591 m.
1921	3000 m.	2757 m.	3057 m.
1922	1207 m.	2517 m.	3724 m.
1925	1900 m.	1558 m.	3458 m.
1926	1906 m.	1448 m.	3354 m.
1927 (June)	1904 m.	1487 m.	3391 m.

The failure of the harvest in 1923 may have contributed to the special strain upon the resources of the country in 1924, and the gold and foreign currency reserves held jointly by the Bank and Treasury declined from 1572 millions in March to 610 millions in August, and the external value of the mark revealed a definite weakening, more particularly on the "black" or unofficial bourses.

From the middle of 1924 a fresh effort was made to stabilise the Estmark in relation to the Swedish krona. The Estonian kroon, equivalent to the krona, became the new unit of account at the rate of one kroon to 100 Estmarks. Since then the dollar rate has been held at 375 marks and the sterling rate at 1800. But it remained necessary to reorganise the general credit structure so as to prevent a recurrence of the experience of 1924, when the bulk of the Bank's resources were frozen up in long-term credits to industry. Under the new proposals the Bank was to be reorganised as a central bank with the sole right of issue and the existing issues were to be amalgamated. The requirements of industry would be provided for by the formation of a new industrial mortgage bank specialised in long-term credits. The cover proposals for the new note issue provided for a minimum reserve of 25 per cent.¹ in gold and foreign balances, the remainder, though not in excess of 2750 million marks, being coverable by commercial bills. The currency would then be placed upon a gold basis, the weight of the mark being given as 1/246th part of a grain of fine gold.²

¹ To be raised to 30 per cent. after five years.

² Since the above draft was written the new currency and banking reform has been legalised by the laws of April 1927. The kroon, with a gold content of 0.40323 gram fine, is defined as the unit of account, the two note issues are to be amalgamated, and the Eesti Pank is to be reorganised on the basis of a central bank of issue. The new bank is obliged to buy and sell foreign gold standard currencies at fixed rates in amounts not less than 5000 kroon. A minimum reserve in gold and foreign currencies of 40 per cent. is to be held against all demand liabilities, but this may be suspended on payment of a graduated tax on the amount of the deficiency. For a period of three years the Bank

Finland.—The fourth of the Baltic States provides an instance of a country which succeeded in recovering monetary stability on a gold basis but at a new gold parity. The example is one of devaluation rather than of deflation, and the instance is instructive in view of the depreciation of the Finnish currency to about one-eleventh of its pre-war value. Under such conditions the amount of deflation which would have been necessary to have enabled the pre-war parity to be restored was outside the bounds of practical policy. On the other hand, a partial deflation was advocated in certain quarters as a pre-stabilisation measure and as a means of restoring to debt-holders some part of the capital values which they had lost during the period of currency depreciation. But against this compensating influence of currency appreciation it was necessary to set the certain dislocation which occurred in other directions, and the official policy aimed primarily at stabilisation of the currency at its current value.

The pre-war monetary organisation of Finland differed from that of the other Baltic States in so far as it was independent of the Russian standard. From 1877 to 1914 Finland had possessed an independent gold standard, the unit of account being the gold mark, which was equivalent to the gold franc and had a sterling parity of 25·2215. The Bank of Finland, which dates from 1811, had a monopoly of the note issue from 1886. The regulations governing that issue fixed a maximum fiduciary circulation at 40 millions,¹ and provided that notes and sight obligations in excess of this amount had to be covered by gold and silver coins and foreign balances. At the end of 1913 the note circulation

will be conducted under the supervision of an adviser appointed by the Council of the League of Nations. A special international loan of £1,350,000 was raised under the auspices of the League and of that sum £1,000,000 was to provide the bank with liquid resources necessary to its operations. The remaining £350,000 was to provide the working capital for the new mortgage bank which was to take over the frozen assets of the Eesti Pank.

¹ Raised to 70 millions in 1915, and to 200 millions in 1918.

amounted to 113 millions, against which there was a metallic reserve of 38.3 millions and foreign credits of 68.5 millions. Gold coins did not constitute an important element in the actual circulation.

After 1914 the Finnish currency depreciated, slowly at first and then more rapidly. The main factor related to financial pressure from Russia, of which Finland was an autonomous Grand Duchy, and the Bank of Finland was obliged to grant loans to the Imperial Exchequer, and these loans were never redeemed. At the end of 1917, Finland proclaimed its independence, but remained confronted with difficulties which led to further inflation. Internal revolution and war with Russia involved general disorganisation and heavy public expenditure was incurred, while tax revenues remained inadequate. In 1919 the public expenditure exceeded the public revenue by approximately 50 per cent. Meanwhile the note issue of the Bank had increased by more than eight times its pre-war average, and the Bank had incurred heavy losses through the depreciation of Russian assets employed as cover for its own notes. In 1918 the Government took over these losses together with the illegal notes issued during the revolution, and substituted, in the accounts of the Bank, Government bonds to the value of 350 million marks.

The depreciation of the mark reached its lowest point in September 1921, when the dollar rate averaged 70.80 marks, but a rapid appreciation occurred to 39.95 marks in December of the following year. In 1922 the internal price level had fallen by 8 per cent., confidence had revived and speculative factors reinforced the upward movement. That improvement was continued during the early months of 1923, and from March to August the dollar rate remained practically stable at about 36 marks. Meanwhile the Bank had been enabled to accumulate a large holding of foreign currencies partly as a result of the favourable commercial position¹ and

¹ In 1922 the visible trade balance showed an unusual excess of exports of 498 millions.

partly as a result of speculative purchases of marks. Between June and October 1922, foreign balances were increased from 79.8 millions to 915.2 millions. With the stable exchange up to the autumn of 1923 the speculative movement declined and gave place to withdrawal, and the foreign balances of the Bank declined to 283 millions in September 1923. At the end of November the official discount rate was raised from 8 to 10 per cent., and a series of foreign loans were negotiated early in 1924.

The following table summarises the principal data :

	Wholesale Prices.	Cost of Living.	Ratio of (2) to (1).	Cost of Dollar. % of par.*	P.P.P. †	P.P.P. ‡
1923. 1st Qr.	1122	1148	102	736	687%	715%
2nd "	1095	1107	101	697	651%	702%
3rd "	1083	1148	106	703	667%	714%
4th "	1081	1184	109	741	684%	711%
1924. 1st "	1081	1148	106	767	675%	716%
2nd "	1091	1129	103	766	668%	742%
3rd "	1104	1183	107	766	682%	743%
4th "	1124	1219	100	764	705%	730%
1925. 1st "	1136	1200	106	763	—	705%
2nd "	1128	1189	105	763	683%	723%
3rd "	1131	1242	110	763	—	707%
4th "	1119	1217	109	764	684%	713%
1926. 1st "	1088	1171	108	99.9 †	—	707%
2nd "	1077	1166	108	99.9	666%	709%
3rd "	1088	1199	110	99.9	—	725%
4th "	1098	1198	109	99.9	681%	742%
1927. 1st "	1100	1186	108	99.8	—	753%
2nd "	1095	1174	107	99.9	679%	760%

* Old par, 1 mark = 19.30 cents, or 5.1826 marks = \$1.

† New par, 1 mark = 2.519 cents, or 39.70556 marks = \$1.

‡ On cost-of-living basis.

§ On wholesale-price basis.

It would be impossible to draw precise conclusions based upon any comparison of price levels in Finland and the United States. The margin of error in the

former group of indices is probably large. On a cost-of-living basis a persistent under-valuation would appear to have existed over the period. The same is true on the basis of comparative wholesale prices except for the second and third quarters of 1923, when a slight over-valuation of the mark appears to have existed. Such a conclusion is the more probable in view of the evidence already mentioned.

The problem of determining the rate of stabilisation was involved. During the early part of 1923 a dollar rate of about 36 marks had been maintained, but this had risen to 40 marks in 1924. The Bank's policy was apparently governed by practical considerations. At the higher value of the mark the exporting industries had experienced particular difficulties. The main exports of the country are paper and timber products, the bulk of which find a market in the United Kingdom, so that a price movement which was confined to those products deserved greater consideration than any movements in the general index. Thus "while the general level of prices rose in the world markets, the prices of the commodities most important in Finnish exports, viz. timber and wood products, sank to such a degree that at one time in the autumn of 1924, part of our export was almost entirely sold abroad without profit and even at a distinct loss."¹ To some extent this was relieved by the movement in the sterling exchange from 179 marks in October to 190 in the early months of 1925.

In November 1924 a special Committee was appointed to consider the conditions under which the gold standard should be restored. Five months later the Committee reported and recommended a return to the gold standard on the basis of the existing rate, to be effective as soon as the United Kingdom had achieved the same end and restored a free gold market. The general fiscal and economic conditions within the country justified this decision, and it remained only to provide the necessary safeguards against unexpected crises. For that purpose

¹ Bank of Finland, Monthly Bulletin, January 1925, p. 31.

the Committee recommended that the Bank should increase its holding of foreign currencies, and that the Government should redeem in foreign currencies its bonds for 370 millions which were held by the Bank.¹

The gold standard was therefore to be restored by devaluating the mark on the basis of its existing value in terms of the dollar. It was not proposed to alter the monetary unit. These recommendations were enacted by the Monetary Law of December 1925. On the basis of the stable dollar rate of 39.70 marks, the gold contents of 100 marks was fixed at $3\frac{1}{8}$ grammes of pure gold. The circulation of gold coins was to be discontinued, and the Bank retained the option of maintaining convertibility in coin, bars or foreign gold currencies.

Certain technical readjustments followed. The gold reserve was automatically raised from 43.3 million to 330 million marks. In addition it was decided to increase the capital of the Bank from 100 millions to 500 millions, and to build up a reserve fund to the same amount by an annual allocation from the profits of the Bank. The fiduciary note issue was definitely fixed at 1200 millions, and a minimum gold reserve of 300 millions was prescribed.

¹ Bank of Finland, Monthly Bulletin, April 1925, p. 27.

CHAPTER XV

CONCLUSION

THEORETICAL discussion of monetary problems in the post-war period may be considered in distinct phases corresponding with the different stages in the evolution of the general problem. As was perhaps inevitable in the circumstances, monetary policy during the war years was conducted with little regard to its aftermaths. In itself this disregard for the future was a sufficient source of potential danger for the years which were to follow, although it was obscured by the various devices of regulation and control which were adopted. The "pegging" of the exchanges involved a policy which was practically possible only so long as foreign securities could be mobilised in the different countries for sale abroad, or so long as it was possible to secure adequate foreign loans for the purpose. The rationing of goods and the fixing of maximum retail prices during a period of inflation limit in particular directions the opportunities which people have of spending the extra money which has been created. But that extra money when expended in other directions tends to bring about an uneven rise in prices which corresponds to no real economic relationship between different groups of commodities, and this uneven movement leads to difficulties which are apparent at some later stage. The difficulties of the budget are increased if the prices of certain commodities, such as food-stuffs, are kept artificially low by means of subsidies from the national exchequer. But the post-war problem was made doubly difficult by the psychological attitude created by earlier conditions, and by the general reluctance to recognise the importance of monetary factors.

In the preceding discussions the difficulties which confront the detailed use of comparative index-numbers of prices are apparent, and it has been questioned in certain quarters whether the method of comparison adopted can be accepted as affording valuable conclusions. The recognition of the limitations to the method does not, however, necessarily justify its abandonment. If the attempt at measurement is to be made, index-numbers of prices and their comparative movements must be employed, though the interpretation of the results must be subjected to important qualifications. If employed for purposes of illustration their use may be wholly valid, and in the historical account given in these pages that condition may be satisfied. The greater limitations occur when attempts are made to employ these indices in detail as guides to practical policy.

The first phase of the monetary problem as it occurred after the war concerned the relationship between the condition of the national finances and monetary instability, and it has already been shown that during a period of inflation the difficulties of the budget, which are themselves the starting-point for the process, are increased by the policy actually adopted. At the Brussels Financial Conference of 1920 this particular issue was clearly defined, and an attempt was made to outline the conditions necessary to financial and monetary reconstruction. The objectives aimed at were the balancing of budgets and the general return to the gold standard. Nevertheless there were important practical difficulties confronting the realisation of these objects which were hardly worked out. It is probable that a comprehensive system of international loans to those countries in which the problem was most difficult would have prevented much of the subsequent depreciation and dislocation. But in the political circumstances of the time it may be doubted whether such a proposal would have been of practical value. For the restoration of the gold standard the Brussels Conference had in view the method of gradual deflation in the

different countries in which such a policy was possible. Subsequent events in the United States increased the difficulties of this process. As the value of gold rose the amount of deflation necessary in other countries to secure a return to the gold standard at pre-war parities was increased. Between May 1920 and January 1922 the value of gold as measured by the United States Bureau of Labour's wholesale-price index rose by 44 per cent. From the latter date American prices rose and so reduced the difficulties of deflation in other countries, but the original task remained more difficult of application than it appeared at the date of the Brussels Conference.

By 1922, when the Genoa Conference was assembled, the general problem was in essence identical with that which had been considered two years earlier. There had nevertheless occurred important changes in form. For some countries, deflation as a method of returning to the gold standard had become inapplicable owing to the further inflation which had occurred since 1920. For others, the possibility of deflation remained, but its chances of success had become more remote. For the United Kingdom and the war-time neutrals it was still a practical policy. The general problem had therefore to be approached along alternative routes. It was still recognised as desirable that all currencies should be based upon a common standard, and gold appeared as "the only common standard which all European countries could at present agree to adopt." But the alternative method of devaluation was recognised. This involved a certain advance in current conceptions of stabilisation as an objective of monetary and financial policy. Under the conditions which existed the mere cessation of inflation did not ensure monetary stability, since some amount of monetary readjustment remained to be effected. But if in addition to the cessation of inflation the gold value of the currency was defined, part of the future uncertainty would be removed and another part reduced to within more measurable proportions.

The second phase of the monetary problem was concerned with the selection of the appropriate rates at which to link the different currencies to gold, and this selection had to be made under conditions of several choices. Theoretically the rate chosen might lie anywhere between the outside limits as determined by the external and internal values of the currencies. During periods of currency depreciation it has been shown that the external value of the currency tends to fall below its internal value. Under other conditions the reverse relationship may exist. But under both sets of conditions some degree of readjustment between the two values must be effected. If the external value is fixed the readjustment must occur on the side of the internal value. If the internal value is fixed, the readjustment must occur on the side of the external value. If the rate selected lies between these outside limits a readjustment on both sides must occur. The Genoa Resolutions envisaged the adoption of new gold parities in those countries where devaluation was to be employed, at rates "approximating to the exchange value of the monetary unit at the time," and in the case of depreciating currencies that meant at the lower external value of the currency. This had the advantage that from the point of view of the stabilising country a smaller reserve of foreign currencies would be sufficient in comparison with the amount which would be required if a higher value was made the basis of stabilisation. But if stabilisation is adopted at a higher value than that ruling at the time in the foreign exchange market the final loss of values to be suffered by *rentiers* will be less than would otherwise be the case. The Committee of Experts which examined and reported upon the French situation in July 1926 favoured the adoption of a rate of stabilisation more favourable than that actually ruling at the time, and a rehabilitation of the franc was subsequently effected. In other cases the suggestion of the Genoa Conference was adopted.

The second phase then is concerned with short-period

readjustments consequent upon stabilisation. But it does not follow that when these have been effected the monetary difficulties to be incurred will be at an end. There remains the third phase, which has now been reached. In a sense it is not peculiar to the post-war situation. The problem here concerns the long-period trend in the value of gold itself. From the standpoint of those countries which succeed in reorganising their monetary systems on a gold basis, further movements in internal prices would be occasioned by any changes in the value of gold subsequent to the stabilisation of those currencies. This represents a type of problem which was not unknown before the war, but its discussion had remained largely academic. Recent events, however, have brought the issue more directly into the conduct of actual affairs. The Genoa Conference, in particular, gave special attention to the adverse consequences of any future changes in the value of gold and proposed measures of international co-operation between the central banks with a view to preventing these changes from occurring in fact. It may reasonably be argued that the difficulties which have confronted British trade and industry since May 1925 have been intensified by the fall of fully 10 per cent. which has occurred in the level of world gold prices. If this should represent merely a cyclical movement, these difficulties should be reduced during the following upward course of the same cycle.

But the secular trend of gold prices in years to come raises a number of important problems the discussion of which must remain largely tentative. Recent tendencies in world gold production have been in the direction of a diminishing gold output, and in the absence of new discoveries or important developments in the technique of gold extraction, this tendency may be expected to continue.¹ Under these conditions it would be desir-

¹ It should be noticed, however, that up to the present the course of world gold production has exceeded certain important estimates which have been made in recent years and which anticipated a more rapid decline.

able to eliminate any unnecessary demands for the metal which might contribute towards an appreciation of its value. Thus the Genoa Resolutions after recommending the continuous co-operation of the central banks of issue suggested that an international Convention should be convened to "centralise and co-ordinate the demand for gold, and so avoid those wide fluctuations in the purchasing power of gold which might otherwise result from the simultaneous and competitive efforts of a number of countries to secure metallic reserves." It is clear that what was feared was that the reforming countries would endeavour to build up large gold reserves and that the suddenly increased demand on a large scale would precipitate an appreciable rise in the value of the metal. Hence the Genoa Resolutions recommended a more general adoption of the gold-exchange standard so that important economies in the monetary use of gold would be secured. The attempt to dispense with internal circulations of gold coins represents a further step in the same direction. Under these conditions the function of the gold reserve of the central banks would be to meet possible external demands, and by means of continuous co-operation on the part of these banks these international gold movements could be reduced. And where the gold-exchange standard is adopted the currency is convertible *either* into gold *or* into gold exchange in the form of sterling or dollars. Thus when a gold-exchange standard is adopted the actual reserve may take the form of foreign bills, drafts, or deposits in gold-standard countries. The necessity for large reserves in actual gold is therefore diminished, although in practice it is probable that the central bank in a gold-exchange standard country will maintain a reserve of which part at least is in the form of actual gold.

In Appendix I a table is given showing the comparative magnitude of the gold reserves and foreign assets reserves of the different countries at the end of 1913, 1924 and 1926. There is definite evidence of a tendency to hold larger reserves of foreign assets than

formerly, and particularly is this the case in those countries where monetary disorganisation was acute. Gold reserves, however, have also increased, and the danger which might arise is that a general attempt to convert large parts of the foreign assets reserves into gold might occur. On the other hand, there are important modifying circumstances. The peculiar distribution of the world's gold reserves resulting from the war has concentrated these largely in the United States, where the actual gold reserves are considerably in excess of the normal requirements of that country. A certain increased demand for gold for reserve purposes by the other countries could therefore be met out of the redundant American holding without precipitating any marked rise in the value of the metal. A second factor operates on the side of the countries of Europe. From the standpoint of the central banks of these countries the holding of large reserves in actual gold is unprofitable, whereas a reserve in foreign assets represents a source of income to these banks. Apart, therefore, from any change in the direction of official policy the circumstances would appear to be favourable to the continued stabilisation of the currencies of Europe on a gold basis without any adverse future effects on the value of gold itself.

The qualification mentioned above—that no change occurs in the direction of official policy—nevertheless points to an important potential difficulty. The desire for greater prestige as represented by actual gold holdings might mitigate the advantages of the fuller adoption of the gold-exchange standard which have been mentioned. The question therefore arises as to how far the "continuous co-operation" of the central banks of issue which the Genoa Resolutions foreshadowed may hold in check any recurrence to the pursuit of purely national policy by particular countries. It has to be recognised that this anticipated collaboration has not yet matured in the form in which it was contemplated. There have been unofficial conferences between the Governors of the Bank of England, the Reichsbank and the New York

Reserve Bank, but of the proceedings at these meetings no official information is available. In the absence of this information it is necessarily difficult to pronounce upon the practical possibilities of the systematic collaboration which was recommended. Under the conditions prevailing during the period of actual stabilisation and monetary reorganisation in Europe it is possible to argue that unofficial discussion would be more fruitful of success than formal councils. But once the period of transition to stabilised conditions is completed, new difficulties may be experienced in the attempt to initiate regular collaboration. European central banks will be better able to resist pressure exercised on the part either of the United Kingdom or the United States or both. The unofficial conference, therefore, which may be sufficiently effective during the period of actual reorganisation, may prove inadequate over a longer period of time. On the other hand, there are indications that some definite attempt to conform to the Genoa Resolutions may yet be made. In evidence given before the Royal Commission on Indian Currency and Finance (1926) the present Governor of the Bank of England and Sir Charles Addis indicated that when the stabilisation of the Latin currencies is completed, "it may not be long before the banking resolutions approved by the Powers at the Genoa Conference come into play. A deliberate and concerted attempt will then be made by the central banks of Europe to prevent undue fluctuations in the future value of gold."¹

This may be taken as a pointer to future developments the precise nature of which cannot be anticipated here. The recent movements in banking policies with regard to reserves have not had important results as regards the general situation. In the European countries between 1924 and 1926 the gold reserve of the Reichsbank increased by \$255 million, that of Belgium by \$33 million, that of Hungary by \$22 million, that of Poland by \$7 million, but decreases occurred of \$22 million

¹ *Minutes of Evidence*, Vol. V. p. 191, Q. 13,724.

in the United Kingdom, \$37 million in Holland, \$3 million in Sweden and \$7 million in Switzerland. The general factors governing the future trend of gold prices are, (1) the course of gold production, (2) the growth of trade and population, and (3) the nature of banking policy with respect to reserves. In the *Federal Reserve Bulletin* for June 1927 it was estimated that on the basis of the published balance sheets of about thirty central banks, these held liquid foreign assets at the end of March 1927 of fully \$1600 million. About one-half of this sum was held in conformity with the legal requirements imposed upon these banks, but more than \$800 million was held as matter of policy. It was also estimated that about \$1000 million of foreign central bank reserves was held in the form of dollar exchange. It is not evident that any attempt on the part of foreign central banks to pursue independent reserve policies has yet occurred on a scale which, if continued, would lead to serious adverse results upon the world market. But the absence of an immediate danger affords little guarantee against subsequent developments.

APPENDIX I

TABLE OF GOLD AND FOREIGN ASSETS RESERVE OF CHIEF BANKS.

a = Gold. *b* = Foreign Assets.

	Dec. 1913.	Dec. 1924.	Dec. 1925.	Dec. 1926.
Germany. <i>a.</i> (marks)	1,170 m.	760 m.	1,208 m.	1,831 m.
<i>b.</i> " "	68 m.	253 m.	403 m.	519 m.
Austria. <i>a.</i> (schilling)	—	11 m.	15 m.	53 m.
<i>b.</i> " "	—	347 m.	499 m.	613 m.
Belgium. <i>a.</i> (francs)	249 m.	272 m.	274 m.	446 m.
<i>b.</i> " "	167 m.	30 m.	30 m.	323 m.
Bulgaria. <i>a.</i> (levas)	55 m.	40 m.	41 m.	44 m.
Denmark. <i>a.</i> (kroner)	73 m.	209 m.	209 m.	209 m.
<i>b.</i> " "	—	—	90 m.	27 m.
Spain. <i>a.</i> (pesetas)	480 m.	2,535 m.	2,537 m.	2,537 m.
<i>b.</i> " "	194 m.	34 m.	29 m.	35 m.
Finland. <i>a.</i> (markka)	276 m.	332 m.	332 m.	327 m.
<i>b.</i> " "	820 m.	563 m.	1,272 m.	1,317 m.
France. <i>a.</i> (francs)	3,517 m.	5,545 m.	5,548 m.	5,548 m.
<i>b.</i> " "	—	69 m.	65 m.	83 m.
Greece. <i>a.</i> (drachmæ)	25 m.	64 m.	66 m.	77 m.
Hungary. <i>a.</i> (pengo)	—	39 m.	59 m.	169 m.
<i>b.</i> " "	—	149 m.	207 m.	117 m.
Italy. <i>a.</i> (lire)	1,493 m.	1,723 m.	1,726 m.	1,650 m.
<i>b.</i> " "	—	147 m.	182 m.	630 m.
Latvia. <i>a.</i> (lats)	—	24 m.	24 m.	24 m.
<i>b.</i> " "	—	60 m.	35 m.	35 m.
Lithuania. <i>a.</i> (litas)	—	31 m.	32 m.	31 m.
<i>b.</i> " "	—	62 m.	30 m.	37 m.
Norway. <i>a.</i> (kroner)	44 m.	147 m.	147 m.	147 m.
Holland. <i>a.</i> (gulden)	151 m.	505 m.	443 m.	414 m.
<i>b.</i> " "	14 m.	112 m.	247 m.	187 m.
Poland. <i>a.</i> (złote)	—	103 m.	134 m.	138 m.
<i>b.</i> " "	—	254 m.	(-3) m.	125 m.
Portugal. <i>a.</i> (escudos)	8 m.	9 m.	9 m.	9 m.
Rumania. <i>a.</i> (lei)	152 m.	248 m.	252 m.	257 m.
U.K. <i>a.</i> (pounds)	35 m.	129 m.	145 m.	151 m.
Russia. <i>a.</i> (roubles)	—	142 m.	182 m.	164 m.
<i>b.</i> " "	—	102 m.	51 m.	65 m.
Sweden. <i>a.</i> (kroner)	102 m.	237 m.	230 m.	224 m.
<i>b.</i> " "	122 m.	136 m.	202 m.	204 m.
Switzerland. <i>a.</i> (francs)	170 m.	506 m.	467 m.	472 m.
<i>b.</i> " "	—	47 m.	26 m.	35 m.
Czechoslovakia. <i>a.</i> (k.)	—	913 m.	916 m.	918 m.
<i>b.</i> " "	—	737 m.	1,199 m.	2,083 m.

(From League of Nations, *Monthly Bulletin of Statistics*.)

APPENDIX II

INDEX NUMBER OF PRICES (Wholesale).

(Monthly Averages.)

	1913.	1920.	1924.	1926.	1927 (June).
United Kingdom *	100	307	166	148	142
United States †	100	226	150	151	144
France ‡	100	509	488	703	622
Italy §	100	624	585	708	568
Germany	100	1,486	137	134	138
Holland	100	292	156	145	149
Denmark ¶	100	341	234	141	142
Spain	100	221	183	181	171
Finland	100	1,183	1,100	1,088	1,102
Norway	100	—	267	198	166
Poland	100	—	110	181	206
Russia **	100	—	172	177	173
Sweden	100	359	162	149	146
Switzerland	100	—	175	147	147
Czechoslovakia	100	—	997	954	992

(From League of Nations, *Monthly Bulletin of Statistics*.)

* Board of Trade.

† Official.

‡ Official: New Series from 1924.

** End of year.

† Bureau of Labour.

§ Bacchi.

¶ Finanstidende.

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