

THIS MONEY BUSINESS

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*A Simple Account of the Institutions and Working of the
Banking and Financial World*

By

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CHAPTER I

THE GOLD STANDARD

THIS book does not deal with the theory of money. For those who wish to pursue that study excellent text-books are available. Our object is to describe the machinery of banking and finance and to show how the machine works.

The evidence heard by the Macmillan Committee on Finance and Industry has been published in two expensive volumes which contain over one million words. This wealth of information has been largely drawn upon in an attempt to describe the machine so that it may be understood even by readers who have no previous knowledge of the subject.

The Great War which commenced in 1914 was the cause of various alterations in the monetary system of the United Kingdom, and it is, therefore, necessary to consider what that system was before the War, and what alterations took place at the outbreak of and during the War, and subsequent changes which were made in the system by certain laws passed by Parliament. These laws were the Gold Standard Act of 1925, the Currency and Bank Notes Act of 1928, and the Gold Standard Amendment Act of 1931.

Before the War, Scotland, Ireland and the Isle of Man had £1 notes, but England had no notes under £5. The people carried in their pockets sovereigns and half sovereigns, which were gold coins of £1 and 10s. The Bank of England always kept a certain amount of gold, and a lesser quantity was held in the tills and vaults of the deposit banks such as the Midland Bank. By far the largest amount of gold, however, was carried about in the pockets of the people for their daily use, and, of course, a considerable amount was in the tills of the shops and offices for the requirements of their businesses.

There were, and are, notes issued by the Bank of England in various amounts up to £1,000 each; £5 and £10 notes are used by people who wish to carry a fairly considerable sum of money, but do not wish to bulge their pockets out with £1 notes. The notes of higher values, or as we say of higher denominations, of £100 to £1,000, are mainly used nowadays for paying for purchases of land, houses, etc., but to a less extent than formerly.

When one person wished to pay another a debt, he could always offer to his creditor Bank of England notes, and the creditor was bound to accept them. This is what we mean when we say that Bank of England notes are "legal tender" in the United Kingdom. There was, however, one place where, before 1914, these notes were not "legal tender" and that was at the Bank of England itself, which institution had always to pay gold sovereigns in exchange for its notes if asked to do so.

In these days, however, all bank-notes, including 10s. and £1 notes, are legal tender even at the Bank of England. Silver coins are legal tender up to £2 and copper coins up to 1s. As formerly bank-notes were not legal tender at the Bank of England, it was necessary that the Bank should always hold a stock of sovereigns, or gold which could be coined into sovereigns, sufficient to give such coins in exchange for bank-notes when so requested by any member of the public.

In practice, of course, it could never happen that all the notes were presented on the same day for payment in gold, but according to law the Bank was obliged to keep gold for every note issued with the exception of bank-notes to the value of £19,750,000. The notes issued against this £19,750,000 were represented not by gold, but partly by a debt owing by the British Government to the Bank and partly by Government securities held by the Bank.

The debt dated from the formation of the Bank of England in 1694. The note issue against £19,750,000 was called the Fiduciary Issue because it was backed by the faith of the British Government, and the word

“fiduciary” is derived from the Latin word meaning “faith”.

About every ten years during the 19th century there was a financial crisis, very often a financial panic, and people hastened to the banks to take their money out with the idea of hoarding it, fearing that the banks were not sound. The consequence was that the banks had not enough notes or gold to pay their depositors, and had to go to the Bank of England and ask them for more bank-notes or gold. But there was never enough gold or bank-notes, either in the Bank of England or in the other banks, to pay off the deposits which were in the banks, no more than there is to-day, because deposits are not all made by paying in notes, they are very largely made by paying in cheques and there was no obligation on the part of the Bank of England to keep gold against the deposits of the banks. In such moments of panic, therefore, there was a shortage of notes, so the banks went to the Bank of England, which could not, however, issue any more notes according to law beyond the £19,750,000 fiduciary issue. The Governor of the Bank of England then went to the Chancellor of the Exchequer and the Prime Minister, and told them his troubles, and the Chancellor of the Exchequer, with the knowledge of the Prime Minister, wrote a letter (known as the “Chancellor’s Letter”) to the Governor of the Bank of England, promising him that if he would break the law and issue more notes without having gold behind them the Government would ask Parliament to pass an Act indemnifying the Bank of England for the breach of the law. All that the people wanted, however, was money in some form or other. On the two or three occasions when the Chancellor’s Letter was used (except in the panic of 1857), the mere fact that the public were told that the Governor had received the Chancellor’s Letter was sufficient to allay the panic, and they paid back their notes and gold into their different banks. In 1857 it did not allay the panic, and a certain number of notes were actually printed.

All credit is based on confidence. If we obtain credit

from our tailor or from our doctor, it is because they have confidence that we will pay them at some future date. As the Chancellor's Letter restored confidence, people were once more willing to give credit to the banks, which, of course, everyone does when he puts money into the bank.

It was not only an Englishman who had the right to receive gold at the Bank of England in exchange for his bank-notes; any foreigner who was owed money by an Englishman and was paid a cheque in settlement of his account, could go to the bank, cash his cheque, and the bank had, of course, the option of paying him the money either in gold or in Bank of England notes. If the bank paid the foreigner in notes all he had to do was to go to the Bank of England and ask for gold, and ship the gold to his own country. That was one of the chief reasons why London was the money market of the world, because there was no other country where it was as easy to get gold in exchange for the bank-notes, and to export it. We were never frightened in those days of too much gold going out of the country, because, as we had a very large export trade, we had considerable sums owing to us for this, for freight earned by our shipping and for interest on all our foreign investments (money invested in different countries all over the world); that is, the world always owed us more on balance than we owed the world, so that when we had parted with a certain amount of gold we knew we could very soon get it back again by asking some of the people who owed us money to pay us, which meant that gold began coming back into the country.

The first thing that happened when the War broke out was that there was a panic, and many people wanted to draw their money out of the banks at the same time and to hoard it; so that it became necessary for the Bank of England to issue more notes to the banks to enable them to pay their depositors. But on this occasion the Government foresaw that it would require to get all the gold out of the pockets of the people into the Bank of England, as centralizing it would increase the strength of

the nation during the War, when it had to buy armaments and food from other countries. It also foresaw that as it would have to buy many things, prices would rise, and as prices rose, more money in the shape of notes would be required in the country, so that instead of issuing the Chancellor's Letter, as it had done on previous occasions, the Government determined to print and issue notes itself. These notes were known sometimes as Currency Notes, sometimes as Treasury Notes, and sometimes as "Bradburys." The Government issued these notes, and promised to pay gold against them; but practically no gold was ever paid against any notes during the War, as the Government let it be known that it would be unpatriotic to ask for gold and therefore it was not demanded, and the gold gradually came out of the pockets of the people and went into the Bank of England, where it has remained ever since. The people of this country settled down to conduct their business with bits of paper, as they do to-day, instead of with gold. The system works perfectly well, and there will never be a return to the wasteful system of gold currency in this country.

After the Armistice in 1918 there was an embargo placed on the export of gold. No gold was allowed to leave the country, and that position remained until 1925, when the Gold Standard Act was introduced. The Gold Standard Act of 1925 did not restore the gold standard as we knew it before the War, in fact it took away from the people the right to exchange their bank-notes and their Treasury notes for golden sovereigns. This did not inconvenience them, as they were so accustomed to the use of notes. Theoretically, up to that time the Bank and the Treasury were obliged to pay gold if asked for it. The Gold Standard Act, 1925, took away that right and obliged the Bank of England to give gold in bars only, in exchange for bank-notes and Treasury notes in quantities of not less than four hundred ounces fine, that is 24 carat, and at the price of £3 17s. 10½d. a standard ounce, that is 22 carat, a price equivalent to the value of the weight of gold

in a sovereign. One could not, therefore, demand coin, and four hundred ounces of gold were not convenient except for shipping in payments of foreign debts; and the circulation of gold in this country never returned. The name of the standard was suitably altered. Before the War we said that we lived under the "gold standard", but after the Act of 1925 it was only gold bullion which could be obtained in exchange for notes, and therefore it was known as the "gold bullion standard" instead of the vaguer term "gold standard".

There were two sorts of notes, the Bank of England notes of £5 and larger amounts, and the Treasury notes of £1 and 10s. In 1928 the Government came to the conclusion that the time had arrived when Treasury notes should be withdrawn and replaced by Bank of England notes, so that the whole of the note issue of the country should be under the control of the Bank of England. The Currency and Bank Notes Act, 1928, was therefore passed. The Government issue of Treasury notes at that time—during the War it was larger—was about £240,000,000, and there was only about £28,000,000 in gold held against that issue. It was thus almost entirely a fiduciary issue, not backed by gold but by the Government's own securities. Besides this fiduciary issue of £240,000,000 there was the other fiduciary issue of £19,750,000 of the Bank of England, so there was, in addition to the bank-notes that were issued against gold, about £260,000,000 fiduciary issue.

In the Act of 1928 the Government arranged to hand over all the Government securities which it held against its note issue (i.e. the Treasury note issue) to the Bank of England, and against these Government securities the Bank was to issue Bank of England notes of 10s. and £1 instead of the Treasury notes. These are the present notes which we now carry in our pockets.

Of course, on these Government securities there was interest being earned. So long as the Government held them as it did previous to 1928, the interest came out of one pocket and went into another; that is, the interest was

paid by one Government department, namely the Exchequer, to another which was responsible for the Treasury note issue; but under the new arrangement, the interest would have gone to the Bank of England. As the Bank of England pays no interest on notes, it would thus have reaped an enormous profit in obtaining control of these £240,000,000 because it would have received the interest the Government would have to pay on the securities for this amount which the Bank would hold henceforth. But the bargain was made that the Bank, after it had deducted all the expenses of managing its note issue, should hand over to the Government all the profit which accrued from this interest, and this arrangement still exists to-day.

Furthermore, various provisions of considerable importance were made. For example, if the Bank of England found that more bank-notes were required, due to the amount of trade being done, or because of the population increasing and so on, it could then go to the Treasury and obtain the Government's permission to increase the fiduciary issue for a fixed amount to be used for periods of six months, provided that if such increases ran to two years the consent of Parliament had to be obtained. It was very clearly laid down at that time that the Bank of England's right was not meant to be a substitute for the former Chancellor's Letter (which was only used in moments of crisis), but was to be used at any time that the Governor of the Bank of England thought the interests of trade demanded it.

When the Currency and Bank Note Act of 1928 was debated, the questions centred mainly round Clause 8 of the Act which fixed the fiduciary issue. The Labour Party particularly tried to induce the Government to increase the fiduciary issue by £15,000,000, and before we left the gold standard in 1931 it was found desirable to make this increase. The fear in their minds and in the minds of many other members, of different parties, who understood the question, was not that the fiduciary issue was too small to meet the requirements of that particular time,

but that the Bank of England would not use their powers to increase it except in moments of grave crisis, at times corresponding to those which before the War would have necessitated the "Chancellor's Letter." It was also felt that there was not sufficient provision for an increase of currency necessary to meet an expansion of trade, due either to a growth of population, or production, or for emergencies such as the heavy withdrawal of foreign money from London necessitating a shipment of gold.

The Government met this criticism by a most categorical statement given in Parliament by Sir L. Worthington-Evans, Financial Secretary to the Treasury, who, after consultation with the Governor of the Bank of England, said: "Clause 8 of the Bill makes a statutory provision intended to be used not reluctantly and with hesitation in time of crisis, but whenever the Governor of the Bank feels that the present limit of the fiduciary issue is unduly restricted. . . . We are replacing an illegality by a legal power intended to be used, not in a crisis, but before the crisis arises. I do not pretend to be able to forecast every contingency which may cause the Governor of the Bank to make the application . . . but let me examine some of the possible eventualities. . . . A new kind of emergency has become possible now that the foreign banks have adopted the practice of accumulating a large reserve of sterling bills. It is always possible that owing to a change in policy upon the part of these banks a large sum of gold might be withdrawn in a short time by a realization of these balances. . . . If the withdrawal of gold was insisted upon it might become necessary to extend the fiduciary issue and that would be an occasion which would justify the Governor of the Bank in asking for that expansion and the Treasury in granting it."

Precisely this contingency arose in 1931, and on a former occasion when a big withdrawal of gold seemed to be imminent, all preparations were made with the Treasury for granting the permission, but the withdrawal of gold did not eventuate and the fiduciary issue was not increased.

Another contingency mentioned by Sir L. Worthington-Evans was that if the central banks were to absorb gold without regard to each other's actions, they would find themselves competing for a limited supply; and a rise in the value of gold or, in other words, a fall in the price level calculated in any gold currency, would inevitably ensue. He added, "Should the Bank of England find that owing to a world demand for gold, credit would be unduly restricted, not as a check on speculation, but to the injury of legitimate requirements, then the Bank can request the Treasury to extend the fiduciary issue and so free gold in the hands of the Bank for further credit operation."

Since then the position has been that America and France have acquired about two-thirds of all the gold in the world, but although many people think that the result of this has caused an undue restriction of credit, it is apparent from the evidence given by the Governor of the Bank of England before the Macmillan Committee that he did not share that view, and, although there was a great fall in prices, the fiduciary issue was not increased.

This state of affairs lasted nearly until September 18th of 1931, when we went off the gold standard. What actually happened was that the banks and financial houses had lent considerable sums of money to Germany, Austria, Hungary, and other countries. Other foreign countries, such as France, Switzerland, Holland, and America had deposited large sums of money in London because at that time, and for some time prior to that, they could obtain a higher rate of interest there than in Paris and Amsterdam or in America, so that a very large amount of foreign money was on deposit in London. As illustrative of what we mean by a "foreign deposit" let us suppose we go for a holiday to Boulogne and take a book of Cook's cheques with us with which we pay our hotel bill. The hotel-keeper will send these cheques to his agent in London to be paid by Cooks, and if the hotel-keeper then puts the money into the Midland Bank to be kept for him, that transaction would constitute a French deposit in London.

This is not, of course, the method by which the great bulk of foreign deposits come to London, but the means by which this is done will be described later.

It became obvious in July 1931, when there was a big bank failure in Austria which reacted on Germany, Austria, and Hungary, that the borrowers in those countries who owed money to foreign and English financial houses could not pay their debts, or at all events could not pay for some time. That caused a universal panic, and the consequence of this panic was that American, French, Dutch, and Swiss banks and financial houses all demanded their money from London at the same time, while we could not get any of our money from Germany, Austria, Hungary, and the other countries. We paid America, France, etc. as much money as we could, and shipped more and more gold until it became quite evident that, if we shipped all the gold that was in the Bank of England, there still would not be enough to pay the money owed by us to foreigners. At that moment, therefore, the Government decided that we must go off the gold standard.

Going off the gold standard was a very simple matter. It meant that the Bank of England need not sell gold at £3 17s. 10½d. per ounce; in fact, Parliament cancelled the obligation of the Bank to sell gold at all. Consequently, if there were any foreigners who had a cheque on the Midland Bank, for instance, they received notes in payment for it; it was useless for them to demand payment in gold from the Bank of England because it had been released from that obligation. People abroad who had pounds sterling, therefore, wanted to sell them for francs and dollars, as these latter were still exchangeable for gold, and as consequently there were more sellers than buyers of pounds, the price of the pound in terms of gold currencies declined, as would the price of any commodity for which there were more sellers than buyers. That is why the pound fell when we went off the gold standard.

CHAPTER II

BILLS OF EXCHANGE AND ACCEPTING HOUSES

WE have discussed the gold standard and found that before the War there were gold coins in circulation in the country, and in 1925 the right to demand gold coins against notes was taken away from the public. From that time there was an obligation imposed on the Bank of England to sell *standard* gold, i.e. 11/12th fine, at £3 17s. 10½d. per ounce only in bars containing not less than 400 ounces of *fine* gold. That obligation lapsed when we went off the gold standard. What was the good of having gold before that took place if it could only be obtained in these large quantities? This question brings us to the working of international trade, some idea of which is absolutely essential to any understanding of our monetary system and of our monetary problems.

We do not use gold to buy our imports because obviously there is not nearly enough. Payment is worked on the same principle as two friends going on a walking tour. Let us suppose that one week A has paid 17s. 6d. for B's share of the food and B has paid 14s. for A's share of lodgings. Then B does not pay A 17s. 6d. and A pay B 14s., but they calculate the difference and strike a balance and B merely pays 3s. 6d. to A. That is what happens in international trade: against the value of all the goods exported, all the services rendered to foreign countries, and all the money which is due for interest on foreign investments we set the value of all the goods which have been bought, of all the value of the services which foreign countries have rendered us, and any money due to foreign countries for interest on investments in this country. The amounts owing by England to foreign countries or by foreign countries to England are not actually added up

by the different banks, but the operations which they are continually conducting between themselves have the same effect. To settle the balance, one of two things must be done; either it must remain owing for some time until wiped out by future transactions, or it must be regulated by shipments of gold, and it was for this purpose that gold was used before the gold standard was abandoned. Obviously it was the only way in which the balance could be regulated. Let us narrow it down to two countries, America and England, trading with each other. Suppose that America buys £1,000 worth of goods and England buys a corresponding amount in dollars worth of goods in America, and the two transactions pass through the banks. In that case as each debt cancels the other out, no money need pass between the countries. But if the Americans had sold to the English people, say £1,100 worth of goods at the ruling rate of exchange, and the English people had sold only £1,000 worth, then there would be owing to America the equivalent of £100. There would be no point in sending them £100 because they do not use pound notes in America; but if gold were sent, they could go to a Federal Reserve Bank in America with the gold and demand dollar notes in exchange for it, and in this way they would have been paid the balance.

Take a specific case: Supposing there is in America a cotton merchant, Hiram J. Hocking, and he sells to John Smith & Co. in Liverpool 4,866 dollars' worth of cotton, which was equivalent to £1,000 before Great Britain went off the gold standard, because \$4.86 bought exactly the same amount of gold as £1 sterling bought. A firm in Bradford, Robinson & Co., sells to Silas J. Lawson in New York £1,000 worth of woollen goods; all that need happen is that J. Smith of Liverpool pays Robinson & Co. of Bradford; and Silas J. Lawson pays H. J. Hocking of New York through the medium of their respective banks, and without the exchange of any money between the two countries. But directly you have any one of these parties between America and England owing, for example, £100 or possibly \$1,000 more than the other parties, that

balance must be either paid in gold or remain owing until the balance falls the other way. If we sold to America \$1,000 worth of goods more than America sold to us in £'s, we should say the balance of trade was against her; and if America sold us more than we sold to her, we should say the balance of trade was in her favour.

People in discussion are apt to confuse the terms and they sometimes talk about the balance of trade when they mean more than that, namely, the balance of international payments. There are other things besides exchange of commodities with other nations which must be taken into consideration when using the term balance of international payments. For example, we carry our own goods and those of different countries in our ships to all parts of the world and earn money for freights. Americans come over here and spend a great deal of money in London, more, in fact, than our travellers spend in the United States. We have large foreign investments all over the world, for which interest and dividends are due to us. All these form what we call our "invisible exports." In exactly the same way moneys that we pay for similar purposes are called "invisible imports." If we add all that is paid to us for goods and services, and for interest on investments, and take from it the amount of money that we pay the rest of the world for goods and for services, the balance, which, as already pointed out, some people call the "balance of trade," is more properly called the Balance of International Payments.

There is one other point; why was the exchange between New York and London \$4.86 to the £, or the French exchange 125 francs to the £, or the German exchange 20.40 marks to the £? It was because these are the sums with which people in all these countries could have bought exactly the same quantity of gold as a £ would have bought before we went off the gold standard, and this fact fixed the exchange as long as the countries were on the gold standard.

Having dealt with the gold standard, and having discussed how the Bank of England was responsible for the

issue of all bank-notes, it would perhaps appear natural that the next step should be to describe the other banks in the country and then the Bank of England, what it does and how it does it. A difficulty in taking that sequence is that it necessitates referring to Bills of Exchange, the famous "Bill on London," the Discount Market, and Accepting House and Acceptances. We will discuss these first as it is essential to understand what they all mean and what functions are performed by them so that we may comprehend the working of the banks and the Bank of England.

A bill of exchange is, in a manner of speaking, a glorified cheque; in fact, a cheque is really a bill of exchange, but it is not generally called this because it has one typical difference from the ordinary bill of exchange, and that is that a cheque is an order signed by one person or a firm on a bank, ordering the bank to pay a certain sum of money to a third person on demand. When we talk about "drawing" a bill or a cheque, all that is meant is writing an order for the payment of a certain sum of money; a bill of exchange is an order by one person or a firm drawn on a bank or on another firm, instructing them to pay a certain sum of money to a third party or to the drawer, but as a rule not on demand but at some future date, it may be thirty days after the date on which the bill is drawn, or sixty days, or ninety days, or longer, but in practice not longer than six months. In some cases it may be what is called thirty days, sixty days, or ninety days "sight". What is called a "sight bill" is a bill drawn and payable at, for example, sixty days after the man who has to pay it has seen it. Of course, if the bill is drawn on London from Manchester this makes little difference, because the man will see it the next day; but if the bill is drawn on China and it takes a month to get there, it makes an enormous difference to the man who has to pay it, whether he has to pay it thirty days after it was drawn or thirty days after sight.

The famous Bill on London is nothing but a name for bills of exchange drawn on someone in London, and

it is not because of any insular pride on our part that it is called the famous Bill on London. It is so called because more bills are drawn by all sorts of people all over the world on firms and banks in London than on any other financial centre in the world. There are various reasons for this, amongst which are the following, namely, that the London market is more developed than foreign markets, and that this country was the first to adopt the gold standard, as it was also the first freely to exchange gold for notes.

It is very easy to draw a bill, but if a bill be drawn for three months on a Mr. Smith, say in New York, it is no good to the man who draws it, and who is called the "drawer", if he wants the money immediately instead of three months hence. In that case he must sell this bill to someone who will pay him cash, and will collect the money in three months from Mr. Smith. This person who pays the cash will wish to know whether Mr. Smith will pay the bill, so what is done is that the bill is sent to Mr. Smith, who writes across it the word "accepted", making it an "Accepted Bill" or an "Acceptance", which means that he undertakes to pay the bill in three months from the date on which it is drawn, and once having bound himself to pay, he cannot evade his obligation in the eyes of the law. If he owed money for any commodity, he might say the quality or weight, etc., was not correct, and refuse to pay and take the matter to court. If, however, he had "accepted" the bill of exchange he *must* pay it, and can fight his disputes out afterwards and, if he is right, get his money back from the person who drew the bill. This, of course, makes it perfectly safe, provided that he is good for the money, for any one to buy the bill. The buyer is further safeguarded, for if Mr. Smith does not pay it because he cannot, the person to whom it was sold can always come back on the drawer and demand payment. Therefore he has two people liable to him for the amount of the bill. These two facts make bills of exchange documents for which it is very easy to obtain money, provided that the people who have

accepted the bills of exchange are people of repute who are able to pay what they have promised.

Many bills are drawn on banks and accepted in the usual way, but there are also houses in London—and this is a peculiarity of London, because firms of this description hardly exist in any other centre of the world—Merchant Bankers or Accepting Houses, whose business it is to accept bills for other people and earn a commission by doing so. These accepting houses, in order to maintain their credit, limit the amount of bills for which they are liable at any one time, to about three or four times the amount of their capital. As it has happened at various periods they have had more business offered to them than they were able to accept, unless they broke their rule, therefore, the deposit banks have gradually undertaken more acceptance business, than was the case in former years, in order to fill the void.

Sir Robert Kindersley, a director of Lazard Bros. and Co., Ltd., one of the best known accepting houses, in giving evidence before the Macmillan Committee, described the origin of the London accepting houses. Practically all of them commenced as merchants trading with foreign countries, and most of them were founded by men of foreign origin, but to-day they are mainly of English nationality, and although some people think that they are still perhaps under foreign influence on account of the foreign names, this is not the case. It was largely through these merchants and their foreign connexions that England was able to take so large a share of the railway and other developments of the world. These accepting houses have connexions in all foreign countries, and, of course, agents who procure business for them. They rely on these agents and their knowledge of the people with whom they are dealing to ensure that undue risks are not being taken.

As these merchant bankers or accepting houses are firms of world-wide repute, it makes it very easy to sell bills drawn on them, and for this purpose the discount market exists. This market is described in the next chapter.

As an example of the need for the existence of the accept-

Bill
Stamp
27-

N^o 357

£ 200. 0. 0

Sterling

Manchester

11th February 1932

Three months after date payable to the order of ourselves

Two hundred pounds sterling

To Messrs. Thorne Smith & Co.,
Glasgow.

Accepted payable at
The National Bank of
Scotland, Glasgow
£200 0-0 Due May
14th 1932
Thorne Smith & Co

M 1000 M
K 10
E M

per s.s. Antenor

Ellis & Sons

12
ms
7-

No 357 £ 200. 0. 0 Sterling

Manchester

11th February 1932

Three months after date pay to the order of ourselves

Two hundred pounds sterling

Accepted payable at
The National Bank of
Scotland Glasgow
£200. 0. 0 Bank of
Glasgow
14th Feb
1932
Bank Smith & Co

M K
1000 10
E M

per s.s. Antenor

Ellis & Sons

To Messrs. Smith & Co.,
Glasgow.

ing houses, suppose a Mr. Brown bought £100 worth of goods, and the seller wanted his money at the time of sale, he could go to his bank, or to a class of person known as discount brokers, and ask them to buy a bill drawn on Mr. Brown, but they might refuse if they did not know Mr. Brown. The vendor would thus find it difficult to give his client three months' credit. Mr. Brown could, however, arrange with an "accepting house" to accept the bill for a commission, provided it was assured that Mr. Brown would pay the money before the bill became due.

That is the service which accepting houses perform for people all over the world, but in these transactions they do not part with any money at all. They only lend their good name, for, provided that the buyer to whom credit has been granted keeps to his undertaking to pay in three months, they have not to find any of their own money. They have simply substituted the credit of their name for the credit of the buyer's name, and for that service they have received a commission. The actual cash is found by the discount broker, or by a bank acting in the same capacity, who charges interest for the time elapsing between buying the bill and receiving the money from the acceptor when the bill falls due. The rate of interest charged is called the "discount rate".

There are numerous kinds of bills of exchange.* Take for example one form, a bill drawn by a firm called Ellis and Sons on Frank Smith and Co., Glasgow. Assume that it is dated 11th February, 1932, and it is for £200, and it reads as follows: "Three months after date pay to the order of ourselves £200." The words "two hundred pounds sterling value against 10 bales of cotton per S.S. *Antenor*" are put on the bill to show that it is a real transaction against goods. Then Frank Smith & Co., of Glasgow, write across the bill "Accepted. Payable at the National Bank of Scotland £200 on 14th May, 1932. (Signed) Frank Smith & Co." The National Bank of Scotland are Frank Smith's bankers. He does not want the bill to be brought to his own office for payment. "Pay

* Actual bill to be reproduced.

to the order of ourselves" simply means "pay to our order", so that when the bill is sold, say to Mr. Tom Robinson, all that has to be done is to write on the back of it "Pay to Mr. Tom Robinson", and then the man who has accepted the bill owes it to Tom Robinson. The fact that the bill is drawn to the "order of ourselves" enables the drawer of the bill to make up his mind at any time to whom he is going to sell it, and he then need only endorse it to that firm. If, when he drew the bill, he had already made up his mind that he was going to sell it, say to Tom Robinson, then he could equally well put in the name "Tom Robinson" instead of "ourselves". But this is not the general custom, as it restricts his liberty to deal with the bill.

Consider another bill drawn on John Brown & Co., Ltd., in Shanghai, for goods shipped to John Brown.* The bill is drawn at sixty days sight, so that John Brown has sixty days after he has seen the bill in Shanghai in which to pay it. It says: "Sixty days after sight pay this first of exchange, second unpaid." "Second unpaid" simply means there is a copy of this bill which is called a "Second", so that if the first gets lost in the post, the man presents the copy which orders the acceptor to pay the money on the bill, provided the original has not been paid. Another bill might be prepared in much the same way, but saying "Value in account. Charge the same to account as advised." All it means is that, instead of saying on the bill that this is against such and such goods, in such and such packages or ship, it is drawn against the general account which this man owes.

A third bill is drawn on Amsterdam, and contains the words "Exchange as per endorsement."* It is a bill for £300 drawn on Messrs. L. Simon & Co. in Amsterdam, who will possibly only have Dutch guilders. Ellis & Sons want pounds sterling, and will sell the bill to the Comptoir National d'Escompte de Paris, who will send it to their agents in Amsterdam for collection. When the Comptoir National buy the bill, they will endorse on the

* Actual bill to be reproduced.

Shang hai 07 C N^o —
Manchester. 11th February 1932

Sixty days
£ 854 19 7

after sight pay this first of Exchange second
impaid to the order of ourselves eight hundred and fifty four pounds
nineteen shillings and seven pence sterling with interest added thereto at seven per
cent per Annum from date hereof to approximate due date of remittance

Payable at the current drawing rate for Hong Kong Shanghai Banking Corporation's
Demand Bank Drafts at Shanghai on London Documents to be

given up to the drawee on payment of the bill. Value received against $\text{£} \frac{22}{10}$

To John Brown & Co

Shang hai
Ellis & Sons

per SS Kan Linn

Bill stamp
91

N^o 43

Shang hai D/E N^o 11
Sixty days after sight pay this first of Exchange second
£ 854 19 7 Manchester, 11 February 1932

paid to the order of Messrs. Messers. Eight hundred and fifty four pounds
interest added thereto at seven per
cent per annum from date hereof to approximate due date of remittance

Payable at the current drawing rate for Hong Kong Shanghai Banking Corporation's
Demand Bank Drafts at Shanghai on London Documents to be

given up to the drawer on payment of the bill. Value received against $\text{E } 22 \text{ S } / 10$
To John Brown & Co

Shang hai Ellis & Sons
Per S^r Rankin

Bill
Comp
9/1

7043

Bill
Stamp
3/-

Sterling
For £ 300. 0. 0

Manchester 11th February 1932

_____ ninety three days after date pay this first
of Exchange _____ to the order of ourselves
Three hundred pounds sterling. Exchange as per endorsement

Value in account and charge the same to account as advised.

To Messrs. L. Simon & Company

Ellis & Sons

Amsterdam

No. 358 A

BILLS OF EXCHANGE

19

back the rate of exchange of the day for a 90-day bill, and Messrs. L. Simon & Co. will then pay a number of guilders which, converted at this rate, will give £300.

Three days' delay is allowed after the due date in which bills of exchange may be paid. These are called "days of grace"

CHAPTER III

THE DISCOUNT MARKET

THE Discount Market in London has been in existence for about seventy years. Its sphere of usefulness is not limited to those mercantile holders of bills who wish to have them discounted, but extends also to the banks. The banks are always liable to have a large part of their deposits withdrawn on demand, and it is, therefore, essential that a considerable part of their money should be invested in such a manner that they can get hold of it at very short notice. When we come to deal with the banks we will describe how they invest all their funds, but here we are only concerned with the Discount Market, which enables the banks so to lend some of their money that they can get it back quickly in case of necessity.

Although the discount brokers buy a very large amount of bills, estimated in 1930 at more than £115,000,000 sterling held at one time, the thirty-two firms of discount brokers who do the business have only a capital of about £15,000,000 sterling. This they treat as margin, so in order to purchase bills they borrow their money, (largely from the banks). The banks lend the money to the Discount Market for periods of one to seven days, receiving bills as security. If they have no immediate need of the money, they will renew the loans for further periods. If one bank wants to be repaid say a quarter of a million pounds on any particular day by the Discount Market, it may be for one of two purposes. If it requires it to pay out to its depositors, or to lend money for overdrafts to traders, etc., the amount of money may simply be passing from the customer, say of the Midland Bank, to the customer of Barclays Bank, and so Barclays Bank would have the same amount to lend to the discount brokers that the Midland had withdrawn from them. The

discount brokers would soon discover this, and would borrow from Barclays Bank the money which they had had to pay back to the Midland. But supposing that the Midland Bank want the money to pay to their depositors, who require it to pay their income-tax, then it will find its way into the Bank of England for account of the Government, and there will be a delay before the Government spends it and before it comes back into the banks through the public. In this eventuality the discount brokers would have to pay back the quarter of a million mentioned, and possibly could not borrow from any one else except the Bank of England.

The Bank of England will always lend money against bills under certain conditions. One condition is that the Bank of England must have a 5 per cent margin, that is it can only advance £95 against a £100 bill. Moreover it will only discount bills at what is known as "Bank Rate", which is the minimum rate at which the Bank of England will discount, and is always above what is called the "open market rate", that is, the rate which the discount brokers charge. This means that the discount broker may have discounted the bill at the open market rate of 4 per cent per annum, so that he has given his customer £99 for the three months bill (4 per cent per annum being 1 per cent for three months). If he takes that bill to the Bank of England and the Bank Rate is 5 per cent per annum and he discounts it for the whole three months, he will only receive from the Bank of England £100 less a quarter of 5 per cent, that is £98 15s.; so that he loses 5s. on every £100 by the transaction, if he discounts bills which have three months yet to run. This latter is improbable, as he will select bills which fall due to be paid in two or three weeks.

The discount broker would also lose if the acceptor and the person who sold him the bill both went bankrupt, which, however, is not likely to occur.

Yet again there is another way in which the discount broker may lose. Suppose he buys a bill where the discount rate is 4 per cent, and after he has bought it

money becomes dearer, perhaps because the Bank Rate it put up to prevent gold leaving the country, and he has to pay more than 4 per cent for the money he borrows. He will lose, possibly, if money remains dear during the whole of the three months that the bill has to run, but he hopes that although he may have to pay a high rate for some days, there will be other times when the rate will be low, and that on the average he can borrow his money at a lower rate than that at which he has discounted the bill. Banks lend money to discount brokers at 1 per cent under Bank Rate and as we have seen, the open market rate is always below Bank Rate, so if Bank Rate is 5 per cent and the discount broker borrows from the banks at 4 per cent and the open market rate is $4\frac{1}{2}$ per cent, he will make a profit of $\frac{1}{2}$ per cent per annum, or 2s. 6d. for every £100 on a bill which has three months to run. He need not, however, always borrow from the banks because there are other lenders in the market, such as the accepting houses, big merchant houses, etc., and these people will usually lend to him at a rate which is somewhat cheaper than the rate at which he can borrow from the banks.

In former years the fact that we had all these accepting houses and discount houses in London, brought us, in one respect, more business than it does to-day. For instance, formerly a wheat merchant in the Argentine who wanted to ship a cargo of wheat which he had not sold, would send the ship to a port in England, where, in the early days, it was probably looked after by the accepting house or their agents. If, on arrival of the boat, the wheat was still unsold, the cargo would be landed and we should earn all the charges for warehousing the wheat, etc., and commission for selling it. Even if the cargo were not landed and the ship came to an English port merely for orders, we should still earn port dues, etc. Nowadays, thanks to wireless, this has all been changed, for if, while the boat is on the sea, the merchant in Argentine hears that the market in Genoa, maybe, is better than the market in London, all he has to do is to wireless to the boat in mid-ocean to pro-

ceed direct to Genoa. The bills against such cargoes, however, have probably been drawn on a London accepting house and discounted in that market.

There has been, too, a change of recent years to the detriment of the discount brokers, namely the growing tendency to send telegraphic transfers instead of buying a bill of exchange when people wish to send money from one part of the world to another. Instead of bills being drawn, the banks regulate transfers by telegraphing to their agents in the different countries, and thus all that is involved is a number of book-keeping entries by the different banks.

Every bill drawn on a London accepting house or bank is not necessarily discounted in London. Supposing, for instance, that a firm of cotton merchants in Liverpool want to import £5,000 of cotton from New York, it would go to Rothschilds or some other firm, and say, "We want you to open a credit for £5,000 against shipment of cotton, in favour of our friend Silas J. Hocking in New York, who is selling cotton to us." Silas J. Hocking in New York then ships this cotton, gets his bill of lading (i.e. receipt from the ship for the goods), insures the goods with an insurance company, and draws the bill on Rothschilds for £5,000. He takes this bill, together with the bill of lading and the insurance policy, to his banker in New York and says, "We want you to pay us in dollars the equivalent of this £5,000; here is the letter of credit from Rothschilds undertaking to accept this bill when it reaches London." If the banker is quite satisfied that everything is in order, he will pay the firm the equivalent in dollars of £5,000 and then send the bill to his branch or some other bank which acts as his agent in London, to be presented to Rothschilds for "acceptance". When Rothschilds have accepted the bill, the agents may, if the New York bank needs the money immediately, take the bill to a discount broker who will discount it, and the agents can then remit the money to the banker in New York. If they did not want the money at the moment, they would not discount the bill. If they discounted the

bill in London, the cotton would be financed by English money; if they did not discount the bill, it would be financed by American money. If the bill is discounted in London, the result of the transaction is that the man in New York has been paid cash by the bank in New York, the bank have received their money back from London, the cotton merchant in Liverpool has only to find the money at the end of three months, and the money in the meantime is found by the discount broker in London. When the bill becomes due, the discount broker will present it to Messrs. Rothschilds, who will pay the bill and who should by this time have received the money for the cotton from the Liverpool merchant; but whether they have or have not received it, they are still obliged to pay the bill to the discount broker.

An instance of another kind of transaction is the following. A coffee merchant in Brazil sends coffee to a firm in Hamburg, and wants his money immediately the coffee is shipped. He cannot sell a bill on the firm in Hamburg to the bank in Brazil, because the bank does not know the firm in Hamburg. He goes, therefore, to an accepting house in London, because nowhere in the world is "acceptance" business so fully developed as it is in London, and says: "I want you to open a credit for me for coffee which is going to be shipped from Brazil to Hamburg. I will sell it in Hamburg, and when I have sold it, I will send the money to you in time to pay the bill which you have accepted."

In some cases the foreigner is not in touch with London financiers, and therefore the accepting houses and also to a great extent the banks, do a business which is a variation of the one just described. Instead of being in touch directly with the man who draws the bill on them, they work through a Continental bank. For instance, a London accepting house will place a credit for say, half a million pounds at the disposal of a Continental bank, so that its customers can draw on them against this credit. These credits are known as reimbursement credits, and the Continental banks guarantee the English accepting houses.

Since this business was thought to be very safe, it was done for a small commission, as low as $\frac{1}{2}$ per cent per annum, or 2s. 6d. for every £100 for a three months bill, whereas the ordinary commission is 1 to $1\frac{1}{2}$ per cent per annum. Unfortunately, it has been proved that this business is not as safe as was thought; in fact, these reimbursement credits led, to a great extent, to the present financial trouble with Germany in 1931, where two of the largest banks to whom reimbursement credit had been granted became involved in difficulties. In order to meet the situation, the "standstill agreement" was arranged, by which these people, instead of having to pay in three months, were allowed an extension by the London and foreign bankers, who said, "If you cannot pay in three months, we shall have to wait six months, or a year, until you can pay." In the meantime of course the discount brokers and banks in London found the money.

Although credit may be granted to foreigners it does not follow that English money is being used to finance foreign trade, because as a rule the accepting houses have as much foreign money deposited with them as the amount of bills which they accept against such credits. But naturally the foreign money deposited with them does not necessarily belong to the people for whom they have accepted the bills.

The acceptance of so many foreign bills has helped to make London the financial centre of the world, and, apart from the commissions earned on these foreign acceptances, a further benefit has accrued in the form of increased business with consequent earnings in brokerage, warehousing, transport, etc.

The other main centres for this accepting business are New York, Paris, and Amsterdam, which is a very small market.

London is the best market for this reason among others, that, alongside the accepting business, there is a fully developed discount market. It is obvious that there is a great advantage in being able to get your accepted bill, take it across the street and have it discounted. The discount market in New York is developing, and is gradually

becoming competitive with London and will, no doubt, continue to grow. But Paris, like Amsterdam, is a small discount market which very soon gets filled up. Of course, a handicap to New York is its distance from Europe; it takes so much longer to send a bill, say from Germany to New York, and have it returned accepted than it does to send it to London. The holder of the bill will naturally prefer to discount it in the cheaper market, when New York is the cheaper market the drawback of distance is overcome. The French suffer on account of the smallness of their discount market, they have no discount houses and all the business is done with the banks, who, as they will only take a small amount on each accepting house, very soon reach the limit of their capacity. Another disadvantage is the cost of the Government stamp which has to be put on the bill and is 3s. for every £100 as against 1s. in London.

The amount of acceptance business done in London is very large. It has been estimated that between £230,000,000 and £250,000,000 was outstanding at one time in 1930 and this was probably considerably lower than in preceding years owing to the fall in prices; because naturally if the price of wheat, cotton, sugar, rubber, etc., is low the total amount of the bills drawn against them is also reduced.

There was at one time a class of bill which has very largely gone out of fashion, namely the internal bill. Formerly if a firm of manufacturers or merchants sold goods to a house in London and the house wanted credit, the seller used to draw a three months' or six months' bill on the London buyer. This was called an internal bill, but such bills have fallen into disuse because the buying firms now are more in the habit of paying cash for their goods taking loans from the bank for this purpose. In the evidence given before the Macmillan Committee it was said that the banks deplored the disappearance of these internal bills. There still exist, however, certain types of internal bills; for instance, there are bills for financing the making of beet sugar. When the crop is

gathered it has to be treated, material has to be paid for, and it takes some time to market the sugar. In the interval the accepting house furnishes the necessary credit by accepting bills, and by the time these bills become due, the sugar will have been made into crystals and sold, and the acceptors will be paid in time to meet their bills.

There are also discounted in the London market, bills for shipbuilding. The builders naturally want money from time to time to pay for labour and materials, and as the building of the ship proceeds bills are drawn on the purchasers of the boat.

Bills serve all sorts of purposes for all kinds of trade. Various interesting examples were given in evidence before the Macmillan Committee. For instance, a bill may be drawn for the import of raw cotton into this country from America; or for the import of hemp; or hides; or food; that is to say bills drawn for commodities for use in this country. Bills are drawn for imported sundries, such as castor oil, peppermint oil, menthol crystals and other commodities. A bill may be drawn in Japan, on an Australian Bank in London, for goods supplied to Australia, or, for Hessian cloth from Calcutta to New York, but in either case the goods never come to England at all. Export bills also are used for similar credit transactions; for textiles, coal, iron and steel manufactures, machinery, etc., sold by our manufacturers to customers abroad.

“Anticipatory bills” are also discounted in London. They are drawn, for example, by Finland for timber. The timber is felled in the north, money is needed to pay for the labour, and the wood cannot be exported because the northern seas are frozen. An accepting house, therefore, probably guaranteed by some foreign bank, accepts a bill for the value of the timber, and when the northern seas thaw, the timber comes down, is sold locally or sent to some firm in London who sells it for account of the Finnish firms and pays the accepting house. In the meantime the people in Finland have been paid months before the timber was actually received in London.

Bills are also drawn by the Metropolitan Water Board,

the Port of London Authority and similar public bodies. They require money, perhaps at a time when it is not suitable to make a loan extending over a series of years. To carry them over, they issue bills which are discounted in the London Market.

Finally there are bills which are of enormous importance, namely three-month Treasury Bills, which form part of the National Debt and are issued weekly by the British Government. These are payable at the Bank of England for money which the Government borrows and which it pays off as they fall due, issuing at the same time other bills according to its requirements. The amount of these bills varies, but in February 1933 it was £833,000,000, about one-ninth of the National Debt. The bills are sold to the Bank of England, the banks, discount brokers, big insurance companies, merchant bankers, etc., and also to foreign banks and finance houses who wish to have money in London which is always falling due; for the bills which they hold will be paid off each week, and if they want the money they are under no obligation to replace them.

The Government finds it convenient to borrow a certain amount of money in this manner rather than to issue a loan payable many years hence, because in the former way they get their money, on the average, at a cheaper rate. It is also convenient for the banks and discount brokers to buy these bills, because they then have so many more bills in the market on which they can make a profit; besides which it provides the banks with a means of investment which is liquid for part of their funds, that is to say the money is always being paid back to them at regular intervals on which they can rely.

In countries with an undeveloped banking system, bills are often passed from hand to hand between traders as a means of payment. The following is an account of an actual transaction of this nature. A firm in Manchester were the agents of a Persian who owned a mine of red oxide of iron, which was largely used in this country for painting ships' bottoms. The mine-owner shipped cargoes

to England, and drew bills on the Manchester firm for the value of the oxide. The Manchester firm also had a business of selling bleached cotton goods to a firm in Bombay. After a time the firm in Bombay began to pay the Manchester firm by sending the bills drawn on the latter by the Persian mine-owner. This aroused their curiosity and they wrote and asked their Bombay friends how these bills came into their possession. The reply was that the bleached cotton goods were re-exported to Persia, and sold to a man who also imported tea. The latter sold his tea to the mine-owner who also did business in tea, and who paid the Persian importer for the tea which he bought from him, by handing him an equivalent amount of bills drawn on the Manchester firm. The importer of the bleached cotton goods into Persia, in his turn, used them to pay the Bombay merchant, and the Bombay merchant sent them to Manchester in settlement of his indebtedness. Thus four transactions were liquidated in the Manchester office, without the intermediary of any bank, and without the exchange of any money, except small amounts necessary to settle balances.

CHAPTER IV

ISSUING HOUSES

DISCOUNTING of bills is a method of finding money for short periods, but there exists also in London the organization necessary to provide loans for long periods, namely loans repayable only after the lapse of years. The houses which do this business are called "Issuing Houses" and they often are the same firms as the merchant banks and accepting houses. For instance, houses like Rothschilds and Barings are accepting houses and also issuing houses, but chiefly for foreign loans. Issuing a loan simply means this: if the City of Manchester, for example, wanted to borrow money in order to build an underground railway, it would go to a house like Rothschilds, or Barings, and state that it required a loan of say £2,000,000 and would ask at what rate of interest it could be put on the market. The reply probably might be $4\frac{3}{4}$ per cent. If the City agreed to this, they would ask Rothschilds to arrange the loan. It would undertake to repay the loan after a certain term of years, and in the meantime it would pay $4\frac{3}{4}$ per cent interest and Rothschilds would obtain the money, for which service they would receive a commission.

In order to ensure that Manchester would obtain the money even if it were to happen that the public might not be willing to subscribe, the issuing house would make arrangements for the loan to be underwritten, that is to say, it would be arranged with certain people, that for a commission, they would undertake to buy these bonds, should they not be bought by the public. If the public did not apply for the whole of this loan the underwriters would be obliged to provide the balance. They would keep the remainder of the bonds in their safes until times were better, but gradually would sell them to the

public. Rothschilds and Barings and other issuing houses, as a rule, deal only with bonds on which the rate of interest is fixed. Preference and ordinary shares are dealt with by rather different classes of houses which are known as brokers or finance houses, and they are not generally marketed by these big issuing houses.

A prospectus in a newspaper will often state in rather large type "Subscriptions will be received by the Midland Bank or by Lloyds Bank." This does not imply that banks have examined the prospectus, or that they recommend it, but merely that they will receive the subscriptions; but if Baring Bros. or one of the other great issuing houses are making an issue, for example, on behalf of the Manchester Corporation or on behalf of the city of Madrid, such houses do examine the proposal, and the association of their name with the prospectus shows that they recommend the investment. These big accepting houses of repute do not guarantee the loan, but they certainly look after the public interests, and only put a loan on the market if they believe it to be a sound proposition.

The Macmillan Committee was somewhat uneasy about prospectuses which stated in heavy type "subscriptions will be received by the — Bank," etc., because they thought the public was deceived to some extent and induced to put money into companies on the faith of the names of these great banks, for which they would not otherwise have subscribed. The Committee pointed out that of two hundred and eighty-four companies floated in 1928 (not by the big issuing houses) for £117,000,000, seventy had already been wound up by 1931, and the shares of thirty-six others were valueless. These one hundred and six companies were floated for £20,000,000, and the whole of the £117,000,000 which the public had subscribed in 1928 had, in 1931, a market value of only £66,000,000. In fact, many of the issues were made at a premium, i.e. at a price above their nominal value, so that the loss to the public was even greater than that figure. Professor Clay in 1932 pointed out in a paper read before the Manchester Statistical Society that the years 1928-31 referred to by

the Macmillan Committee, were exceptionally bad years, and if other periods were taken the result would be much better.

It is estimated that the savings of the public in this country amount annually to about £500,000,000. What becomes of them? They are invested. But although John Smith may invest by buying some securities on the Stock Exchange, this obviously does not mean that his savings have found their ultimate home in the securities which he has bought. The Stock Exchange is what the name implies, that is to say, it is a place where stocks and shares can be exchanged. The purchase by John Smith naturally entails a sale by somebody else. Governments, municipalities, and industrial undertakings are constantly seeking new capital both at home and abroad, and it is by this demand that the annual savings of the country are absorbed: the chief financial houses which obtain the public's money for this purpose being the "issuing houses".

The most important issuing houses for foreign issues, such as Rothschilds, Morgans, Barings, Schroeders, Hambro's Bank and Lazards, are also accepting houses. It has been estimated that about 44 per cent of the total borrowing is for overseas, that is for foreigners and for our Dominions. When we speak of loans we mean those investments which take the form of bonds or debentures. These are given for money lent at a fixed rate of interest, and secured on the property of the borrower. Preference shares are shares which get a fixed rate of interest without security, and ordinary shares depend for their dividend upon the profits of the concern. In the event of the liquidation of a company, bond-holders or debenture-holders are paid before the ordinary creditors who, in their turn, are paid before the preference or ordinary shareholders. Securities which take the form of preference and/or ordinary shares are usually put on the market by a somewhat different kind of financial house. The six big houses mentioned, however, do not deal entirely in overseas loans, for out of about £89,000,000

issued by one of these houses over a series of years, £45,000,000 was for foreign, £20,000,000 for colonial, and £24,000,000 for home investment.

Although the big issuing houses will not themselves put issues of ordinary shares on the market, they have frequently associated with them other finance houses who do this kind of business for the public.

Quite apart from the big issuing houses, there are a number of firms and brokers connected with trust and investment companies, who also look after this function of obtaining new money but mainly for the home market.

Issues are generally made when business is good, and when there is plenty of confidence. When business is bad, however, it is very difficult to obtain new money. There are many people who think that the machinery would be more complete, if there were firms in existence which were prepared to find the money in bad times and nurse the securities until the public was ready and willing to buy them; but on this point there is a considerable divergence of opinion.

The amount of money which we lend abroad varies each year, but the annual average between 1924 and 1930 of new issues for overseas, that is both for the British Empire and for foreign countries, was about £117,000,000. When this money has been subscribed by people in this country, how does it get abroad? It is quite obvious it is not sent in gold, because over the seven years this would have meant an export of over £800,000,000, whereas the total amount of gold in the country during this period was not more than about £150,000,000. Furthermore, the total production of gold in the world is only about £80,000,000 a year. It is quite true that out of this amount the British Empire produces about £60,000,000, but this has to be paid for, like any other import.

In order to understand how money raised in London for overseas loans is sent abroad, we must come back to the question of the balance of trade, or rather, of the balance of international payments. A glance at the following table will enable us to understand the position more easily.

TABLE I.
THE BALANCE OF PAYMENTS OF THE UNITED KINGDOM
ON INCOME ACCOUNT.
1924 to 1930 (£ millions)

	1924	1925	1926	1927	1928	1929	1930
Excess of Imports of Merchandise and Bullion	324	384	475	390	358	366	392
Government Receipts from Overseas (nett)	*25	*11	4	1	15	24	21
Nett National Shipping Income ...	140	124	120	140	130	130	105
Nett Income from Overseas Investments	220	250	285	285	270	270	235
Nett Receipts from Short Interest and Commission	60	60	60	63	65	65	55
Nett Receipts from Other Sources ...	15	15	15	15	15	15	15
TOTAL ...	410	438	484	504	495	504	431
Estimated Total Credit Balance on above Items ...	86	54	9	114	137	138	39

*Excess of Payments made Overseas.

TABLE II.
NEW OVERSEAS ISSUES ON THE LONDON MARKET.*
(£ millions.)

British Empire	73	58	62	88	86	54	70
Foreign	61	30	60	51	57	40	39
Total ...	134	88	112	139	143	94	109

*Midland Bank figures.

The figures in Table I. should be taken as being estimates and
not as exact figures.

We see that this is called "Balance of payments of the United Kingdom on Income Account," and it does not include what are called capital items, like the sale by Englishmen of securities abroad, or by foreigners of securities in England, nor does it include foreign deposits

in England, or bills on London held by foreigners, or British deposits abroad, or bills on foreign countries held by Britishers. It is necessary to bear this in mind, because fluctuations in these amounts play a very important part in causing fluctuations in our exchange with foreign countries.

The items marked A on Table I represent the excess of imports over exports of commodities and bullion, and these are called visible imports and exports, the excess being called our balance of trade; the items B represent the balance of what are known as invisible exports and imports, and A and B together form our balance of payment on income account.

We could balance the surplus shown in Table I in one of three ways. We might import gold, which we obviously have not done, otherwise we should have it; secondly, we might increase our imports without paying for them by gold or by exports, but as goods which we import are brought into this country by a multitude of firms and sold to millions of people, and as it is obviously in the interest of the importers to sell as much as they can, presumably they have imported all the goods which they can sell; thirdly, we could re-invest abroad the money due to us for interest and sinking funds without bringing it home at all. Needless to say, it is not necessarily the people who are entitled to receive the surplus who re-invest it abroad; the transactions are merely transfers through the banks of their claims to the people who want to invest the money.

Money for loans raised in England for investment abroad is required for various purposes. It may be borrowed by a Government or municipality abroad for the development of the country, e.g. for building docks, bridges or irrigation works, or it may be borrowed by private companies for mining, growing rubber, or other schemes.

Issuing houses in London will not put loans on the market which are required for purposes detrimental to the interests of the country, for example, for excessive armaments or to bolster up unsound national finance. Some

people think that, where we lend money for development purposes, we should insist that the orders for machinery, etc., necessary for the development, be placed in this country with our manufacturers, and this is a course largely adopted by France in relation to the foreign loans which she makes. The issuing houses always try, although they do not make it a condition of the loan, to ensure that the orders for the material are placed with our manufacturers, and this undoubtedly brings with it certain advantages. For instance, a foreign railway company buying its rolling stock, etc., in this country, will continue to buy the replacements which it may require year by year also from our manufacturers, whereas if the initial purchase had been made in Germany, for example, it would be the German manufacturers who would obtain the orders for replacements. We have seen, however, that whether the proceeds of the loan are used for direct purchases here or not, an export of goods or services by us in excess of our imports of goods and services must take place, in order that the foreigner may receive the proceeds of the loan which he has raised in London, or there must result a curtailment of imports which we might otherwise have received.

If we glance again at Tables I and II, we shall see that the available surplus in 1930 was £39,000,000, but that we lent £109,000,000. There may have been a certain amount of overlapping with the previous year, when the available surplus was £44,000,000 more than we lent. On the other hand, we lent a certain amount in 1931, but instead of there being a surplus in that year there was a considerable deficit.

How then can we lend money which we do not possess? It can be done, but it is very unsatisfactory. It is borrowing from Peter in order to lend to Paul. What it comes to in the long run, is that we are buying some of our imports on credit in order to sell a portion of our exports on credit. This is more fully explained in Chapter X.

The issuing houses, before they make any loan to foreigners, generally consult the Bank of England, and if

they are told that the moment is inopportune, they suspend their operations for the time being. But this, unfortunately, does not always solve the problem. After all, it is individuals in this country who, for one reason or another, desire to invest a portion of their savings in foreign securities, and if there are no new loans available on the market for this purpose, they buy securities from the foreigners, and particularly from the Americans. These latter make a regular business of selling their securities in England, so that, even where loans are not floated here, the securities are often ultimately bought by English people from American holders.

Loans raised in the English market for foreigners or our Dominions overseas have one advantage from the investor's point of view over issues made purely for British purposes. The former loans are almost entirely floated by the large issuing houses of world-wide repute, whereas the English issues are put on the market by all kinds of promoters, good, bad, and indifferent. It is very necessary that money available for home investment should go into useful enterprise, and it would be a very good thing both for the investor and for industry generally if, following the recommendations of the Macmillan Committee, all issues made for home industry were vouched for by houses of similar repute to those who care for the issues of foreign loans. This is a very sound recommendation, the soundness of which was not at all diminished by the fact that, since the Report was written, forty-two foreign states and municipalities defaulted and could not pay the interest on their loans. This was a misfortune which occurred through the terrible financial disturbances throughout the world in 1930-1933.

CHAPTER V

THE BANKS

THERE are in London between one hundred and thirty and one hundred and forty banks; but for the purpose of discussing the monetary system we are really concerned with only ten. The difference between these ten banks, which we will call Deposit Banks, and all the others, is that their main business is to receive and deal with the deposits of the people. They transact a certain amount of foreign business, particularly since the Great War, but their main function is to hold deposits. All the other banks do mainly overseas business, and these are for the great part colonial and foreign banks. Some may receive a certain amount of deposits, usually from people who live abroad, but this is only incidental to their chief business. These colonial and foreign banks keep accounts with the ten clearing banks or deposit banks. For instance, one of these colonial banks is the Hong-Kong and Shanghai Banking Corporation, which deals with business between this country and India and China. If the Hong-Kong and Shanghai Bank owes money, it will send a cheque drawn on the Westminster Bank, because it keeps an account with the Westminster Bank for this purpose. In this way these ten banks are the bankers for one hundred and thirty other banks. The various names by which they are known are perhaps a little puzzling. They are called "Joint Stock Banks" because that was the name given to limited companies at the time when banks were formed into limited companies, and the name has remained; they are called "Deposit Banks" because they look after the deposits of the people; and they are called "Clearing Banks" because they belong to what is known as the "London Clearing House".

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millions of anything it becomes impossible to imagine it. In order to attempt to grasp an idea of the sum, the following illustration may be of use. There are about one million people in Manchester and Salford, men, women, and children. Try and imagine all this number, see them walking in the main streets of the city; see them coming out of the stations at 9 o'clock in the morning, go to the cinemas, go to the public parks, take a tram for miles and miles and look at all the houses, imagine all the people in them; and then think that each of them has £100, and that the whole million suddenly say, "we are going to take our £100 and form a bank." That would give £100,000,000 of capital.

Of the £109,000,000 capital and reserve of the "Big Five" about half is capital and half reserve. The following figures are approximately those which were given in evidence before the MacMillan Committee and generally relate to the year 1930. The deposits of the ten clearing banks were about £1,700,000,000, so that our million people would have not only their £100, but every day for seventeen days they would receive another £100 which they would put into the banks, so that there would be £1,700,000,000. Or again, if every man, woman and child in the whole world had £1 which they deposited in the ten London clearing banks, it would be very little more than the £1,700,000,000 which was there. It is a sum which somewhat exceeds all the wages, excluding salaries, paid in this country during a whole year.

Many people imagine that the deposits of the banks are all notes or coin which have been paid into the bank, but we saw in the first chapter that there was in this country only about £120,000,000 to £150,000,000 of gold, and that it was in the Bank of England. We saw also that there was an amount of about £400,000,000 in bank-notes, and those were all the bank-notes in the country. Now of these bank-notes, about £50,000,000 to £70,000,000 are in the Bank of England; about £250,000,000 are always in the pockets of the people and the tills of the shops. The total number of notes in the banks was in 1930 in round figures

about £100,000,000, and the deposits amounted to about £1,700,000,000.

The amount of the business which these banks undertake is enormous. The value of cheques which passed through the London Clearing House in 1930 was £38,000,000,000. It is almost impossible to form an adequate idea of such a huge sum. Let us suppose that we call it £36,500,000,000; let us then divide it by 365, that is as many days as there are in a year. That would bring us back to our £100,000,000, the amount we have tried to imagine; so we may say that if each one of the million people in Manchester wrote out a cheque for £100 every day for a year, it would amount at the end of the year to the sum of money which has passed through the London Clearing House.

This does not include every cheque which is drawn, because if Mr. A has an account with the Midland Bank and Mr. B has an account with the same bank, and Mr. A owes money to Mr. B, then Mr. A's cheque is paid into the Midland Bank, Mr B's account is credited and Mr A's account is debited, but this transaction does not pass through the clearing house. Mr. A's and Mr. B's transaction take place within the four walls of the bank. In addition, we have the provincial clearing houses. Manchester has a Clearing House of its own, and so have other towns. Again, in towns like Sidmouth, Buxton, etc., the cheques drawn on the local banks are not cleared at all, but the banks regulate the business between themselves in these little towns. The amount of cheques handled in all these ways is about half as much again as the £38,000,000,000. The cheques drawn during the month on the clearing banks averaged about £5,000,000,000 in 1930, that is to say £60,000,000,000 a year, and as deposits were £1,700,000,000, it meant that in some form or other an amount equivalent to all the deposits in the banks changed hands three times during the month.

The deposit banks perform many minor services for the public, but they have two main functions; the one, to receive deposits from the people, and the other to lend and

invest these deposits, thus acting as a channel by which credit is distributed throughout the country.

The first object and duty of the banks is to keep the money of their depositors safe, and to keep it in such a way that they can pay their depositors whenever they demand the money, or whenever they are entitled to it. There are two classes of deposits, one of which is known as "fixed deposits", or "time deposits", and for these the depositors make an arrangement with the bank by which they agree to leave their money there for a fixed length of time, or, in some cases, that they will give the bank a certain number of days' notice before they draw the money out. The other class consists of what are known as "deposits on current account", for which no notice of withdrawal is required. The banks pay a rather higher rate of interest for fixed deposits than they do for current deposits, and the proportion between the two is one of the barometers by which the state of trade may be gauged, because it is obvious that when trade is very good and people are using money freely, they will keep their money in current account, but when trade is very bad they will prefer to get a higher rate of interest and they will, therefore, transfer a part of their current account to a deposit account. Thus when the total figure in the fixed deposit account is relatively high compared with the figure in the current deposit account, it is an indication that trade is bad, and vice versa. During the boom of 1919-20 the current account deposits were 65 per cent of the whole. In 1931 they were only about 50 per cent and in 1933 only 39 per cent of the whole. Trade was bad, people could not use the money, and, therefore, they transferred it to fixed deposits, causing fixed deposit accounts to go up and current deposit accounts to go down.

Another object of the banks is to earn profits. They have, of course, enormous expenses, as there must be in undertakings which require large staffs and big buildings. They also have shareholders who expect a dividend, and therefore they must make a profit.

In order to understand how the banks achieve these

objects, it is of importance to see what they do with their money. To begin with, experience has shown the bankers that to be sure that they can pay money out whenever asked for it, they need only keep 10 per cent of their deposits either in notes or coin, or to their credit at the Bank of England from whom they can always demand notes. But they do not earn any interest on the notes or coins in their tills or vaults, and they do not earn any interest on the amount which stands to their credit at the Bank of England, because the latter does not pay interest. That 10 per cent is always there, and can be paid out at any moment. Then they have about $3\frac{1}{2}$ per cent of their assets represented by cheques on other banks, which have not yet been collected. They have also a second line of defence (cash in hand being their first). About 8 per cent of their deposits is lent to the discount brokers, and other people who borrow what is called "short money" or sometimes "day-to-day money", that is to say, money lent from day to day which can be demanded back at any time. Sometimes it is lent for seven days, but always for so short a time that the banks can get it back very quickly should it be necessary for them to pay out large amounts to their depositors. They also fulfil the same function as the discount brokers by buying or discounting bills of exchange. This function acts as a third line of defence. In 1930 about half of these bills were commercial bills, and about half Treasury bills, the whole forming about 15 per cent of their assets. In the case of the Midland Bank, only about 25 per cent were Treasury bills, and 75 per cent commercial bills—the proportion varies between one bank and another. Now, all these bills have been drawn on different days, so some are falling due every day. The banks are automatically receiving a certain amount of cash from those bills which are falling due. All this money—10 per cent cash or balance at the Bank of England, $3\frac{1}{2}$ per cent cheques on other banks, 8 per cent lent at call or short notice to the discount brokers, 15 per cent bills which they have discounted themselves—is liquid and will return to the bank within the course of a few days.

The banks also invest about 12 per cent of their deposits in British Government securities, War Loans, Victory Bonds, etc., or any other securities of the very highest class, which are always marketable, that is to say, which in case of necessity they can always sell. This money is not quite so liquid as the 10 per cent cash or balance at the Bank of England, or the $3\frac{1}{2}$ per cent cheques on other banks, etc., but it can be made liquid should need arise. These percentages vary, but in 1930 they came to a little more than 45 per cent and left about 55 per cent which was lent to traders, merchants, and others, sometimes in the shape of loans, sometimes in the shape of overdrafts. A loan is for a fixed amount and usually in London for a fixed period; if a man asks his bank for a loan of £1,000 for three months he will have to pay interest on the £1,000. In the case of an overdraft, he will ask the bank to grant an overdraft on his account up to the amount of £1,000, and he will only have to pay interest as he requires to take the money. The rate of interest which is charged on loans is often lower than that charged on overdrafts. In the Provinces the banks have some sort of security in the case of about half of these loans and overdrafts, but for the other half they have no security except the honour and credit of the man who has borrowed the money. In London most loans and overdrafts are secured.

This, then, is what the banks do with the deposits. But how do they earn a profit on them? On the 10 per cent cash they earn nothing, and on the $3\frac{1}{2}$ per cent in the course of collection they earn nothing, but on the 8 per cent, which they loan to the discount brokers and for the bills which they have discounted, they earn a higher rate of interest than that which they pay to their depositors. On their $12\frac{1}{2}$ per cent investments they earned in 1930 about 5 per cent, which was the interest on the War Loan, and which was higher than the banks could earn by discounting bills or lending money to the discount brokers. The highest rate of interest banks charge is to those customers who wish to borrow money on loan or overdraft, the reason being that this is the most risky part of

their business and that the money is less easy to call in quickly. In 1930, 8.2 per cent of the total amount of loans and overdrafts went to the textile trades; 6.3 per cent to the iron, steel, shipbuilding and engineering; 6.9 per cent to agriculture and fishing; and another 6.3 per cent went to the trades connected with food, drink and tobacco; about 3 per cent to coal-mining, quarrying, etc.; about 2.2 per cent went to the leather, rubber and chemical trades, 2.5 per cent to railways, shipping, and other forms of transport; 4.8 per cent to the building trades; 5.2 per cent to municipalities, gas works, electrical undertakings, etc.; 2.7 per cent to amusements, clubs, churches, charitable organizations (which are always in debt!), 14.3 per cent was lent out to banks, discount houses, stock exchanges, building societies, etc.; another 14.7 per cent. was lent to miscellaneous trades, including retail trades, and 21.8 per cent to other unclassified borrowers. Their loans, therefore, are very well distributed and the banks serve every industrial and commercial interest in the country.

The banks, as we have seen, keep 10 per cent of their deposits in cash or in the shape of a balance to their credit at the Bank of England. If all the people in this country permanently did with less money in their pockets and paid the surplus money into the banks in notes where it could form a new deposit, or if the banks' balances at the Bank of England were increased, then for every £100 which the banks obtained in either of these ways they could increase their deposits ten times, that is, up to £1,000. Let us see how it works. Suppose that a man has a hoard of £1,000 in notes that he has never used, and he takes it to the bank and asks for it to be paid into his deposit account. If there is only one bank, it will now have £1,000 more than it had before. But as it only needs 10 per cent cash against its deposits it will keep only £100 of this money in notes. It can then invest or lend £900, partly in the shape of overdrafts and partly to the discount market, etc., and this money will come back to the bank as fresh deposits because the money is paid to somebody, and these people who re-

ceive it will pay it into the bank against their own deposit accounts. The bank, however, says, "Now we have your £900 deposit we must keep £90 of that to maintain our 10 per cent, but we have £810 which we can lend." So they loan out the £810 again, which is spent in various ways. It goes first into the shops perhaps, and then into the banks where the deposits of the shops are increased by £810. The bank keeps £81 of this (10 per cent), and so on until in the end it has £9,000 new deposits and the original £1,000 cash and has maintained its ratio of 10 per cent. It can thus go on repeating these transactions until it has virtually created deposits to nine times the amount of the original deposit. All the notes which were in the banks amounted in 1930 to about £100,000,000 and the balances which the banks had in the Bank of England were about £70,000,000, that is £170,000,000, i.e. 10 per cent of the amount of £1,700,000,000 deposits, and the more the banks obtain in this way the more they can lend to traders, because they lend a proportion of 50 to 55 per cent of their deposits on loans or overdrafts. They cannot keep the money idle because they have to pay interest, and the only way they can earn interest is by using the money.

We have now seen how the banks earn their money, but of course they have other sources of revenue besides merely their interest. For instance, they charge people for the services rendered in keeping their accounts, and they do this in one of two ways. In the north they usually charge a commission on the account, whereas in the south a more general custom is to let the client have an account without charging commission, as long as he keeps a certain balance on which the banks will not pay interest. In one of these two ways the banks earn something for keeping their customers' account. There are other functions which they fulfil through the departments which finance foreign business and for which they earn money. Like the accepting houses, they also accept bills. They do not, however, accept any bills for internal trade, but only bills for overseas transactions. The Midland Bank gave the MacMillan Committee some rather interesting information on this

point. It charges a commission of 2s. 6d. for three months for every £100 it accepts, and the proportion of these acceptances, which represents imports into or exports from the United Kingdom, is about 35 per cent of its total acceptances. The remainder represents transactions between our overseas dominions, or between them and foreign countries, where the goods never come into England at all. Very likely a large part of these goods was carried in English ships, so we earned the freights and insurance, and our bankers and discount brokers benefited likewise.

There is just one other point, and that is concerned with the principles which guide the banks in making loans and overdrafts. Of course it would be very pleasant and easy if we could go to the banks and ask for a loan because we wanted to buy a motor-car. The banks would naturally refuse such a loan as they have always to consider how and when their money will be returned. They do not want to have their money locked up for a long time, but require it to be repaid within a reasonable period. If a man went to a bank for a £1,000 loan to build a house for himself to live in, and offered them a mortgage, the bank would refuse it because that money would never come back until the mortgage was paid off—which might be many years. But if a builder went to a bank for a loan for the purpose of building a row of houses which he proposed to sell for, say £500 each, the bank would furnish him with a loan until he could sell the houses, provided that he was a man of good credit, for their money would be repaid as soon as the houses had been sold. On the other hand, if a shopkeeper went to a bank and asked for a loan to buy some stock with which to start a shop, the bank would refuse to lend the money. If he had asked for £1,000 the bank would tell him that he would always require £1,000 worth of stock in his shop, therefore, their money would be tied up and he would not be able to repay the bank. But if a man went to a banker and said that he had a shop with £1,000 worth of stock already in it, but that he needed a loan as Christmas was coming along and

he required another £1,000 worth of stock which would all be sold by Christmas week or by January 1st, after which he could repay the loan, then the banker would let him have the money provided his standing and credit warranted it.

The guiding principle is that the banks must keep the money of their depositors safe and reasonably liquid. "We will," say the banks, "only go into transactions which have a quick turnover and in which we can get our money back. If people want to buy houses to live in, or to stock shops, or to build factories, they must draw their money out of their savings or borrow it elsewhere. That type of business is not the business of the deposit banks." Whatever we may say against our banking system, we must remember that in these bad times of storm and stress our banks have remained steady and safe. It used to be very fashionable to say that the German banking system was better than ours; but several of the big German banks were in trouble in 1931 and had to be helped by the Government. Some people have said that the banking system of America was better, yet 10 per cent of their banks failed in that year, and certainly one big bank in France was also in trouble, while ours were still standing firm as a rock. There must be something, in the long run, to be said for the principles of the English banks.

CHAPTER VI

THE BANK OF ENGLAND

PART I

WE have dealt in the previous chapters with the gold standard and the note issue, with the accepting houses, the discount brokers and the issuing houses, and in the last chapter with the banks, thus describing the monetary machine with the exception of the central power-engine, which is the Bank of England.

The Bank of England is the country's Central Bank. The ultimate solution of our monetary problems will depend, to a very large extent, on the strength of the collaboration between the Central Banks of the world. There are since the War many more Central Banks than formerly. Several of them have been inaugurated under the influence of the League of Nations, and their constitutions have, of course, a very considerable degree of similarity to the American central banking organisation, i.e., the Federal Reserve Board, working through the twelve Federal Reserve Banks, which was formed in 1914 and originated as a consequence of the crisis of 1907. The functions of all Central Banks are much the same. They must care for the stability of the monetary unit. In order to do this they must have the sole right of issuing bank-notes, so that they can regulate the amount of notes issued, and they must also have custody of the gold reserves of the country. They should be the bankers for all the other banks in the country, so that through the knowledge and influence thus gained they have control over the amount of credit which can be extended or restricted, according to the needs of the industry and commerce of the country in which they are functioning. Then again, a Central Bank should be the bank of the government of the country, because, through taxation on the one hand, and through the government's expen-

diture on the other hand, an enormous amount of money is received and paid out, and unless this is regulated in an orderly manner through one channel, the receipts and payments will cause quite an unnecessary disturbance in the money market, and through the money market to industry and commerce.

All liabilities of Central Banks are payable on demand. It is, therefore, necessary that they should always keep their assets in a very liquid condition. Central Banks must act in the interests of the general public, and even if they have shareholders, the primary consideration must not be to earn a profit for their shareholders but to serve the interests of the public, and to do so they must be prepared occasionally to face a loss. If they are to act in the general interest they must necessarily be free from the influence of any particular section of the community, and from any political pressure on the part of the government. As they are to be the bankers' bank they must not compete with them, and therefore must not do any of the ordinary banking business which is usually conducted by the other banks in the country; not only because it would not be fair to their banking customers, but also because by keeping their hands free from the entanglements of the general commerce and industry of the country they put themselves in a position to help the other banks and financial institutions at any time of financial or commercial crisis. Because they are not to work primarily for profit and have occasionally to face a loss, it is universally arranged that they shall have the advantage of paying no interest on any deposits which they receive, but of course they earn interest on investing this money in securities and bills.

How far does the Bank of England fulfil these functions? It holds the gold reserves; it is the bank for the other banks; it holds a considerable portion of their cash reserves; it manages the note issue: and, before we went off the gold standard, it bought and sold gold at a fixed price determined by Act of Parliament. It is the Government's bank, and holds all the Government's balances of

money; it manages the National Debt; it pays all the interest on behalf of the Government (for which the Bank is paid by the Government in order to meet the expenses of doing this business for them), and receives subscriptions for any new loans which the Government may raise from time to time.

The Bank of England is divided into two main departments, one of which cares for all the banking activities of the Bank, including the issue of notes, and the other which deals with the management of the National Debt, the payment of dividends, and the registration of transfers from buyer to seller. That is the division of the internal organization of the Bank, and it must not be confused with another division, the one between the issue department and the banking department. The Board of the Bank is called "The Court of Directors", and meets every week. There are twenty-six directors, and at least thirteen must be present at a "Court" in addition to the Governor or the Deputy-Governor of the Bank. There are, of course, many committees working inside the Bank, but the chief one is called "The Committee of Treasury". It is a kind of inner cabinet consisting of nine members who are elected by secret ballot, and who are consulted on all important business connected with the Bank. In addition to the Governor and the Deputy-Governor there is a controller of the Bank, the chief cashier, and in recent years various advisers who are men with special knowledge of certain matters with which the Bank deals, for instance, matters concerning its relations with foreign Central Banks, rationalization of industry, etc. These special advisers are constantly travelling abroad to visit the Central Banks of other countries, who in their turn return the visits to the Bank of England. All this is the result of an increasing effort to obtain the necessary collaboration between the Central Banks of the world, without which it has proved, and will prove in the future, to be impossible to continue a world monetary system on a gold basis.

There are also other departments, such as the statistical department, which supplies very full monthly and half-

yearly statistical information to the Central Banks; in addition to this, every fortnight, it writes an exhaustive general review of conditions, and sends it to all the Central Banks within the Empire.

Then there is the secretarial department and the audit department, the auditors having direct access and being responsible to no one but the Governor and the directors, and acting independently of any other officials of the Bank. The staff of the Bank is between 3,700 and 3,800, and performs an enormous amount of work. They keep three million different accounts for the National Debt, in addition to which they have a large business for the colonies, municipalities, etc. They deal with over one million transfers; nearly five million dividend warrants; five million coupons (both of which are documents giving people the right to claim the interest on their securities); and the value of bank-notes which they issue yearly amounts to £650,000,000. All these warrants, notes, etc., are printed in the Bank of England's own printing factory.

Although the Bank of England is a Central Bank it differs in some respects from other Central Banks in the world. As we pointed out at the beginning of the chapter, the Central Bank system of America was only formed in 1914, and a great many of the other Central Banks have been formed since the War. The Bank of England, however, was formed in 1694. Consequently there are many traditional characteristics and relics of the past which are not common to the other Central Banks of the world. It is a private institution, and with the exception of certain regulations regarding the granting of loans to the State, the issue of bank-notes, and the prohibition of dealing in merchandise, it can legally do anything it likes. Although it is the bank for the bankers, it still has some old private accounts, and it has other accounts with insurance companies; not so much because the latter desire to enjoy such facilities as the Bank can offer, as because they have an idea that the safest place in which to keep the vast amount of securities which they hold, is in the vaults of the Bank

of England. Again, the Bank still has a good many private accounts with merchant firms, which it has had for a very long time. In many cases they have not been used for twenty or thirty years, but these firms like to keep a balance there in order to maintain the tradition that they have a banking account with the Bank of England. Other customers of more importance to the Bank are the accepting houses, issuing houses, discount brokers, and a limited number of Stock Exchange firms. The Bank of England is also, to some extent, the bank for the other Central Banks of the world. Except for the foreign Central Banks, the Bank of England opens no accounts for foreigners unless under very exceptional circumstances at the request of their government; nor will the Bank of England open accounts for foreign banks except through their own Central Banks. That is a deliberate policy in order to force the foreign banks to do all their business through their own Central Banks.

We saw in the previous chapter that, in addition to deposit banks, there were about 130 to 140 other British, foreign, and colonial banks in England. These, besides having accounts with the deposit banks as has been explained, nevertheless find it convenient to keep certain balances with the Bank of England, enabling them always to go there in case of emergency.

The Bank of England has eight provincial branches. It has a branch, for instance, in Manchester; and these branches at one time used to do ordinary commercial banking business, but this has ceased, and they are only there now to be a depot for currency which the other banks can use, and to perform certain services for the local banks of the town in which they are situated. These go to the Bank and get any currency they may require, and they pay into the Bank any old worn currency that they wish to return because it is light and cannot go into circulation any more, or any other currency of which they may have more than they require.

Another way, and an important way, in which the Bank of England is breaking away from tradition is in the

election of its directors. There has been a very considerable amount of criticism and controversy concerning the method by which the directors of the Bank of England are selected, all of whom, incidentally, must retire at the age of seventy. It has been thought by some people that they are not sufficiently representative of the industry of the country, and that while on the Board there are directors of railway companies and shipping companies, there is, says the Macmillan Report, only one director connected with the steel trade, and no director connected with the cotton, engineering, mining or other branches of industry. Formerly brewing and distilling had more directors on the Board than is now the case. This question of the selection of the directors of the Bank has a considerable amount of importance because it has undoubtedly created uneasiness in the minds of a certain number of people, and it is, therefore, worth while recalling what Sir Ernest Harvey, Deputy-Governor of the Bank, said to the Macmillan Committee in his evidence when dealing with the election of the directors: "They are elected as men of good credit, first-class credit in the city, who are associated with some form of actual trade, be it foreign trade or home trade . . . as men who not only have knowledge but can bring to the Court information and knowledge as to what is proceeding in various spheres of commercial business, who can keep the Bank well posted with reliable information as to questions of credit, questions of industry, as to the prosperity or otherwise of industry, and as to the trend of business as between this country and certain foreign countries.

"There has never been any idea that members should be chosen strictly as representatives of a particular industry, or particular class or particular trade, definitely as a representative, that is to say that anybody should be chosen to come and represent that industry as a recognized representative of that industry. If he is informed regarding the affairs of a particular industry, so much the better, but not to come as a recognized representative."

Sir Ernest pointed out that in the constitution of the more

recent Central Banks, it had been laid down that there should be so many representatives of agriculture, so many of finance, so many of industry, etc., "which has been found," he said, "a most unsatisfactory method, as directors were apt to take a narrow view." He concluded by saying: "Now the whole theory of the Bank of England is to get a body of men who are in a position to take a detached view, who can afford to take a detached view, who are of such standing and credit that they could be relied upon to sink all personal feeling in taking a broad view of the problems which may be submitted to them, and I have been advised that they do not encourage the appointment of representatives of particular classes of industry . . . and I think I can say, as one who stands entirely outside this, not having been appointed from outside the Bank, that in my experience I should doubt whether it would have been possible to have collected a body of men by any other method who do, in fact, as I can bear testimony, bring such absolutely unbiased and disinterested a judgment to bear on every question that is put before them." That evidence, whatever view one may take as to the constitution of the Court of Directors, must be accorded due weight in forming an opinion. Sir Ernest Harvey emphatically denied the suggestion that members of certain firms of merchant bankers are entitled to serve by virtue of hereditary rights.

Below is the Bank of England statement (for January 6th, 1932) which is issued by law every Thursday. It deals, according to the Bank Charter Act, 1844, with the issue department and the banking department. The issue department deals entirely with the issue of bank-notes. The first item on the left hand side of the balance sheet in the issue department, is "Notes Issued". It will be found that this is divided "in circulation," £362,000,000; "in banking department," £32,000,000. The "notes in circulation" are all the notes which are either in the till or the vaults of the other banks of the country, or which are in the pockets of the people—in the widest sense, of course. The notes "in banking department" £32,000,000 are in

BANK OF ENGLAND

RETURN FOR WEEK ENDED WEDNESDAY,
JANUARY 6, 1932.

ISSUE DEPARTMENT

Notes Issued	£	Government Debt	£
In Circulation	362,859,093	Other Government	11,015,100
In Banking		Securities	242,966,595
Department	32,890,692	Other Securities	17,166,860
		Silver Coin	3,851,445
		Amount of	
		Fiduciary Issue	275,000,000
		Gold Coin and Bullion	120,749,775
	<u>£395,749,775</u>		<u>£395,749,775</u>

BANKING DEPARTMENT

Proprietors' Capital	£	Government Securities	£
Rest	14,553,000	Other Securities	64,890,906
Public Deposits*	3,481,814	Discounts and	
Other Deposits:	15,680,723	Advances	19,898,960
Bankers	81,823,788	Securities	35,789,497
Other A/cs	38,503,282	Notes	32,890,682
	120,327,070	Gold and Silver Coin	574,630
Seven-day and other Bills	2,068		
	<u>£154,044,675</u>		<u>£154,044,675</u>

*Including Exchequer, Savings Bank, Commissioners of National Debt and Dividend Accounts

the till of the banking department of the Bank of England. This same figure will be found at the bottom on the other side of the balance sheet in the banking department. The other side of the account shows the value of the securities which the Bank holds—that is, as security for the public against these notes—the first being the Government Debt to the Bank of £11,000,000 odd. This is an old debt which has existed since the early days of the Bank, and the Bank was originally founded on the capital raised for the purpose of lending money to the Government. The amount, which is now a little over £11,000,000, has remained stationary since 1834, nearly a hundred years ago.

The next item is "Other Government Securities", which can include any form of Government security which the Bank chooses to hold; but as a matter of fact, at the time of the Macmillan Committee in 1930, the bulk of that money was in Treasury bills.

The next item called "Other Securities", consists of all other securities of every nature, because the Bank is entitled to hold any form of securities that it likes; its only obligation being to inform the Treasury what those securities are. In November, 1929, the Deputy-Governor, giving evidence, said that these "Other Securities" consisted entirely of bills, partly domestic bills and partly foreign bills. The foreign bills are bills of gold standard countries and they formed at that time about 40 per cent of the total. The percentage varied; they were bills which would have been discounted in the ordinary way by the Central Bank of the country in which they originated. We will come back to that point later because it is of considerable importance, owing to the power it gives to the Bank to realize those bills in the foreign country at any time, and it thus reduces the necessity of shipping gold to meet any demand on the part of that country.

The next item is "Silver Coin". That item is being reduced by paying out to the banks as required more silver currency for the people. It accumulated during the War, when there was quite an abnormal demand for silver

currency, but when the War ended the demand declined, and this accumulation of silver remained with the Government and has been steadily reduced. As the country requires further silver coin, it is paid out by the issue department to the banking department—which department hands over securities in return, and pays the silver out to the banks as requested by them.

The next two items on the statement are the "Fiduciary Issue" of £275,000,000 (which is the total of the foregoing items), and the "Gold Coin and Bullion", amounting to £120,000,000. In our former chapters we discussed the figure of £260,000,000 for the fiduciary issue. In August of 1931 the fiduciary issue was increased from £260,000,000 to £275,000,000. Every half-year the securities of the issue department are, if necessary, written down—that is, valued at current market prices—but the Bank has declared during recent years its intention of writing them up to the market value should the securities rise again.

We can now turn to the banking department. On the left-hand side of the statement will be found all the liabilities of the Bank—that is, the amount of money which the Bank owes. The first term is "Proprietors' Capital", that is, the sum of £14,000,000 which it owes to its shareholders. There is a good deal of talk at various times about the capital of the Bank being held by private shareholders and of the possible danger of undue influence being exercised by shareholders, so that things might be done in the interest of the larger shareholders rather than in the interest of the public. It is, therefore, worth while explaining that every shareholder in the Bank of England has only one vote; whether he holds £500 or £50,000 worth of shares his vote is of the same value. There are 14,000 shareholders, of whom 13,000 hold less than £2,500 worth of shares, and, indeed, 7,000 of these hold less than £500. Of the remaining shareholders only thirty hold more than £25,000, but the vote of each one of these thirty would amount to exactly the same as that of a man who holds £500.

The item "Rest" is what a public company would call

“ Reserve ” and is undistributed profits. In practice it is not allowed to fall below £3,000,000.

The next item is “ Public Deposits ”, which includes money which the Exchequer, the Savings Bank, and the National Debt Commissioners and many other Government departments have deposited with the Bank.

Below that comes “ Other Deposits ”. They are divided between “ Bankers’ Deposits ” and “ Other Accounts ”. “ Bankers’ Deposits ” are the deposits of British banks only. “ Other Deposits ” includes deposits of the foreign Central Banks, accepting houses and other finance houses, discount brokers, insurance companies and trust companies, Indian and Colonial Governments, etc. “ Other Deposits ” also includes accounts for payment of dividends for Colonial stocks, corporation stocks, and Government guaranteed stocks—that is, stocks where the Government has guaranteed the dividend but is only called upon to pay it in case of default. Then there are various other accounts, like that of the “ Agent General ” for Reparations payments, and certain financial accounts of an international nature connected with the debts of Greece, Egypt, and other countries. Again this item includes the Bank’s own internal accounts. The accounts of the foreign Central Banks in “ Other Deposits ” are only for the balances which the Central Banks hold with the Bank of England, but they also have other transactions with the Bank which are very important. They say to the Bank of England: “ Here is so much money which we do not wish you to put into our deposit account, but with which we would like you to buy bills to be held on our behalf.” A great many people consider that that is a liability of the Bank which is not really sufficiently disclosed, or disclosed at all in the statement because the Bank is under an implied liability to discount these bills for the foreign Central Banks at any time. The answer of the Bank of England, and it seems a very fair answer, is, that that liability or implied liability, is no different from the implied liability which the Bank has to discount *all* the bills in the London market so far as it can; for if

a discount broker brings a bill to the Bank at any time, it can be discounted. Because the Bank is also willing to discount bills for the Central Banks, there is no more reason why it should show these bills of the foreign Central Banks as a liability than that it should show the contingent liability to discount all the other bills which are floating round the London market.

On the other side of the statement are the assets of the Bank of England, that is to say the property which the Bank of England possesses against the money which it owes. The first item is £64,000,000 "Government Securities"; and these are all British Government securities for which the Government is directly liable. There are certain securities for which it is indirectly liable, for instance, if a loan of £6,000,000 is floated for Nyasaland and guaranteed by the British Government, this would not be considered a direct British security, and no security of that sort would come under the head of "Government Securities", which includes Treasury bills and any temporary advances which the Bank of England may make from time to time to the Government, and which form part of what are known as "Ways and Means Advances". The Treasury bills come to the Bank in two ways. If the Bank buys the Treasury bills they go under "Government Securities", but if a discount broker goes to the Bank and asks to have Treasury bills discounted on his behalf they would go under "Discounts and Advances". It is only Treasury Bills which are acquired on the Bank's own initiative which appear in the "Government Securities" item.

Then come "Discounts and Advances", the first item of the "Other Securities". "Discounts" are the bills which the discount brokers bring to the Bank to be discounted from time to time. All the "Advances" which the Bank may make either to discount brokers or to other customers against securities are always against first-class securities and saleable on the London Stock Exchange. The Bank of England sees that it has a reasonable margin between the amount which it advances, and the market price of the

securities in case the value of the securities should go down, and for these advances it charges $\frac{1}{2}$ per cent over Bank Rate. Bills, as we have seen, it will discount at Bank Rate.

The next item is that of "Securities" which comprises Bank bills which the Bank may buy on its own initiative on the open market; loans guaranteed by the British Government, or Indian, Colonial, or municipal loans; and are all first-class gilt-edged securities. There is no limit to the kind of security which the Bank of England might buy if it were so disposed, but as a matter of fact it would not, for instance, purchase ordinary shares in industrial companies; it always holds only the very highest class of securities.

Below the item of "Securities" comes that of "Notes", which is the same item as in the issue department. These are notes which are held in the till of the Bank of England. The "Gold and Silver Coin" is kept for the convenience of everyday transactions.

The statement of the Bank of England is always published in the newspapers on a Friday morning, and at the bottom is a figure of percentage which is called the "proportion of reserve", i.e. the proportion between the total of the £15,000,000 of "Public Deposits", and the £120,000,000 of "Other Deposits" which the Bank owes, and the total of the £32,000,000 notes, and that small balance of coin. The proportion of these notes and gold to these two items of £15,000,000 and £120,000,000 added together is 23.7 per cent. This ratio to a large extent influenced the Bank rate when we were on the gold standard. When that proportion was very low, it was a danger signal, and the bank rate tended to go up. As the proportion went up, the Bank reduced its rate.

The relationship between the Bank and the discount brokers and the accepting houses is very close indeed. The discount brokers and the accepting houses discuss their business with the Bank, and, if necessary, the Bank can see their balance sheets. The relationship between the Bank and the issuing houses, although not a relationship of that nature, is very satisfactory. Though the Bank of

England has no control over the issuing houses, these latter do go to the Bank and inform them of any proposals which they may have for issuing foreign loans. Should the Bank deem the time inexpedient for issuing such loans, the issuing houses would drop that business temporarily. A similar kind of informal relationship exists between the Bank of England and the deposit banks. They have periodical meetings, and the position seems to be becoming increasingly satisfactory.

At one time, it was felt there was not enough collaboration and co-operation between the Bank of England and the clearing banks. The connexion between the Bank of England and the clearing banks is the connexion between a bank and its customers, except that the clearing banks, in practice, do not ask the Bank of England for any accommodation, or any financial help. They keep their balances there, they reduce these balances when they want to take bank-notes out for their customers, and they decrease their balances at times in order to provide money to pay taxation for their customers to the Government. That is the way in which the banks as a whole decrease their balances in "Other Deposits", but, of course, individual banks may decrease their balances with the Bank for other reasons. The Bank acts as the clearing-house agent between one bank and another, and therefore the balance of one bank may be decreased and the balance of another increased through the balance of the cheques cleared on any particular day; but these transactions leave the totals of the bankers' balances in the "Other Deposits" unchanged.

The Bank of England not only supplies the banks at its head office in London with all the notes and coin which they require for the use of the public, but holds considerable reserves of notes at its branches in various parts of the country, which are available for the banks at any time. The amount of notes actually in the hands of the people is about £260,000,000, and it was estimated that in July 1930, the notes in the hands of the bankers were £105,000,000. These figures are worth bearing in mind

because the amount of notes in the hands of the people coincides very closely with the amount of the fiduciary issue, and as these notes are in daily use it is unlikely that they can be ever presented to the Bank (or could have been before we went off the gold standard) with a demand for repayment in gold bullion. The only notes which could, in practice, have been presented for this purpose would have been the notes which were in the tills of the banks.

CHAPTER VII

THE BANK OF ENGLAND

PART II

THE Bank of England is naturally in very close touch with the Treasury. The Governor sees the Treasury at least twice a week. The fullest information is given on both sides; but the Bank never interferes with politics, and the Treasury never dictates financial policy to the Bank. The Governor of the Bank frequently visits the Chancellor of the Exchequer and discusses all questions of Government loans and issues of Treasury bills, etc., which issues, however, are always made by the Bank in the presence of a representative of the Treasury who decides the amount to be sold and the amount to be offered the following week.

As we have already said, the Treasury bills form part of the National Debt. The National Debt represents all the money which the Government has borrowed. Normally, of course, the Government raises, by means of taxation, sufficient money to cover its annual expenditure, but every nation is faced from time to time, particularly during war time, with the necessity of obtaining more money than it can raise by means of taxation, and such money is raised by borrowing from the people under promise by the government to pay them an annual rate of interest and to redeem the loan after a period of years.

Our National Debt, in its modern form, originated in the reign of William III when over £15,000,000 was borrowed between 1688-1702. In order to carry on the War of the Spanish Succession, nearly £38,000,000 was borrowed during Queen Anne's reign, and the debt was further increased by £121,000,000 to carry on the American War between 1775-1786. But the great bulk of the pre-War National Debt was created between 1793-1815 in order to carry on the Napoleonic War, when a sum of over

£600,000,000 was borrowed, and at the outbreak of the Great War the National Debt still stood round about this figure.

Although vast sums were raised by taxation between 1914-1918 in order to carry on the War, the expenses were so enormous, amounting at one time to £7,000,000 a day, that the Government was obliged to borrow huge sums both for its expenditure and to lend to its Allies. On March 31st, 1932, the National Debt consisted of £7,420,775,000, the chief items of which were £903,699,000 borrowed from the United States Government, the 5 per cent War Loan of £2,000,000,000, which has been converted to 3½ per cent, and various other types of loans, including £371,000,000 of National Savings Certificates and about £700,000,000 Treasury bills.

So far as the internal National Debt is concerned, an estimate made in 1924 showed the following broad distribution of the total debt, including Treasury bills:

ESTIMATE BY SIR WALTER LAYTON IN EVIDENCE BEFORE
COMMITTEE ON NATIONAL DEBT AND TAXATION. Cmd. 2800.

	£ (in millions)
British Joint Stock Banks and Foreign Banks with offices in London (including an estimate of £100 millions Treasury bills) - - - -	750
Bank of England - - - - -	70
Post Office Savings Bank and Trustee Savings Banks - - - - -	215
Government Securities purchased for Depositors through Savings Banks and Trustee Savings Banks - - - - -	240
Treasury Note Reserve - - - - -	240
Ways and Means Advances - - - - -	70
Insurance Companies (approximately) - - - -	350
Railway Companies - - - - -	80
Addition to bring previous items to par value -	277
Treasury bills held by bill brokers and others -	300
Held by private persons liable to Estate Duty -	2350
Held by foreigners, trusts, charities, trade unions, joint stock companies, etc. - - - -	1650
	6592

A very interesting development connected with the Bank of England has taken place recently. A new bank has been set up which is called "The Bankers' Industrial Development Company", and it has a capital of £6,000,000 of which £1,500,000 was found by the Bank of England. The remainder of the capital was subscribed by practically all the British banks and financial houses in London, but three-quarters of the capital can only be called up if the company is liquidated, and even then the Bank of England must lose its £1,500,000 before the other subscribers can be called upon for their uncalled capital. The Bankers' Industrial Development Company was formed to help with the rationalization of industry, and as it was meant to deal with an abnormal situation, the life of the Company was to be for five years only, but it could be prolonged. There are many industries in the country which have been through such bad times during the last few years that they cannot show any profit—industries like cotton, ship-building and iron and steel. In order to rationalize these and get them on their feet again, it is necessary to spend money on replacing obsolete machinery, providing new working capital, etc. They cannot raise that money in the ordinary way because they are unable to show any profits. It is no use issuing a prospectus and asking people to subscribe to it when the businesses have been losing money for several years. But the money had to be forthcoming from somewhere, therefore this Company was formed.

The Board of this new Company consists of six gentlemen, with the Governor of the Bank of England as chairman, and includes the managing director of the Securities Management Trust. This latter is another organization created by the Bank of England to deal with problems connected with rationalization of industry, and has on its staff experts on law, labour, industry, and economics, whose work is at the disposal of the Bankers' Industrial Development Company.

The Company was formed at the instigation of the Governor of the Bank of England, for the purpose of raising

funds for these industries until such time as the public would be willing to subscribe the money, either because they were in a position to earn profits or because their prospects had so much improved. It is said that the object of the Bankers' Industrial Development Company is "to receive and consider schemes for the re-organization and re-equipment of the basic industries of the country, when brought forward from within the particular industry; and if approved, to procure the supply of the necessary financial support for carrying out the scheme." The Bankers' Industrial Development Company does not purport to suggest to an industry what it should do, but when the industry has made up its mind what it wants to do, and provided the Company approves of the scheme, it is ready to help. It may be of very great use by means of discussion in the early stages, but the initiative has to come from the industry and not from the Company. If the Company approves the scheme, it tries to evolve a proposition which, with its backing, they can ask the public to support.

The Company recognizes that it must be prepared to take risks which the ordinary issuing houses would not take, and although it does not want to give its guarantee if it can be avoided, in the last resort the capital of the Company is available for that purpose. Provided it fits in with the general picture of rationalization of industry as a whole, the Company does also envisage the possibility of even having to take up a certain number of small issues. It would not attempt to act in a similar way for any individual who came to it for money. It has been described as being "a nurse, not a tonic", for it was felt that certain industries needed nursing during a period of sickness and convalescence, and this Company was to fulfil that function. This Company is spoken of as the B.I.D.

A much more important organization is the B.I.S.—the Bank of International Settlement, that is, the bank set up by all the Central Banks of the world. It has its headquarters at Basle. The intention was that it should act as a clearing house for reparations and international debts, and in the development of co-operation or collaboration

necessary to the working of the gold standard. It performs a very useful function in furnishing a meeting-ground for the representatives of all the various Central Banks of the world. Some people think that it may develop in the future into something very great and useful. Other people are much more pessimistic. What is really going to happen to it is in the lap of the gods.

We should mention here the Exchange Equalization Fund established by the Finance Act of 1932, the object of which was to prevent undue fluctuations in the exchange and to make certain adjustments in the accounts of the issue department of the Bank of England.

The Act empowered the Treasury "to cause any funds in the account to be invested in securities or in the purchase of gold in such manner as they think best adapted for checking undue fluctuations in the exchange value of sterling", and for these purposes the Government was empowered to borrow £150,000,000.

It was made quite clear that, while the Fund was to be administered by the Bank of England, it was to be controlled by the Treasury.

The Auditor-General is only to certify to the House of Commons that the money has been used in accordance with the law, and he cannot, as he normally would, make any report regarding the state of the fund without the consent of the Treasury. Thus there is no way, until the fund has been finally wound up, in which the House can ascertain if there has been any loss, an eventuality which the Chancellor of the Exchequer did not exclude.

Many Members of Parliament of all parties objected to the secrecy with which the fund was to be surrounded, and pointed out that such secrecy was opposed to the general recommendations of the Macmillan Committee.

CHAPTER VIII

HOW THE BANK OF ENGLAND WORKS

WE have now described the machinery of our monetary system. Now we are approaching a more difficult part of the subject, namely, the description of how this machinery works. In order to describe it, we will deal with the Bank of England first, examine its machinery, then return to the Deposit Banks, and finish with the problems connected with the gold standard.

We have seen in Chapter VI that the primary function of a Central Bank—and the Bank of England is our Central Bank—is to maintain the stability of the national monetary unit, in our case the pound sterling. The stability of the national monetary unit corresponds with the stability of the general level of prices. If we say that the value of the pound sterling has risen, we mean that it will buy more commodities than before, and it is the same thing as saying, therefore, that the general level of prices of commodities has fallen; and, on the other hand, if we say that the value of the pound sterling has fallen, we mean that it will buy less commodities than before, or in other words, that the general level of prices of commodities has risen. Let us suppose a pound buys twenty articles at a shilling each to-day, and in a few years from now the value of the pound has doubled so that it will then buy forty of the same articles, which will only cost on an average sixpence instead of a shilling, then the value of the pound has doubled. If the pound falls to half, then instead of buying twenty articles at a shilling you can only buy ten articles at two shillings. The object of the Bank of England, and of other Central Banks, is to prevent this kind of fluctuation as far as possible and so keep the monetary unit stable. For that purpose, the

Bank of England uses two instruments, one of which is the Bank Rate and the other is known as "Open Market Operations". Of course, the Bank of England deals with the National Debt and the issue of bank-notes, etc., but its main function, which affects our monetary system, is the use of these two instruments in order to maintain the price level stable by altering the spending power of the people. The more money spent the more prices rise, if, of course, the quantity of commodities remains the same. The less that spending power is, the more the price of commodities will fall.

Now, how does the Bank of England work? Let us go back for a moment to the deposit banks. We have seen that Bank Rate is the minimum rate at which the Bank of England will discount bills which are brought to it by discount brokers and other people. The deposit banks pay depositors who have money with them withdrawable at short notice, 2 per cent under Bank Rate.* We also saw that the deposit banks lent money to the discount brokers. They lend that money at a rate which is somewhat higher than the rate paid to their depositors, in order to make a profit. They also lend money, such as loans and overdrafts to traders, and for that they charge from $\frac{1}{2}$ per cent to 1 per cent over Bank Rate, with a minimum of 4 per cent or 5 per cent. If these are the customary rates of the deposit banks, it is quite obvious that they fluctuate with Bank Rate, and therefore, if the Bank of England raises the bank rate, it makes money dearer for the discount brokers to borrow, and it makes money dearer for the general body of traders to borrow, because the deposit banks charge them more.

The effect of making this money dearer is twofold. First of all, people in business are less inclined to borrow from the banks, and as they are less inclined to borrow, they will have less money to spend in wages, and therefore the spending power of the people is reduced, so prices will

* When, in 1932, the Bank Rate was reduced to $2\frac{1}{2}$ per cent and later to 2 per cent, the difference between Bank Rate and the rate paid on deposits was only $1\frac{1}{2}$ per cent.

tend to fall. Then there is a second change. Imagine four firms in Liverpool, three of whom, perhaps, have large stocks of cotton, and the fourth a stock of wheat. One of these firms is in a financial position which is not too strong, and has a considerable amount of money owing at the bank, so that when Bank Rate goes up the bank manager sends for the head of the firm, Mr. Jones, and informs him that he must either reduce his overdraft with the bank or give more security, because his cotton may fall in price as a result of a higher Bank Rate. Mr. Jones, therefore, may be obliged to sell his cotton in order to reduce his overdraft. This is one step that tends to a reduction in the price of cotton. Mr. Smith also has some cotton, but he is not in the hands of his bank. He is a wealthy man, but he sees the price has gone down, and realises that as Bank Rate has gone up money will be dearer, prices will fall further, so he decides to sell his cotton too. Down goes the market a little further. Then Mr. Robinson, knowing Mr. Smith to be a good business man, decides to follow his example and also sells his cotton. That evening he talks to his brother-in-law, who holds wheat, and his brother-in-law tells somebody else, and so the tale goes on and on, inducing more and more people to sell, and prices continue to fall. That is another way in which Bank Rate operates on the prices of commodities.

Bank Rate also operates on long-term transactions. For example, directly Bank Rate goes up, all securities which we call "fixed-interest bearing securities" such as War Loan, municipal loans, etc., which bring the investor an annual fixed amount of interest (which is always payable independently of profits), go down in value, but if Bank Rate falls, they go up in value.

Suppose there is a high Bank Rate, say of six per cent, financial institutions and other firms will be tempted to sell their securities which only bring them in say five per cent interest, in order to lend their money to someone who will be willing to pay them six per cent interest or more. As many people will be selling, the price of

these five per cent securities will fall, and on the contrary, if there is a low Bank Rate many people will be anxious to buy more bonds as long as they show them five per cent, and consequently the price of War Loan, etc., will rise. As these securities stand at a high price and the rate at which money can be borrowed is low, people will be encouraged to borrow money repayable over a long period of years for building new factories, docks, harbours, etc., and this building sets up a demand for all sorts of commodities, thereby again tending to raise prices.

Those are ways in which Bank Rate operates internally, but it also operates externally, by affecting our foreign exchanges. If Bank Rate goes up, it means that people will earn a higher rate of interest in this country than abroad and consequently foreigners will be more prone to leave in England any money which they have owing to them, and to invest it here. Therefore, there will not be the same demand for foreign currency. If they take it away from England because Bank Rate is low, it will create a demand for foreign currencies. If a Frenchman, for instance, who has money deposited in London in sterling wishes to take it back to France because the rate of interest in London is low, he will, as pounds sterling are, of course, of no use to him in France, sell his pounds sterling and buy francs, and this will tend to send down the sterling exchange as sterling is being sold and raise the franc as francs are being bought, and thus the rate of exchange will be against us. If it goes down far enough beyond gold point, then gold will start to leave this country. When we approach that danger the Bank of England raises its rate, and so the Frenchman is more inclined to leave his money in London because he is able to earn a bigger interest than in Paris or New York. The demand for francs will then go down and the pound sterling will rise in value, there will be no danger of gold leaving the country, and if it goes far enough, gold will begin to flow back into England; that is, always provided that the action of the Bank of England in raising its rate

is not immediately followed by all the big foreign financial centres doing exactly the same thing.

We have seen that the deposit banks lend money to the discount brokers and other people. If there is a great deal of money in the market at the time when the Bank of England raises its rate, or very few bills offering for discount, then the market discount rates which the discount brokers are willing to give, will not rise proportionately to the Bank Rate, and the Bank of England will not have succeeded in its policy. When that happens, we say that Bank Rate is "ineffective". That is to say, that the market has not followed the Bank of England rate, and therefore the consequences which normally result from an alteration in Bank Rate have not followed on that occasion.

This could not happen if the discount brokers only borrowed from the deposit banks, because the banks charge for these loans one per cent under Bank Rate and, therefore, if the discount market had no other supply of money, it would be obliged to raise its rate of discounting as it would be paying more for its borrowed money. If Bank Rate were raised one per cent then the banks would charge the discount brokers one per cent more for loans, and the discount brokers in their turn would have to charge their customers one per cent more.

The discount brokers, however, only borrow about half of the money which they use from the deposit banks; the remainder of the money is borrowed from all kinds of firms and insurance companies, etc., who have surplus funds lying on deposit with the banks, which are earning only a very small rate of interest. These firms can afford to lend it to the discount market at a lower rate than that charged to the brokers by the deposit banks, and yet earn a higher rate of interest on it than that which they are receiving from the deposit banks on their deposits with these banks. If there is a considerable amount of this money lying idle, the discount brokers can borrow it cheaply, and the competition between them prevents the rate which they in turn charge to their customers, from

rising proportionately to the increase in Bank Rate, and this increase is therefore "ineffective".

If that happens, the Bank of England then adopts its other policy, namely its policy of "open market operations". The Bank, in order to make its own rate effective, wants to pull the market rate up nearer to Bank Rate. The Bank of England does not, of course, know exactly how much surplus money of the above description there is seeking a temporary home in the discount market, and can only take steps to reduce the amount and continue doing so until it sees that Bank Rate has become "effective", in order to do this it will sell bills or possibly Government bonds.

We will suppose that the Bank of England starts by selling £100,000 worth of bills, and for the sake of simplifying the argument we will assume that there is only one deposit bank, namely the Midland Bank, in existence. The people who buy the bills from the Bank of England will pay by a cheque on the Midland Bank, the Bank of England will debit the account of the Midland Bank with this cheque, and that will reduce the balance of the Midland Bank with the Bank of England by £100,000. We have seen that the deposit banks lend out ten times the amount of their balance at the Bank of England plus the amount of cash that they hold themselves. The Midland Bank on finding its balance at the Bank of England reduced by £100,000 will be obliged to reduce its loans by ten times this amount, i.e. £1,000,000, so that the Bank of England by selling £100,000 of bills will cause to be reduced by ten times the amount of money lent by the bank. The Midland Bank will immediately proceed to call in their easiest money, which is the money they have lent to the discount brokers, who, in their turn, will reborrow it from the owners of the surplus money. The result will be that the amount standing to the credit of these people with the Midland Bank will be reduced by this amount or, in other words, the deposits of the Midland Bank will be £1,000,000 less; but on the other hand, as the discount brokers will

have repaid this money to the Midland Bank, the money lent by the bank to the brokers will also be £1,000,000 less.

It might be asked why the Midland Bank must do this, why cannot it call in only £100,000 from the discount brokers and by paying this to the Bank of England replenish its balance with them. How could it do this? It can only pay money into the Bank of England in one of two ways. It might pay in a cheque on itself, but in this case the Bank of England would debit the Midland's account with this cheque, and this, therefore, could not increase its balance; or, it might pay in notes out of its vault, but this would reduce its own cash reserve and would cause it to reduce its advances by ten times the amount, just as a reduction of its balance at the Bank of England would.

This is equally true if there are several banks. If the people who buy the £100,000 bills from the Bank of England, pay with a cheque on the Midland, then the Midland's balance with the Bank of England will be reduced; if it called in £100,000 from the discount market and was repaid by money borrowed from the customers of Barclays, then it could replenish its account with the Bank of England by paying in the cheque on Barclays, but in that event the Bank of England would debit Barclays account with the £100,000, and that bank in consequence would be obliged to reduce its loans and advances by ten times that amount, so that, either way, it would come to the same thing.

As a result of the above operation, money will be dearer to borrow, and consequently the people who wish to discount bills will have to pay a higher rate to the discount brokers, and thus the rate will go up nearer to the Bank of England's rate. The Bank can continue its open market operations until it has forced the discount market to charge rates sufficiently high to attract foreign money.

If there is not enough money in the market the Bank of England will be able to deduce this by looking at the various signs. They will see, for instance, that the index

number of production is going up and that the unemployment figures are going down; their advisers will tell them that trade is better; they will hear of people grumbling that trade is better but that it is difficult to get money from the banks to increase their trade. If the Bank were of the opinion that it would be desirable to have more money in the market, but that it did not want to lower Bank Rate because of it affecting the exchange, it might conduct "open market operations" for the reverse purpose. In this case, the Bank of England might say to its brokers, "Go into the market and buy £100,000 worth of Treasury bills." The broker buys this amount of Treasury bills from Mr. Smith, and gives Mr. Smith a cheque on the Bank of England for £100,000; Mr. Smith pays his cheque to his banker, maybe Barclays; Barclays send the cheque to the Bank of England and ask to be credited with this £100,000. Then Barclays' balance goes up £100,000 at the Bank of England, and Barclays' can lend £1,000,000 more to traders and to the discount market, and industry and commerce receive the extra money that the Bank of England thought it was desirable for them to have.

It may happen that way, or it may happen the reverse way. If trade is good, and production is increasing, traders might ask the banks for more overdrafts and loans, which it would not be feasible to allow them if the banks had already lent the customary proportion of their deposits. They do not, however, want to stop the recovery of trade; therefore they call in some of their easy money from the discount brokers. If all the banks are doing this because trade is better, the discount brokers will be unable to borrow from these banks and will be obliged to go to the Bank of England and discount, say £100,000 of bills or securities to pay back the money which the deposit banks are recalling, which will then be lent out by the banks to the traders. The discount brokers pay back the banks with cheques on the Bank of England. The banks send these cheques to the Bank of England, which go to the credit of their accounts, and

thus the deposit banks can lend £1,000,000 more to traders, etc.

With a gold standard monetary system there is one difficulty that very frequently arises and which appears hard to overcome. If the Bank of England buys securities or bills in the market, and thus increases the balance of the deposit banks, enabling them to lend more money, this balance with the Bank of England earns no interest. But the people who have sold the securities or bills will have deposited the proceeds of the sale with some deposit bank and will expect to receive interest immediately from the deposit bank on this, and as already stated, the bank is getting no interest from the Bank of England. Unless, therefore, the deposit bank lends the money in order to earn interest, it is going to lose. Although trade may be better and require money, traders are not all standing on the steps of the banks asking for these overdrafts. They ask for these gradually, but in the meantime the money stands idle. Therefore, every morning at ten o'clock the bank looks at its cash position, and if it can increase its loans while maintaining its normal proportion of ten per cent cash, it lends out enough to restore that proportion. The first people to whom it lends that money are the discount brokers, knowing that if its industrial friends are looking for increased overdrafts, it can get it back at a day's notice. But the fact that it has lent the money to the discount market means that there is more money on the discount market, and so the rate of interest falls. As it falls, the foreigner is more likely to take his money away from London, and as he does so the exchanges go against us. If they go against us sufficiently, the Bank of England becomes afraid that it will lose gold, and it sometimes happens that before this credit which has been created in order to help industry, can really find its way into industry, the position has been reversed by the surplus funds in the discount market lowering the rates, and thus causing a danger of gold leaving this country. The Bank of England may even be obliged to raise its Bank Rate before the money has reached

industry. That problem is one which troubles a great many people, and lies at the root of a difficulty that many economists are trying to solve. Is it possible to find any machinery which will enable the Bank of England to keep the exchange steady without interfering with the industrial position in the country? They are so interlocked, and they react so much on each other that an alteration in the Bank Rate, initiated merely for the sake of safeguarding our international position, may have an effect, an unintentional effect, on our internal position.

Either of these two methods, whether it be by altering Bank Rate, or by "open market operations", has the effect of making money either cheaper or dearer, resulting in a long train of consequences. The first consequence will be an alteration in the amount which we borrow from foreign countries on the one hand, or which we lend to foreign countries on the other hand, according to which way Bank Rate moves or how "market operations" have been undertaken. These operate in much the same way whether the money which we are borrowing or lending is short-term money—i.e. money lent for a short period, or long-term-money; but they operate more slowly in the case of long-term money, that is lent over a long series of years. Then as Bank Rate and "open market operations" affect the foreign exchanges one way or another, they may affect the amount of our gold reserve, because, as we have seen, if the exchange falls to gold point, or below gold point, that is the point at which instead of continuing to buy bills it is more advantageous to pay debts in gold, the metal may leave the country. On the other hand, if the foreigner finds it is costing him too much to buy sterling bills, he has the alternative of paying in gold, and so gold would flow into this country. We must remind ourselves again that we are talking of the period before we went off the gold standard. Of course these effects can only be brought about if the change in the Bank Rate alters our position as compared with other countries, making it relatively advantageous or

disadvantageous for the foreigner to borrow or to lend in this country. If our Bank Rate is only altered simultaneously with, and in proportion to, that of other countries, the whole effect will be lost as regards the foreign exchanges and the position of our gold reserve.

An alteration in the lending rate for money will increase or decrease enterprise at home and the spending power of the people. It will have another result through its effect on our balance of trade. If money becomes cheaper, prices in this country rise, our goods become dearer, and the foreigner does not buy so much. If prices are dearer in this country relatively to other countries, it is a good market for the foreigner to sell in. Our imports increase and our exports decrease, and the balance of trade tends to go against us. When this happens the Bank of England will raise its rate, or conduct its "open market operations" so that our imports will decrease, and our exports increase, and trade will then again balance. Lastly, if the high bank rate persists, resulting in dearer money and falling prices, people who cannot stop producing immediately will forego some of their profits as the alternative to closing down altogether. They will continue working even at a loss, so long as they can get back part of their overhead charges. This, however, cannot go on indefinitely, and unless cheaper money is available, causing prices to rise, they will be compelled to close down. When that point is reached, there will be increased unemployment, which, if it lasts long enough, leads to a period of reduced wages.

The difficulty when we returned to the gold standard in 1925 was that if our gold standard was to work, prices had to come down. They did not come down because wages were too rigid. We had very strong trade unions whose members had suffered enormous reductions in wages in 1921, and it was impossible to go to them again in 1925 and ask them for further reductions for reasons connected with our monetary system and our gold standard, which they did not understand. Wages, therefore, did not fall, and the consequence was that we lost more

and more of our export trade, and were in the end forced off the gold standard.

In conclusion, the deposit banks are the banks which distribute credit, but they are not the manufacturers of credit. The only credit manufacturer in the country is the Bank of England. Unless the bank balances at the Bank of England increase, the possible expansion of credit on the part of the deposit banks lies within very narrow limits. There are to-day many people who carry more notes than they need, and if the banks could obtain all the surplus notes which are in excess of the number necessary to carry on the trade of the country, they could increase their cash holding, and enable an increase in credit to take place. But, of course, this could be done only once. The Bank of England, however, can always create new credit whenever it is necessary for the industry of the country. Whether the Bank of England, either through altering Bank Rate or through "open market operations", restricts or increases credit, the first effect is generally to decrease or increase the amount of money placed at the disposal of the discount market by the deposit banks, and this market may be considered the chief connecting link between the Bank of England and the deposit banks.

CHAPTER IX

WORKING OF THE DEPOSIT BANKS

WE must now discuss the method and the principles followed by the joint stock banks in granting advances. We have already seen in Chapter V that they work to fixed percentages, i.e. they aim at keeping 10 to 11 per cent of their deposits partly in their tills and partly to their credit at the Bank of England; about $3\frac{1}{2}$ per cent cheques in course of collection and on other banks; 8 per cent lent out to discount brokers and others; 15 per cent for the purchase of bills; 12 per cent in investments; and 55 per cent in loans and advances. These percentages come to rather more than 100 per cent because there is a certain amount of the capital of the banks which is not used in fixed assets, in buildings, etc., and this is available for investments and for loans.

The banks make up their balance sheets every week; but they make up their cash accounts first thing every morning, and they look what cash has come in, whether they have a surplus for investment over their 10 to 11 per cent, or whether they have advanced rather more than they should have done to maintain that percentage. Before deciding on their lending policy for the day, they take into consideration any large amounts which they know they are to receive during the day, or which they have to pay out. If they have a deficit, they will immediately call it in from the short-loan market or from the discount brokers, or perhaps they will decide to wait a day or two, because they see they have large numbers of bills which will be falling due, and the funds coming in from these bills will replenish their cash balances. If they have a surplus they must decide how to dispose of it. Are they going to lend it out to the discount brokers against the security of first-class bank bills? That will depend

on whether the percentage of bills which the bank holds is lower than the normal percentage on which they are working. If this is the case, the bank itself may buy bills in the market rather than lend money to the discount brokers. At the end of the week, when it makes up its balance sheet, it looks at all the other percentages and adjusts them, so that if, for instance, it has too many bills, when these latter fall due, it does not replace them. If its percentage of bills is down, it buys more bills. If it finds that its percentage of advances is higher than 55 per cent it may try to call in some of the advances; if lower, it will be rather freer in making advances. It must be understood that the maintenance of all these percentages is the aim of the bank, but there always are times when the bank is below or above that ideal, and at such times it adjusts the percentage to the normal as quickly as it can.

Now we can turn to the considerations which the banks have in mind when making loans, or granting advances. Here again we will discuss the method of the Midland Bank; all the banks have slightly different methods, but the underlying principles are the same. The Midland Bank has 2,000 branches. It divides its organization territorially, that is, at the head office it has six general managers who are each responsible for one district of the country; the whole of the country being divided into six districts. Normally all advances which are made should be submitted to and approved by the head office before they are granted. But in practice, if a manager of one of the larger branches, like the Manchester branch, were asked for an overdraft of £20,000 or £30,000 from an old client, who was ready to furnish first-class security, the manager would grant the overdraft, tell the head office what he had done, and the reasons which had actuated him. But generally speaking, the branch managers have no authority to grant overdrafts or loans; their duty is to consult one of the branch superintendents, of whom there are thirty.

If the superintendent of the branch, who has authority to approve loans up to a certain amount, approves the

loan, it is granted. If the loan which is asked for exceeds the amount which the superintendent can sanction, the question is referred to the superintendent's chief, who is the assistant general manager. He has a somewhat higher limit. If the loan is still above his limit, it goes to the general manager of that section of the country, and if it is too big for him to sanction, it goes before the managing director in London of the whole of the Bank and of his executive committee, which committee consists of all the general managers of the bank. No application for a loan or overdraft—in the case of the Midland Bank, and arrangements of a fairly similar nature exist in all the other banks—however small, which is forwarded by a branch manager is refused until it has gone before the general manager of the Bank and his full executive committee. If headquarters are advised that the matter is urgent, a special meeting of the executive committee is held in the afternoon to deal with it. Of course a branch manager may refuse to forward an application for an overdraft, and not consider it at all, but once past the branch manager, it cannot be turned down by anyone except the general manager and his executive committee.

In regard to the type of applications that the bank favours, it normally prefers to grant facilities to trade customers for the ordinary purposes of their business, which are for short periods. It will grant loans, for instance, to traders to carry them over a busy season when they require more stock. In such a case, immediately the stock is sold, the money will be returned to the bank. It does not give them overdrafts or loans for capital expenditure, unless they are able to make arrangements that that capital expenditure will come back again in the course of a few weeks or months.

Banks are very often asked to help to tide customers over a period of depression, and they are anxious to help their customers, as far as possible, under such conditions; but they require to be satisfied on various points, e.g. that it is a business which has been successful in the past and, given normal conditions, is likely to be so in the future,

and that the trouble from which the business is suffering is due to a general depression of trade, and not any fault inherent in the business itself or the management thereof. They might want to impose certain conditions regarding the conduct of the business until such time as the firm was able to repay advances.

These are the principles which guide the banks in making advances for ordinary trade purposes, but banks also, to some extent, lend money to the Stock Exchange. The loans of the Midland Bank, for instance, were in 1930 about £8-12 million against securities which must all be marketable on the Stock Exchange, but that £8-12 million formed only about 5 per cent of their total advances. These loans are made to stockbrokers for the ordinary purposes of their business, and as a general rule banks refuse to make loans to a private individual for speculating on the Stock Exchange; but if an important customer came to them for a reasonable amount which he would repay in a short period and for which he could put up good security, then, provided the bank was not over-lent, i.e. that their percentage of loans was not too high, it would be inclined to grant the application.

Banks lend either with security or without security, and probably about as much in the one case as in the other. Where they lend without security they will usually require to see the firm's balance sheet and will have to be satisfied with the business in general. As a rule, advances which are made in London are secured, and of the advances which are made in the Provinces about half are unsecured.

The banks often lend money to insurance companies, who borrow to make investments in anticipation of revenues which they know will be coming to them within a comparatively short time. But here again, the securities which they give the banks must all be readily marketable. Banks will not advance against securities which are not quoted on the Stock Exchange.

We have seen that the banks aim at limiting advances to traders to 55 per cent of deposits. Sometimes the advances

are higher than this for a considerable period. That occurs in this way. Suppose the balances of the deposit banks with the Bank of England are increased by £1,000,000. This will enable the deposit banks to lend or invest nine times this amount, i.e. £9,000,000. Of this £9,000,000, 55 per cent—that is, £4,950,000—would be lent to traders. Now we will assume that conditions alter and credit becomes more restricted. The deposit banks' balances with the Bank of England are reduced by perhaps £500,000. The deposit banks in their turn must reduce their advances by £4,500,000, and of this reduction 55 per cent should be paid back by the traders to whom the money had been advanced. But traders cannot usually pay back their advances quickly without inconvenience, and during the period that the deposit banks are waiting for full repayment, the percentage of their advances to traders will, of course, be above the normal.

We have seen that it is the Bank of England that alters the basis of credit, thus causing the deposit banks to increase or decrease their loans and investments. As increased loans will be used by industry for the payment of wages, they will increase the spending power of the people, and result in raising the general price level, or it will act in the reverse manner and reduce the general level of prices if the Bank of England decreases the basis of credit (the balances of the deposit banks). What really happens is that the Bank of England, having extended its basis of credit and enlarged the balance of the deposit banks, enables the banks to lend more money. If that money is lent to trade it is used by people who want to buy more stocks for their business in some form or other. New money goes in increased enterprise, and this means that more money will be spent by employers in wages. It does not follow that wages will rise, but more people will be employed, and, therefore, there will be more wages in the country to spend. Thus more things will be bought and as more things are bought, the prices of these things will rise; and as the general level of prices is the average of all

prices, even if only some prices rise, then the general level rises.

There has been in recent years a very considerable amount of controversy as to whether the Bank of England has adopted a sufficiently generous policy in increasing the basis of credit. There are many people who think that, owing to the monetary policy of the Bank of England, and period of dear money through which we have passed, credit has been restricted, and, with such restrictions, prices have fallen. As prices fall, a trader who holds stocks of goods, loses money. This continues with every replacement of stock until a time comes when he says, "I must close my factory", and an obvious result is an increase of unemployment. There is, however, a school of thought which argues that the Bank has kept money too easy, and yet another school which believes that the fall in prices is due to influences quite outside monetary policy. The subject was very fully discussed by the Macmillan Committee, and certainly four out of the five big banks—"the Big Five"—agreed that there had never been any refusal of loans or overdrafts on the part of the banks owing to the fact that the basis of credit has been restricted. The fifth bank, the Midland Bank, was of a contrary opinion. But neither the traders nor the trade organizations which gave evidence before the Macmillan Committee were able to support the view that credit had been unduly restricted. The Macmillan Report pointed out that these two opposite views are not necessarily inconsistent, because it said that dear money reduces profits, and reduced profits result in lessened enterprise, and lessened enterprise leads to a decline in the demand of industry for advances from the banks. But once started on the downward road, prices begin to fall and losses are inevitable. There is a want of confidence. It might be perfectly true to say that there was plenty of money that could be advanced for industry and trade, and that no proper demand of industry for credit was being refused; but it might be equally true to say that trade and industry were not making demands and

could not do so because of the want of confidence induced by the fall in prices; thus the two views are not necessarily contradictory. It may be that plenty of money is available to finance the volume of current business at any given time; but if the confidence of the traders has been sapped and losses suffered by the fall in prices, there will not be the necessary enterprise and consequently not the necessary demand for money to be put an increasing population into employment.

From the Macmillan Report we learn that between 1924 and 1929 the output per head in industry increased 10 per cent, and the number of people unemployed increased 7 per cent, so that if we had employed this 7 per cent, we should have had an increase of over 17 per cent in production, and an extra amount of credit of somewhere between 15 per cent and 20 per cent would have been necessary to finance this employment and extra output per head. During these years the advances of the banks increased by something like 24 per cent. So the question then arises, "Why was not this unemployed labour re-absorbed, if sufficient money was forthcoming to finance the extra output per head and to finance the 7 per cent of unemployed? Why do these people remain unemployed?" But of this 24 per cent of increased bank advances, 20 per cent went into the fixed deposit accounts, and not into current accounts. This shows that the money was there and could have been used by traders, had they had sufficient confidence to use it. Furthermore, the banks found the money to make these increased advances of 24 per cent by selling part of their investments. The sale of these investments tended to reduce the price of gilt-edged securities—that is, first-class interest-bearing securities, such as Government bonds, municipal bonds, etc. The result of reducing the prices of these securities was again to frighten people from investing in new securities, and obviously a man who has an investment in War Loan and sees the capital value go down, and is then asked to invest new money in some new enterprise, will hesitate before doing so in case this should depreciate in value like his War Loan. He will prefer to

let his money remain in a bank rather than invest in securities which, in a few months may have lost a substantial part of their capital. This is very serious, because in times of depression the surest way out of the depression is through investment in new long-term securities. A considerable period of cheap money inspires confidence, however, in the end, but it often takes a long time before such a result is brought about.

However cheap money is, the ordinary trader can never borrow from his bank below 5 per cent, and the most favoured trader never below 4 per cent, and therefore, a decline of 1 per cent in Bank Rate, if the rate is lower than 5 per cent, is not an enormous incentive to a trader to enter into some new enterprise, or to buy more stock than he would have done before money became relatively cheap. With long-term borrowing it is different. There are many schemes—buildings, docks, harbours, extensions of factories, etc.—which it pays to undertake if money for example, can be obtained at 5 per cent, but which will not be undertaken if 6 per cent has to be paid; and the cheaper long-term money is, the more possible such schemes become.

It has been calculated that a reduction from 6 per cent to $4\frac{1}{2}$ per cent in the cost of loans—that is to say, in the rate of interest which has to be paid for such schemes as housing is equivalent to a reduction of 25 per cent in the cost of building. We may imagine, therefore, that contractors who will not enter upon new housing schemes when money is at 6 per cent will be glad to do so if they have to pay only $4\frac{1}{2}$ per cent. They will thus start the ball rolling by building houses, and the demand for raw materials and all the things required by the wage-earners employed will stimulate other trades and industries.

We must now consider another point. We have been treating this whole question of the alteration in Bank Rate, or the effect of "open market operations", as though it would always cause some definite effect; that the lowering of the rate must necessarily produce a rise in prices, and that the raising of the rate must necessarily

cheaper goods; but of course, in real life all causes and effects react upon each other. Suppose there is a man who is very fond of smoking but who is apt to get fat if he is not very careful with his diet. That man gets into the habit of smoking more and more until one day he pulls himself up and says he is going to reduce his smoking; but giving up smoking induces a better appetite, and having a better appetite he eats more, and as he eats more he gets fatter, and as he gets fatter he says he must begin to eat less. So he starts, and he has a sandwich in the middle of the day, he walks home in order to take more exercise, and as he is walking home he feels very hungry after his light lunch and so has a pipe, and that begins anew his habit of over-smoking, and so it continues in a vicious circle.

Apply this analogy to alterations in monetary policy.

Consider what happens if the Bank of England increases the basis of credit, enabling the deposit banks to lend more money (which they must lend immediately, otherwise they lose interest on it). They lend it, in the first place, to the discount broker. The effect is to depress the rate at which bills can be discounted, because more money is on the market for the same quantity of bills offering. This causes foreigners to withdraw their money from London (provided they can get a higher rate in New York, Paris, or Amsterdam). As the foreigners withdraw their money from London, the exchanges tend to go against us, and the Bank of England becomes frightened that it will lose gold. In order to rectify its position it puts up its rate; and the discount rate, which was brought down by its policy, now starts to go up again, because the cause and effect have re-acted on each other. Something else happens too. If the rate of discount is lowered, cheaper money stimulates trade and increases imports. As imports increase more bills are drawn and therefore more bills come into the market for discount, and as the supply of bills is increased, the rate of discount tends to rise. If the Bank of England decreases the basis of credit, and the deposit banks in order to maintain their 10-11 per cent proportion have to call in money from the discount market,

then rates in the discount market will tend to rise. The fact that they do rise will attract more foreign money to London, because it can earn a higher rate of interest. As more foreign money comes into London, the demand for bills will increase, and the rate will again tend to fall.

Let us suppose that at the end of the week deposit banks find that their percentage of investments is too low, and they decide to purchase some Government bonds; that will raise the price of the bonds, and as it raises the price of bonds it will lower the rate of interest which can be earned on them. At the same time it will put money into the pockets of the people who have sold the bonds, which money they will wish to re-invest.

It is quite obvious that if 5 per cent War Loan stands at 100, and the price for War Loan goes up to 105, then the man who pays 105 for it is not getting the same return on his investment. The rate of interest which can be earned by a purchaser of these bonds being lower than it was, new borrowers will be able to borrow at a lower rate of interest. That will stimulate the creation of new bonds and of new issues. For instance, the builders will come into the market, borrow money for housing schemes, and the result will be to stimulate trade, more money will be required, and as more money is required the rate of interest will tend to go up again.

The converse will result if, owing to a decrease in bankers' balances, the deposit banks decide to sell some of their investments.

Finally we shall find the same actions and reactions if the loans and overdrafts to trade and industry are increased or decreased.

The first loans that the deposit banks will decrease, if they find that according to their percentage they are over-lent, will be those which have been made for the purpose of financing Stock Exchange securities. The people who have to repay the loans will be forced to sell the securities, and this will have the same effect, as the sale of securities by the banks would have had; or vice versa, if the banks have more money to lend for loans and overdrafts than

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is required for the immediate needs of trade and commerce, they will be more inclined to lend in order to finance Stock Exchange securities. This will tend to a greater demand and the same sequence of events will be set up as if the banks had used their funds to buy Stock Exchange securities.

Again, if more money is lent by the banks to industry and commerce, it is because trade is good. This increases demand. Increased demand means higher prices, and higher prices mean more imports and less exports. This puts the exchange against us once more; the Bank of England gets frightened that it will lose gold, puts up its Rate, dear rates mean bad trade, demand decreases; and we go round again in the circle.

In all these money operations, what is really happening is that there is some point towards which we are always striving and which we never reach, but which we are always a little above or a little below. We are climbing on a hilly road, and every time we reach the top of the hill, down we come again on the other side. We cannot say any of these actions of the Bank of England or of the deposit banks have a final and definite effect; all that we can say about them is that they tend in a certain direction.

CHAPTER X

GENERAL CONSPECTUS

PART I

IN the previous chapters we have dealt with the machinery of our monetary system and described the various parts and how they work. The machine, of course, broke down on 18th September, 1931, when we went off the gold standard. The requisite Act of Parliament was passed on 21st September, but the Bank of England ceased paying out gold on 18th September. Bearing in mind the distinction between these two dates, however, 18th September is a more important date to remember because we find all comparison of index figures of the level of prices, etc., are made with reference to that date.

It was found before we went off the gold standard that there were certain faults, and that the machine as a whole required overhauling. Before we deal with the defects, it will be well to describe the machinery and the working of it as a whole, because up to now we have been seeing how the various parts interlock with each other, and we have not had any general comprehensive view of the whole machine.

In order to discuss the defects in the machinery, it is necessary to understand what we expect money to do. Money has always come into being in any community as soon as it emerged from the condition of a primitive savage state. All kinds of things have been used as money; oxen, sheep, wheat and other forms of grain, oil, rock salt, tobacco, tea, dates, furs and even cowrie shells, which are still used in certain parts of West Africa. Many metals such as iron, tin, lead, copper, silver and gold, have also been used.

The writer was once on the Dutch East Indian island of Celebes. He went up-country and met some coloured men with very beautiful spears slung across their

shoulders, and was anxious to buy one of them. He asked what they wanted for them. They finally agreed that they wanted two bullocks, but, as he was not travelling in bullocks, it seemed as if he would have to do without the spears. After repeated attempts to strike a bargain they ultimately consented to take twelve Dutch guilders for each spear. But their standard of value was evidently bullocks.

Again, let us take the case of a family living in England. Suppose the father is employed on a railway and earns £3 a week, that the two children are at school, and that the mother in her spare time does some sewing for the grocer's wife by which she earns 10s. to 15s. a week.

The father has insured his life for £100 with the Beneficial Assurance Company, paying them a premium of 2s. a week in order that his wife may receive from them £100 when he dies. He buys his tobacco and hands over to the mother the remainder of his wages, with which she buys all the household requirements, food and clothing, and pays the rent.

What really happens, of course, is that the father exchanges the remuneration for his services for the product of the services of the bootmaker, butcher, etc. If there were no money the railway company would have to pay him by giving him all the articles which his family needed and a house rent free. This would be most inconvenient, because every family would require something slightly different; but, by the use of money, his wife can buy such things as she requires from the tradespeople; they can restock their shops with goods purchased from the wholesale warehouses, and the wholesale warehouses can purchase new goods from the manufacturers with the same money. Thus all these commodities will have changed hands by the passing from one to another of the wages paid by the railway company.

The first use of money, then, is to serve as a medium of exchange.

We now come to the 10s. or 15s. which the mother earns weekly by sewing for the grocer's wife. If there

were no money the grocer's wife would give her every week so many eggs, so much butter, bacon, tea, sugar, etc., until she had paid for the sewing, in quantities of these commodities to which the two women had mutually agreed.

The mother, however, would not require exactly the same quantity of each commodity every week, and each change would require a fresh argument, because without money it is difficult to determine, for instance, whether six eggs, half a pound of bacon, a pound of sugar and three-quarters of a pound of tea are equivalent to four eggs, a pound of bacon, half a pound of sugar and half a pound of tea; but by the use of money each article has a price which enables the value of one to be compared with the value of another, money thus acting as the means of measuring the value of each of them, i.e. as a common denominator. This is the second function of money.

Let us suppose now that the father dies after twenty years and the mother receives the £100 insurance money. She will expect to buy with this money the same quantity of the things that she requires as she could have done during the twenty years that the father was paying his 2s. a week. If she can, then money has acted over this long period as a good standard of value; but if her £100 bought either more or less, then, to that extent the standard of value would be imperfect, just as a tape measure would be imperfect which was made of material which easily expanded with heat and contracted with cold, so that it did not always measure the same. The third function of money, then, is to act as a standard of value just as a yard acts as a standard of length.

Now the mother will sometimes want a new dress, but will never have enough money over in any one week to buy it. She therefore saves up week by week, and by using money as a store of value she does this very conveniently, much more so than if, for instance, she grew potatoes and saved up the potatoes until she could exchange them for a new dress.

The general use of money makes it desirable that it should be publicly controlled by the government, and it is the aim of every good government to have a monetary system and a banking organization which will enable all these functions to be performed satisfactorily.

The foundation of our monetary system was the Gold Standard. At one time we had a gold currency and carried gold coins in our pockets. During the Great War we returned all our gold coins to the Bank of England and took paper money instead, although legally our paper was exchangeable for gold coins; and as we stopped the export of gold, and we could not get gold from the Bank of England in exchange for paper, it meant in practice that we went off the gold standard. That was the first time we had been off the gold standard since the Napoleonic Wars. In 1925 we passed a law saying that while the Bank of England must sell gold at £3 17s. 10½d. an ounce, it need not exchange its notes for sovereigns but that it was only obliged to sell gold in quantities of not less than four hundred ounces at this price, and the consequence was that gold was only taken out of the Bank of England for the purpose of export. We saw that in 1928 the Treasury note issue and the Bank of England note issue were amalgamated, and the fiduciary issue (that is that part which is not backed by gold but is secured by Government securities) was fixed at £260,000,000 sterling, and remained there until August, 1931, when the amount was increased to £275,000,000.

During the past century the amount of gold and bank-notes vastly increased, but it did not increase nearly so rapidly as the requirements of the people for money to carry on their business. However, side by side with the gold and the bank-notes, there was developed our cheque system—that is the system of having deposits in our banks and transferring our money from one person to another, not by giving them coin or bank-notes, but by writing out a cheque on our bank. One of the important effects of this alteration was that it led to surplus money being kept in the banks instead of in private hoards

as had, to some extent, been the case when only coins and bank-notes were used. These hoards were thus centralized, and consequently, as it is not necessary to have so big a reserve if centralized as it is for very many individual reserves, the money was really more useful because the banks could lend it out. If fifty people said that they always liked to have 10s. extra in their pockets in case of emergency, then there would be £25 in the pockets of all those people, and that £25 would be performing no service at all. But supposing they were all going on excursion together and somebody said it would be ridiculous for them each to take 10s. extra as £5 would be quite sufficient for them all, then, of course, the total reserve, through being centralized, would be reduced. That is what happens when we centralize our reserves in the deposit banks. These banks will keep a considerable part of them at the Bank of England. As the Bank of England keeps such reserve for the deposit banks it does not require to be as large as if each bank kept its own reserve independently.

Every monetary system in a big industrial country which is also a financial centre and which is conducting its business on modern lines, has various features in common with other systems. It has first what is called "the call loan market"—that is, a market where money is lent for very short periods, from a day to a fortnight. Of course, a market does not necessarily mean a place or exchange where people sell. It means an organization where certain services are rendered or certain things bought and sold. Manchester would be called the market for cotton goods, whether there was an exchange or not. In London the "call loan market" is mainly the discount market where bills are discounted; in New York it is mainly the Stock Exchange—that is to say that, while the greater part of the money that is borrowed on call, repayable on demand, is used in London for the purpose of discounting bills, the greater part of the money in New York is borrowed by the Stock Exchange to finance stock exchange securities.

Secondly, every centre has another market to deal with the demand and supply of loans for short periods, but longer periods than the call loan market. That market, in practically all centres, is formed primarily by the deposit banks. Its function is to loan money for, and to receive money which is payable over, short periods. It is not its function to lend money for very long periods, and in England it is only the issue market that deals with long-term borrowing for foreign and internal loans. Foreign loans are mainly dealt with by the issuing houses, who to a large extent are also the accepting houses, who accept bills of exchange. There are also all kinds of brokers and finance houses who lend long-term money for internal purposes. They all belong to the long-term market. Then we have the organizations which deal with savings of a special kind. These organizations comprise institutions like savings banks, insurance companies, and building societies, etc.

These are the main markets which deal with money, and it is very necessary to have some kind of co-ordination between them. That co-ordination is found by means of the rate of interest. There is always a relationship between the rate of interest which is payable in the call loan market and by the deposit banks and for long-term loans. Fluctuations in the rate of interest on the one hand are caused by, and on the other hand determine, the amount of money which flows into and out of these various markets. We have seen that the first thing that the deposit banks do when they have a surplus of money to lend is to lend it in the call loan market. When that market becomes full and the loans become less easy to make, the tendency is for the rate to get so low that people are tempted to lend their money on long-term instead of leaving it on deposit with the banks. That applies in a very much smaller degree to savings banks and insurance companies. Perhaps it applies more in the case of building societies. People who invest their money in savings banks, and to a large extent in insurance policies, do not look primarily to the rate of interest which they will

earn, they look to convenience and security, and as a rule they will not alter their ordinary methods of saving, or their ordinary channels in which they deposit their savings, on account of any small alteration in the rate of interest. It is very doubtful, for instance, if the Post Office Savings Bank increased its rate of interest from $2\frac{1}{2}$ per cent to 3 per cent, whether that would attract any more savings, and if it did would probably be through some psychological influence produced for the moment, and when the people had got over that they would probably put no more in the Post Office Savings Bank for that year than they did when the rate was $2\frac{1}{2}$ per cent. So much for the various money markets.

We must now consider the Gold Standard. This will never work satisfactorily unless it works internationally, because, as we have seen, the whole object of a gold reserve in every country to-day is not for its internal use but to provide a means of settling the balance of debts which are owing from one country to another and adjusting the international price level.

Price movements are influenced by monetary conditions, and, as we saw in our last chapter, these move in a circle, so that in their turn monetary conditions are influenced by price movements. If various factors are allowed to operate over a sufficiently long period of time, then both prices and rates of interest, in all civilized countries working on the gold standard in normal conditions, will tend to a level which enables them to exchange their goods and services.

The primary function of an international gold standard is to prevent undue fluctuations in the rates of exchange. In the early months of 1932, some time after we went off the gold standard, the pound in one day went up something like 4 per cent in terms of gold. This was a very great inconvenience. It meant that if goods were bought from Germany on a Tuesday, and the man from whom they were bought were to receive so many marks for them, and the buyer had worked out that that number of pounds which when exchanged for marks would give the number

of marks which he owed, found two days after, on the Thursday, when he came to pay, that he was going to get so many fewer marks for his pounds, all his calculations would have gone wrong and the transaction would turn into a loss. If we had been on the gold standard that could not have happened, because if he found that he would have to pay so many pounds more for his marks, he could have gone to the banker with his bank-notes and demanded gold. He could have paid the German with gold, and all that that would have cost him, would have been the charge of insuring the gold and the freight on it. If the transaction were small, or he did not want the trouble of going to the bank and getting out the gold, he would have gone to his ordinary deposit bank or an exchange bank, who would have given him marks for his pounds sterling at a rate equivalent to the cost of shipping gold, within very narrow limits, because if they did not, he could have gone to the Bank of England and obtained and shipped gold abroad himself. Let us take a definite example.

Suppose we owed on 17th September, 1931, £1,000 or £2,000 to Germany; the exchange was 20.40 marks to the pound sterling. After 18th September, when we had gone off the gold standard, the exchange had fallen to 15 marks per pound sterling; if, before we went off the gold standard, we had gone to our bank and had been told that we were going to get only 19 marks for the pound, we could have shipped gold to Germany, and when it got to Germany our client would be able to get 20.40 marks for every pound which we had paid in this country. The only expense would have been the cost of shipping the gold to Germany, and therefore the exchange could never fluctuate to a greater extent than between the cost on the one hand of shipping gold from this country and on the other hand the cost of shipping gold to this country. These two limits are called the gold points.

But suppose that on the 21st September, after we had gone off the gold standard, we owed £2,000 to Germany. We go to our banker and he informs us that he can only

give 15 marks for the pound sterling. We may decide to wait and see whether it will be possible to get more than 15 marks. When next week comes the rate has fallen to 14 marks and we cannot do anything. We cannot exchange notes for gold, and therefore are obliged to lose the difference between the 15 marks which we calculated when we sold our goods and the 14 marks when we come to pay our bill. That is one of the great drawbacks of being off the gold standard. It is not necessarily an insuperable difficulty. There are means through "forward exchange operations" by which it is overcome even where the exchange is not tied to gold.

After England went off the gold standard in 1931 the exchange fluctuated about 30 per cent in six months. It very often takes six months before a transaction is liquidated, so that the man who sold goods in a foreign currency payable six months later would not know how much of the money of his country he was going to receive, and whether it would cover the cost which he had calculated at the time he sold the goods. In any developed financial system this difficulty can be very considerably reduced by what are called "forward exchange operations". If a man were to make a bargain with a Ruritarian in crowns, and he wanted to know that six months hence those crowns were going to buy the same amount of sterling as that which he had calculated when he entered into the bargain, he could, in any developed market, go to a bank and say, "I am going to receive six months hence so many thousand crowns, and I want you to buy them from me now, so that the rate of exchange is fixed, but only to pay me the sterling in six months when I deliver the crowns to you." Operations of that kind are called "forward exchange operations."

If there are fundamental causes which are tending to upset the balance of payments of the country, forward exchange operations will eventually become restricted. The effect of the one-sided payments which will thus ensue, will be to cause an abnormal appreciation or depreciation in the exchange, and may lead the country con-

cerned to impose restrictions on the free working of the exchanges, in which case forward exchange operations will become impossible. But even if this does not occur, difficulties will arise.

In normal times the difference between "spot"—i.e. the rate for immediate delivery—and "forward" rates depends on the rates of interest in the respective countries, but in abnormal times merchants may find a growing premium or discount on the forward rate over the spot rate. If their customer has to pay much more in his currency for forward transactions than for spot transactions, his purchases for goods ahead will be dear compared with goods in stock, and he will be disinclined to operate.

Another impediment may also arise. If John Smith is to receive, say, 3,340 crowns in Ruritania in three months time and wants to make sure that this will yield him £100, he will sell them to a bank for delivery in three months' time, the forward rate for three months being assumed to be 33.40 per £. The bank in covering itself relies on receiving the crowns from John Smith in three months.

English banks do not speculate in exchange, and if they buy or sell forward they cover themselves by various means, chiefly perhaps by entering into transactions with people or banks who wish to operate in the opposite direction. For instance, if they have bought pounds and sold crowns, they will find some one who wants to buy crowns and sell pounds. In cases of violent changes in the exchange, the risk that their customers will not be able to fulfil their forward contracts, is increased, and the banks will only do the business with their first-class customers or with other customers against security for the fulfilment of their contracts.

It must not be overlooked that a merchant, in fixing his "forward exchange" in order to eliminate this risk, may be merely transferring the exchange risk into a price risk. If all his competitors in the market bought their goods and fixed their exchange at the same time, this would not

arise, but if one rival has bought goods of a similar kind but at a later period enabling him perhaps to fix his exchange more favourably, then obviously if all the goods arrive at the market at the same time this rival would be able to undersell his competitors.

CHAPTER XI

GENERAL CONSPECTUS .

PART II

At this stage it is desirable to understand clearly what we mean by the expression "general level of prices". It is a term that crops up as often as King Charles' head, and it is one which causes a certain amount of inaccurate thinking, because people confuse the fluctuations in the general level of prices with the fluctuation of individual prices.

If one goes to a fishmonger and he says that cod is cheap he means that, relatively to sole, turbot or haddock, cod is cheap. He would say that cod was cheap although perhaps fish generally was much dearer than it had been six months previously. If he says that fish is dearer than it was six months ago, he is talking about the general level of the price of fish; but if he says that cod is cheap he is comparing the individual prices between one fish and another. If, however, he kept a record every year of how much of each kind of fish he sold, and for how much per pound he sold it, he could then compare the average price he realized from one year to another. He might find, for instance, that in 1930 his average price was 1s. 3d. per pound; in 1931, 1s. 3 $\frac{3}{4}$ d.; and in 1932, 1s. 2 $\frac{3}{4}$ d., and so on. In order to compare these different average prices clearly, he could call the price in 1930 100, and thus 1s. 3 $\frac{3}{4}$ d. in 1931 would equal 105, and 1s. 2 $\frac{3}{4}$ d. in 1932 would equal 98.33. He could then see the position at a glance.

1930 = 100.

1931 = 105, i.e. a rise of 5 per cent over 1930.

1932 = 98.33, i.e. a fall of 1.66 per cent under 1930.

Figures of average prices so compiled are called "index numbers". Index numbers for wholesale prices are published in this manner for the Government by the Board of Trade, and those for the cost of living (based on retail

prices), by the Ministry of Labour. There are also other wholesale price index numbers of which the best known are those published in the weekly financial journals, *Economist* and *Statist*.

Let us consider another illustration which may be helpful. We will imagine two men at the seaside, one is a shrimp fisherman and the other a lobster catcher, and we will suppose that they both catch more than their respective families consume, and that they are obliged, through lack of other means, to exchange their surplus with each other.

If on any given day the surplus caught by the one is wanted by the other, then, possibly after some bargaining, all the surplus shrimps will be exchanged for all the surplus lobsters, and the number of pints of shrimps which are given for one lobster will fix the exchange value of the two commodities on that day.

If, however, on the next day there is a good catch of shrimps, but the quantity of lobsters secured remains the same, the family of the shrimp fisherman may eat a few more shrimps, but if there is still a larger quantity remaining than on the previous day, an attempt will be made to induce the lobster catcher to exchange the surplus for another lobster, assuming, of course, that the shrimp fisherman's family is very fond of lobsters. The lobster catcher, however, will say that he does not want any more shrimps than he had the day before, nor does he wish to part with any more lobsters than on the previous day as he has no greater quantity. The shrimp fisherman will then try to induce him to take his surplus shrimps in exchange for the lobster which otherwise would be consumed by the lobster catcher's family, and will offer him more pints of shrimps in exchange than he had given in the first transaction. If a bargain is ultimately struck on this basis, then the exchange value of shrimps and lobsters will have altered, and we can either say that relative to each other shrimps have declined in value, or that lobsters have risen, i.e. that the value of the last lobster sold has risen, or the average of all lobsters sold on that day.

Now we will imagine that we are standing by the sea-side watching the waves. The different sizes of the waves may be taken to represent the different quantities of the various commodities which people are willing to buy and to sell, and the relative exchange values of these commodities will depend on these quantities.

As we look at the sea we notice that the waves are constantly changing in size; some of the larger ones become smaller, and some of the smaller ones become larger, and these fluctuations may be taken to represent fluctuations in the supply of and the demand for the various commodities and the consequent changes in their relative exchange value. The amount of these commodities we can consider as being equivalent to the total volume of water in the sea at our resort, and the rising of the tide as being equivalent to an increase in the total quantity for sale or purchase, and the fall of the tide as representing a decrease. The total quantity of commodities, of course, represents not only all the shrimps and lobsters, but also the mussels, cockles, soles, herrings, oysters and so on, and although we may talk of the total quantity, we can only add them up by saying that we have so many shrimps, so many lobsters and so many mussels. We cannot express the total in any but this very inconvenient manner because we have no common denominator.

In order to obtain a common denominator we will introduce money. The total of our commodities must correspond to the total of the exchange values of all the commodities, and "price" is exchange value expressed in terms of money.

Now suppose we have on the shore a post with the figure 0 at the bottom and different sections marked up to 200, the 100 point being in the middle. The figures 0 to 200 indicate the total amount of money people are prepared to use at a given time with which to buy the things that they require. We will further assume that the post has a movable finger, attached to which by means of a lever, is a ball of gold. If we make the ball heavier by adding gold, the finger will move up; if we make the ball

lighter by taking away some of the gold, the finger will move down.

We will now imagine that on the first day of our investigation the level of the tide corresponds with the figure 100 on our post; or, coming back to our conception of commodities, the total of the exchange values of all commodities is equal to 100 units of money when our exchange values are expressed as prices, i.e. in terms of money. We must note that the level of the tide will be the same whether the sea is calm or stormy. It is not affected by variations in the size of individual waves, and in the same way the general level of values is not affected by variations in exchange values of individual commodities, because it is the average of all such values.

If we assume that on the next day the tide has risen, or, in other words, there are more commodities, and that gold has been added to the weight so that the money-index figure has risen to a corresponding degree, say both by 5 per cent, then the tide will come up to 105, the money finger will have moved to 105, and the average of all prices will have remained the same because 100 is to 100 as 105 is to 105.

Let us suppose that on the third day the tide marks only 100, but the money-index finger has risen to 105; then 105 units of money will buy the same quantity of commodities that 100 units bought on our first day, so that the general level of prices will have risen 5 per cent. This maladjustment we should call price inflation. If on the other hand the commodities marked 105 and the money finger still remained at 100 because we had added no more gold, then the general level of prices would have fallen 5 per cent, and this we should call price deflation. The terms inflation and deflation must be understood to express a position relative to some former point of equilibrium.

It must be clearly understood that any additional gold must be added to the golden ball, for a stock of gold which is not so added, but is hoarded, will have no effect on the money-index figure. If there is a stock of gold

which is not being used, it could be sent to some other place, and if added to the ball in that place it would send up the money-index figure there.

It may be thought that this analogy breaks down here, for whereas we can increase the quantity of commodities, it is not possible to increase the quantity of water in the sea. But the quantity of water varies. To use an Irishism, all the water in the sea is not in the sea, some of it is in the air, and the amount changes according to the quantity of rainfall or the degree of evaporation. It was claimed a few years ago that man could cause rain to fall by firing big guns into the clouds. If it is true that we cannot increase the amount of water in the ocean, is it not because human knowledge is imperfect? In the same way, if we are sometimes puzzled because the variation in the general level of prices does not correspond to the extent that we should expect to the variation between supplies of commodities and supplies of money, is it not perhaps because the index which we use to indicate changes in the general level of prices may be imperfect in so far as we cannot adjust it sufficiently rapidly to relative changes in the things on which money is spent?

We may now turn to the practical aspect of the problem. A severe fall in prices has various effects, and a rise has, of course, the contrary effects. All people who are in receipt of fixed incomes (whether it be from investments in Government securities or in debentures, or landlords in receipt of long-term fixed rents, or old age pensioners) benefit from the fall in prices because their income remains the same, while the things they buy become cheaper. They continue to enjoy this benefit either until prices begin to rise, or until the income from their fixed-interest bearing securities is reduced by means of a conversion operation. A conversion is the operation by which the borrower—say the Government or firm who has borrowed on bonds or debentures—offers either to repay the money when the loan becomes due, or to give the lender a security bearing a lower rate of interest. In 1932 the Government did this with War Saving Certificates.

Certain of these had fallen due, and the Government could either have repaid all these certificates to the holders or allowed them to continue for ten or sixteen years on a lower rate of interest than that which they had been enjoying during the previous ten years.

When prices fall, the burden on the other parts of the community who do not enjoy fixed-interest bearing securities is increased. Imagine a boot manufacturer who about ten years ago borrowed £10,000 in debentures at 6 per cent interest so that he had to pay £600 per annum. Suppose the price of boots was £1 a pair when the money was borrowed, the manufacturer then had to pay annually the equivalent of 600 pairs of boots. Suppose the price of his boots fell to 10s. per pair, then he would have to pay the equivalent of 1,200 pairs of boots to satisfy the same amount of interest, and unless he can, through a reduction in wages or otherwise, bring down the cost of his boots to 10s., he will suffer heavily owing to the decline in prices. As a result he may incur losses which in the end induce him to close his works and thus increase unemployment.

Those people who enjoy incomes from fixed-interest bearing securities are also the cause of another dislocation when prices fall. This class of person spends its money on a different type of commodity than that which is bought by the ordinary wage-earner. But the business plans of all manufacturers will have been made to satisfy a demand for the products which existed before the prices fell. So much is being produced in the country for the consumption of those with fixed incomes, i.e. for the wealthier part of the community, and so much is being produced for the wage-earning part of the community. The fall in prices will give the people in enjoyment of fixed interest a surplus to spend on other things, as the commodities which they bought before prices fell will now cost them less. There may be, for instance, an increased demand for motor-cars, and as the income of the workers is reduced a decreased demand for ready-made suits. The people who make ready-made suits cannot make motor-

cars and therefore some of these garment workers will be thrown out of work. The increased demand for motor-cars may absorb unemployed workers in this industry, or may be met by increased efficiency enabling more motor-cars to be turned out by the same number of workers.

If the price level between two countries, both of which have a gold standard, is maladjusted through temporary causes—that is to say it has gone up too much in one country and not enough in another—it can be re-adjusted fairly simply through the medium of the gold standard. What would happen normally is that the country where the prices were too dear would be a dear country in which to buy goods; therefore exports would decrease. It would be a good country in which to sell goods, because prices were high and imports would therefore increase there. The balance of trade would be against it, and it would lose gold to the other country; that is to say, as its imports increased and its exports decreased, it would owe more money abroad than was owing to it, and it would settle that balance by the shipment of gold. When that gold arrives in the other country it has to earn money in some way or other, and, therefore, the people who receive it, immediately start to use it as a basis for new credit. Suppose, for instance, in the case of our country, that it came to one of the deposit banks which could sell it in the market or take it to the Bank of England, that would increase the deposit bank's balance with the Bank of England, and as we have seen, if they increase their balance with the Bank they can increase their loans or investments ten times over. They create more spending power, and people having more spending power desire to buy more things, and prices go up. Therefore prices would gradually go up in the country receiving gold, and down in the country sending gold until the former level was restored. That happens normally under a gold standard if the maladjustment in the prices is not very serious and is due to temporary causes.

Sometimes, however, the maladjustment is due to more

fundamental and permanent causes, such as rigidity of wages, or wars, or results of wars, etc. Let us suppose that in England wages have been so high that the cost per unit of production has been much dearer than in any other competing country, and consequently our prices have been too high to increase our export trade. However much gold might be moved about, and however much less credit became available because we lost gold, prices could only fall down to a certain point unless it were possible to bring down wages. If this could not be done the maladjustment of prices would remain, and consequently our import trades continue to be stimulated and our export trades to suffer.

There are a great many people who think that in this country we pursued in recent years a policy of restricting credit with the idea of forcing down prices in order to become competitive with the rest of the world. They believed, however, that the result of this policy was to force down prices without forcing down wages so that prices only came down to the extent that manufacturers and merchants lost all their profit, and, if they did not wish to close down their works, had even to work at a loss. When that point was reached they discharged their workpeople. We could not cut down our cost of production because our wage system was so rigid that it could not adjust itself easily and quickly enough to the fall in prices, and therefore a large amount of unemployment resulted.

The gold standard will tend to keep the price level stable only if the countries using this standard are really playing the game. The old idea that the gold standard works automatically is only true within fairly narrow limits. For instance, if America takes a large amount of gold from the rest of the world, and having received the gold refuses to allow her price level to rise and refuses to re-invest abroad, she is hindering the working of the gold standard. If, on the other hand, gold is leaving this country, and rigidity of wages or social legislation prevent prices from falling, we are impeding the normal

working of the gold standard. If gold were the only money in existence it would operate fairly quickly. But of course it is not. The great bulk of the money which we use is in the form of cheques, bills of exchange, etc., and credit instruments, and although these have a relationship to the stock of gold and are affected by the amount of gold, the effect of a change in the supply of gold is less direct than it would be if none of these credit instruments were available.

The supply of gold affects the basis of credit in two ways; either by a change in the actual quantity which is available in the country at any given time, or by an alteration in the amount of gold which that country is keeping in reserve against its note issue. For instance, supposing a country decides to have 40 per cent of gold against its note issue, and then alters that percentage and decides to have only 35 per cent, it has then freed that other 5 per cent, which could be used towards settling the balance of its international trade, or forming the basis of further credit.

The Macmillan Committee in 1931 said that the management of an international gold standard "is an art, not a science", and that it is not possible to draw up any formal code of action. It did, however, define what it considers to be the rules of the game. These are all of enormous importance because on the world adhering to them depends when, and if, we shall ultimately revert to the gold standard in this country. The following are what the Committee considered to be the rules.

First, "an international gold standard system involves a common agreement as to the ends for which it exists." Every country living under the gold standard must agree what are the objects of having an international gold standard at all.

Secondly, "it should be an object of policy to ensure that the international gold standard should bring with it stability of prices as well as guaranteeing the stability of exchanges." That means to say that nations endeavouring to work the gold standard together must look not only

to maintaining their own exchanges stable, but also to maintaining, as far as possible, a steady and stable general level of prices throughout the world.

Thirdly, "actions by individual Central Banks which by repercussions on the policy of other countries imperil the stability of the price level, should as far as possible be avoided." If America and France are receiving an undue proportion of the world's gold, and do not use it either to buy goods from other nations or to invest in other countries, nor to allow their price level to rise so that their exports diminish, then the repercussions on the other nations who have parted with the gold, and whose price level consequently will decline, become very serious. Quite apart from what has happened in this country, it will be seen, on examining the figures of the drain of gold into America and France during the years 1927-31, that countries such as the Argentine and Brazil—that is, raw material producing countries—parted with such large quantities of gold that their price level constantly declined. Foodstuffs became so cheap that the farmers there could not live on the proceeds of their produce, and consequently could not buy the manufactured goods from the more developed Western countries.

We have seen in Chapter VIII that the Central Banks influence the course of prices through alterations in Bank Rate and through "open market operations", but the main influence which they bring to bear by these means is the encouragement or discouragement of long-term investments. In times of depression they can raise the price of long-dated securities, thus encouraging confidence and, by raising the price they reduce the interest earned on them and the cost of new borrowing is cheapened, which makes people more inclined to borrow. There are many economists who are becoming more and more imbued with the idea that this is the direction in which we must first look for the lifting of the present depression.

If a gold standard country, having lapsed from that standard, wishes to re-adopt it, or if a non-gold standard country wishes to adopt the gold standard, it should do

one of two things. It should either wait until its general level of prices is in consonance with that of gold standard countries, or it should fix the gold value of its monetary unit at a rate which will enable it to exchange its goods and services for those of the Gold Standard countries.

Let us apply this dictum to England and other countries which were off the gold standard in 1925.

In that year there were very few countries left in the world which were on the gold standard; they were Sweden, Norway, Denmark, Holland, Switzerland and the United States, the latter, of course, transcending all others in importance.

When we reverted to the gold standard in 1925 our general level of prices of manufactured goods for export (including remuneration for the manufacturer and merchant) was higher than that of the United States; some people think about 8 per cent higher. In order, therefore, safely to re-adopt the gold standard one of four things should have happened. Either prices in gold standard countries should have risen 8 per cent or our prices should have fallen 8 per cent; or our prices should have fallen somewhat and the prices in gold standard countries risen somewhat until they met in equilibrium; or we should have said that the Bank of England was obliged to give 8 per cent less gold for a £1 note than it had been before we went off the gold standard; in which case, instead of the United States paying 4.86 dollars to the pound, it would only have paid about 4.47, and we should not have been too dear a country in which to buy. At that time, however, such a thing was never suggested. We were too near the old parity of the English pound sterling, and it would have been outside the range of practical politics to have suggested to the English people, without the experience which they now have, that they should depreciate the pound by making it worth 8 per cent less. At all events, it was not suggested, and none of the other alternatives happened. America did not allow her price level to rise; we did not allow our price level to fall owing to the rigidity of our wages; and the two price levels did not meet each

other by the one falling and the other rising. Possibly, we might have struggled through, if there had not been other events to aggravate the situation.

There were other countries in the world, principally exporting countries, which had not yet returned to the gold standard, such as France and Italy. Their currencies had not fallen by a mere trifle like ours; the French franc was at one time worth only one-tenth of pre-War value, and the Italian lira went down to one-fifth of its value, and so on. Therefore, when these countries reverted to the gold standard, they did not revert to their old parity of twenty-five francs or twenty-five lire to the pound, they adopted an entirely new parity, and in so doing they took very good care to see that they were not putting it too high so that their price level would not be above the price level of the rest of the world, and they actually fixed the new parity very much lower than was justified by their internal price level. The result was that they received, in a way, a bounty on their exports, and for many years their price level was lower than that of the general level of the world. They were, therefore, for a time in a very much better position with their export trade than they would have been had they adopted a higher parity for their new currency. When we reverted to the gold standard we did it when our price level relative to gold standard countries was high and we over-valued our pound, whereas these other countries under-valued their currency. Not only were our goods too dear for exporting, but those of the other countries were unduly cheap in the world's markets, and therefore we were under a double disadvantage.

There was another reason why the gold standard finally broke down, and that was because in our altruistic generosity we reduced the Allies' War debts, and consented to a debt settlement which brought us in nothing more than we had to pay to America, and left Germany and Austria liable to pay huge annual sums all of which, or a great bulk of which, in the end flowed into America and France. As America and France were not willing to re-invest this

money in long-term investments, nor to receive it in the form of goods, a considerable portion of it was paid in gold, which caused another dislocation in the working of the gold standard and in the maintenance of a stable price level.

But all this money did not go in the shape of gold; a certain amount of it was left on deposit in foreign countries; not invested in long-term securities but invested in such a manner that it could be recalled at any moment. In 1931 large amounts were called back, first from Austria and Germany, and then from this country, and during the early months of 1932 even America had to part with gold to France.

The following prophetic words are to be found in the Macmillan Report which was signed in June, 1931. The Committee said that they hoped that the state of affairs to which we have just referred "might be a temporary phenomenon. Should it not prove so we can scarcely expect the international gold standard to survive in its present form. If, for any reasons, however plausible from its own point of view, a creditor country, after making all the purchases it desires, is unwilling to lend its remaining surplus to the rest of the world, there can be no solution except the ultimate destruction of the export trade of the country in question through a relative reduction in the gold costs of other countries. If there were no international gold standard, but each country had its own domestic currency subject to fluctuating exchanges, this solution would come about at once. For in this event the exchanges of France and the United States, for example, would by now have risen to so high a level relatively to the rest of the world that their exporters would have been driven out of business, so that their unlent surplus would have disappeared. According to the classical theory of the gold standard, the same result should ensue, though more slowly and painfully, as a result of movements of gold inflating costs in those countries and deflating costs elsewhere. But in the modern world, where, on the one hand, inflows of gold are liable

to be sterilized and prevented from causing an expansion of credit, whilst on the other hand the deflation of credit set up elsewhere is prevented by social causes from transmitting its full effect to money wages and other costs, it may be that the whole machine will crack before the reaction back to equilibrium has been brought about."

In July, 1931, the Kredit Anstalt in Vienna did crack; a month later, in August, the Danat and the Dresdener Bank and other banks in Germany cracked; in September we cracked by going off the gold standard. There has been bank trouble in France, Denmark, Norway and Sweden; in fact it would be hard to find a country in the world except England where there have not been very grave bank troubles, and the prophecy made in June, 1931, by the Macmillan Committee was fulfilled before the end of the year.

At the end of 1930 there were 22,769 banks in the United States with deposits totalling 53,039,000,000 dollars. By the end of 1932, 5,087 (22 per cent) of these banks had suspended payment involving deposits amounting to 3,286,000,000 dollars. In February 1933 there was a panic and runs on many banks. Hasty legislation was passed and by the 3rd of March for a short period it was impossible for depositors to withdraw their money from any banks in the United States. Two days later, by placing an embargo on the export of gold, the United States also lapsed from the gold standard. This step thus marks the end of another period in post-War financial history.

CHAPTER XII

THE FUNDAMENTALS OF A GOLD STANDARD

SINCE 1924 wholesale prices in this country fell 36 per cent up to the end of March 1931. The index number of wholesale prices being based largely on commodities which are international in their character, such as wheat, rubber, copper, etc., the decline in our index number of wholesale prices corresponds broadly with that in other nations. The fall has been much more severe in primary products than it has been in manufactured goods. The wheat which we imported in 1930 would have cost us, on the basis of prices ruling in December of that year, £30,000,000 less than the cost in 1929, and £60,000,000 less than in 1928. It would appear at first sight to be of great advantage to this country that we should be buying our wheat so much cheaper; but the result was that the customers for our manufactured goods, who are very largely the agricultural nations of the world and therefore do not manufacture enough for their own needs, suffered so much from this decline in prices that they were unable to take from us the usual quantity of our exports, thus leading in a large measure to the unemployment in this country.

It is to prevent maladjustments of this description that it becomes so essential for the Central Banks to endeavour to maintain the stability of prices. It should, therefore, be the aim of international monetary policy to raise prices to a level which would be remunerative to efficient producers, and enable industry to re-absorb the unemployed. There must be a limit to the raising of prices, and in 1931 the Macmillan Committee suggested that the financial policy of the Central Banks of the world should be directed to bringing back the price level to that which existed in the year 1928. Failing a rise in prices, two things must

happen. One is that money wages will have to be reduced in order to bring manufactured goods nearer in price to those of primary products; but this would be likely to cause a very serious amount of social upheaval throughout the world. The other is that some means must be found whereby the burden imposed on the taxpayers or borrowers, by the high fixed interest on existing bonds, mortgages and debentures can be reduced to a degree commensurate with the fall in prices. That could only be done very gradually by conversion operations, undertaken when the borrowers are legally entitled to pay back the money which they have borrowed. If that process takes too long, we shall be in a position of very grave danger. The difficulty of paying this interest will become so intense that there will be a risk of the sanctity of contracts being broken and this will strike at the root of all confidence.

Whatever monetary system is adopted in this country in the future it cannot be left to take care of itself, but must be managed to some extent. We have seen in the previous chapter that the old idea of the gold standard working automatically is true only within very narrow limits, and that the aim of monetary policy should be to maintain the stability of prices and of our foreign exchanges, without unduly interfering with the internal trade of the country. The policy should also be directed to the avoidance of cyclical periods of expansion and depression in so far as they may be due to monetary causes. The first objective should be to raise prices, the next should be to keep those prices stable. Under a gold standard system long-period stability depends on there being sufficient gold in the world, and the proper distribution and use of this gold; and short-period stability depends on the short-term policy of the Central Banks of the world acting in unison.

It is, therefore, desirable that the gold reserves of the world should be ample. Many people think that within the next few years, perhaps ten or twenty years, there may conceivably be an insufficiency of the amount of gold necessary to maintain the stability of prices. There must

be means of conserving the use of gold. The financial world has been too much imbued with the out-of-date idea that it is necessary to keep a gold reserve against the internal note issue of a country. If the Central Banks realized that the reserves which they now kept might be reduced, the gold which would then be available would serve as a basis of extra credit when required. Central Banks should determine that gold should not circulate as currency in their countries, that reserves should not be either unduly large or unduly small in relation to the purposes for which they are required, and that gold held in other countries or with the Bank of International Settlement should be counted as gold reserves.

There are three main difficulties to which Central Banks are exposed in trying to keep the price level stable. First, the effect of non-monetary causes on the general level of prices; secondly, the divergence between the interest of any one country at any given time, and that of the rest of the world; thirdly, inability on the part of the Central Banks to keep sufficient control over the monetary machine.

By non-monetary causes we mean such things as political troubles, wars, reparations and war debts, fluctuations in exchanges with silver-using countries, unbalanced budgets or excessive Government borrowing, rigidity of wages or other economic conditions, changes in tariffs or large changes in fashion or demand, and, not least in importance, the psychological effects on confidence which may follow any of these non-monetary causes.

With regard to the second cause—the divergence in interest between one country and other countries—such divergence is usually more apparent than real. In 1930 for instance, the world in general was suffering from an acute crisis and much unemployment, but that crisis had not affected France. In the French view, therefore, there were no reasons why they should allow the gold which they were receiving to raise their price level to the detri-

ment of their export trade, and if we look at it from that point of view, it would appear that the interests of France were contrary to the interests of the rest of the world. The alternative to raising her price level would have been for her to increase her imports, or to re-lend her surplus money abroad. She did neither, and by her inaction she continued to attract gold and thus accentuated the crisis in the rest of the world, which finally began to react very severely upon herself.

The third difficulty in the way of stabilization of prices by Central Banks is insufficient control of the monetary machine. The Bank of England has considerably more control over the creation of bank credit than either the French Bank or the Federal Reserve Board, because she has greater scope in the investment of her assets. The Bank of England can invest her assets as she likes, in first-class securities, Treasury bills, foreign bills or foreign currencies. In the cases of the Federal Reserve Board* and the Bank of France and the German Reichsbank, the choice of investments is limited by law, and the field of investment is much smaller than that which is offered to the Bank of England, and thus limits the control which these other Central Banks have on the general monetary policy of their country.

It is much easier for all these Central Banks to control the amount of credit which they create than to control the *use* of such credit, and it is much easier for them to prevent a "boom" or depression than it is to control the boom or depression when once under way. For instance at the height of the "boom" on the New York Stock Exchange in 1929, when conditions had become quite impossible, the Federal Reserve Board was constantly endeavouring to restrict credit; but some said that by its action it was curtailing a legitimate expansion of industry.

In crises similar to those of 1931-32, the first steps to recovery must be taken by the creditor, that is the lending countries, and must be taken in one of two directions. They must either become more willing to buy, i.e. import

* The law of America has recently been amended to some extent in this respect.

from the other countries, or be more willing to lend abroad the surplus balance which comes to them from other countries. It is not essential that the loans should necessarily be made to the more backward debtor countries. If the creditor countries feel that conditions abroad are so unsafe that they are unwilling to lend money to debtor countries the effect of investing their money in non-debtor foreign countries, or even internally, although it may be somewhat slower, will still be beneficial because it will start the demand for all sorts of commodities, and the demand is bound to react upon the primary products-producing countries of the world.

The Central Banks are apt to devote the major part of their attention to the control of short-term investments. They must, if a recovery is to be made, take steps to maintain a regular flow of long-term investments, and through their influence regulate that flow so that there is neither too much nor too little investment taking place at any given time. Mr. Keynes in his "Treatise on Money" emphasizes throughout the fact that saving which is not invested has no effect at all on industry. In fact the country would benefit more if such money were spent on commodities. One of the problems that must be solved is that of maintaining an adequate flow of investments commensurate with the savings of the nation.

Let us consider how these various points, which are applicable to all Central Banks, affect the Bank of England. Parliament has concerned itself in the past, as regards the Bank of England, mainly with the question of the note issue, and although changes were made in 1925 and 1928, the principle of the fiduciary issue has remained unaltered since the Bank Charter Act of 1844. In former times when coins and bank-notes were the main money in use, abuses such as inflation crept in, and the Act of 1844 was passed with the idea of preventing such abuses in the future. The position has changed. Nowadays, notes are mainly used for the payment of wages, and for almost all other transactions cheques are used. Therefore, if an extension in the note issue takes place

to-day, it is because there has already been an expansion of trade and more money is needed to pay wages; in other words the money so required does not set up an expansion of trade, but is wanted because there has already been such expansion. The real factor which affects the extension or diminution of trade is the expansion or restriction of the basis of credit by the Bank of England increasing or decreasing the bankers' balances. That has been discussed in former chapters. Despite the fact that the necessity has passed away, we still regulate the fiduciary issue in accordance with the above principle; i.e. of the Bank Charter Act of 1844, namely, we have a fixed fiduciary issue which cannot be increased (except as described in Chapter I), and if any further notes beyond that are required, they can only be obtained by the importation of gold.

In former days the Bank of England's gold reserve was a reserve against the internal note issue and a means of paying any money which the country owed on balance. To-day the necessity of using it as a reserve against the note issue has entirely passed away, and there remains only the external function of regulating foreign balances. But by the present laws governing our fiduciary issue, the great bulk of gold is sterilized as regards its use for the regulation of foreign balances as it must remain in the Bank as security for any notes which are in excess of the fiduciary issue.

In April 1931, the Bank held about £145,000,000 of gold. The circulation of notes which reaches its maximum in holiday times was £380,000,000, excluding notes held in the banking department of the Bank of England. The fiduciary issue was £260,000,000, so that we had a note issue of £120,000,000 backed by gold according to law, although no individual in the country could ever have received that gold out of the Bank of England for use as internal currency. As the Bank of England had only £145,000,000 in gold, and was obliged to keep £120,000,000 against the note issue, the only money available for foreign balances was the remaining £25,000,000.

It is true that in April, 1928, powers were given to the Bank of England to apply to the Treasury to extend the note issue. The Treasury could grant permission to extend this issue for periods of six months and not exceeding two years, without the consent of Parliament. In practice that permission was never sought until the crisis in August, 1931. The Macmillan Committee thought that in the public mind, at all events, any increase of the fiduciary issue, or any demand by the Bank of England to the Treasury to increase it, would be an indication that something in the nature of a crisis existed. It felt, therefore, that it was desirable that the Bank of England should be given greater liberty with regard to the amount of the fiduciary issue, and that the public should become accustomed to the variations in it so that they would not regard them too seriously. It is most undesirable that any of the world's gold should become sterilized and it is unfortunate that this country should set an example which the rest of the world is only too glad to follow.

We have seen that the limit of the fiduciary issue of the various countries should be set, not with an eye to their note issue, but with regard to their probable requirements for the settlement of international balances; that is, it should never be a fixed amount as in England, nor an amount that is a percentage of the note issue as it is in most other countries of the world. It was suggested by the Macmillan Committee that the Bank of England should have power to issue notes up to £400,000,000, which would be £20,000,000 more than the maximum holiday note circulation of recent years, and that that £400,000,000 should be exclusive of the notes which are held in the banking department of the Bank of England. It was further suggested that although the Bank would not regularly allow its gold reserve to fall so low, there should be a statutory minimum of £75,000,000 below which the Bank could not allow its gold to fall. Before we went off the gold standard the Bank of England gold reserve had rarely fallen appreciably below £130,000,000, so that if it were allowed to fall as low as

£75,000,000 it would give a considerable degree of elasticity to our monetary system. It was also suggested that the Bank of England should increase its power by using more of its assets such as Treasury bills, securities, etc., to acquire foreign currencies. These would be available for the settlement of international balances in exactly the same way in which gold is available. Since this recommendation was made the Exchange Equalization Fund, as explained, has come into existence.

The Macmillan Committee pointed out that if the principle underlying the suggestion made here regarding the reserve and fiduciary issue be accepted, then it follows that the present division of the Bank into the issue and banking department is both unnecessary and undesirable. Apart from tradition, there would seem today to be no reason for it except that it provides a method of ascertaining the profits of the note issue, which profits go to the Treasury and not to the Bank, but it would not be a difficult matter to find other means of ascertaining these profits. To anyone who is not an expert the result of the separation is confusing, if for no other reason than that the reserve in the issue department and the reserve or proportion in the banking department mean different things, and leave an unnecessarily unfavourable impression concerning the Bank's strength in comparison with that of other Central Banks.

If the statement of the two departments were amalgamated in the weekly return, it would be recognized that the note issue and the reserve are independent and that the circulation need not be regulated in relation to the amount of gold held by the Bank. This would not only have an internal effect, but would be a step towards dispelling the idea still prevalent in all nations that the gold reserve must bear a fixed ratio to the note issue, which impedes recognition of the fact that in the modern world the only use of the gold reserves is as a means of regulating international balances. When once this fact is recognized it will go a great way to minimize the risk of the world suffering in future from a shortage of gold.

The term "notes in circulation" in the Bank return is also misleading, for a considerable amount of notes, which are never used for circulation, remain in the tills and vaults of deposit banks. A large quantity of these notes are held in the head offices of these banks, and the system doubtless dates from the time when notes played a much bigger role in commercial payments. The amount so held by the banks in 1930 was about £100,000,000 (reduced by January 1933 to £90,000,000) and it was suggested that the banks might place about £40,000,000 with the Bank of England, provided that this institution would keep a stock at various depots throughout the country. The effect would be to increase the bankers' balances with the Bank of England and reduce the amount of active circulation so as to render this figure less artificial. The fact that the deposit banks hold such a large quantity of notes also gives these banks the power which they should not have, of varying the Bank of England's figure of "reserve" and "proportion", and makes it impossible to know whether an increase or decrease in the active circulation is due to an alteration in demand for currency on the part of the public, or whether it is due to action taken for their own reasons by some individual bank.

There is one more point which must be dealt with, and that is the question of foreign balances in London. Whatever arrangements may be made between banks or finance houses for the opening of credit in favour of foreigners, if these foreign balances accumulate in London over a period of years, there must be some commodity value underlying them.

We cannot answer the question: "How are these foreign balances created in London?" merely by saying that: "The Guaranty Trust in New York will create a credit with the Guaranty Trust in London in favour of Morgans in New York. Morgans then draw on the Guaranty Trust in London and that creates the London balance." But the Guaranty Trust in London has to pay out that money to somebody. In one way or another something tangible must come to London in order to create

that foreign balance. If gold were shipped to this country, not in payment of a debt but to be sold for the account of the foreigner, that would create a foreign balance. If an Englishman sent a cheque to a man in Paris and the Frenchman sent the cheque to a London bank and asked them to place it to their credit in London, that would create a foreign balance. In the main, however, the foreign balances must have been created by other means. There are certain international securities such as oil, mining shares, and Government bonds which are dealt in on the chief Stock Exchanges of the world. If a Frenchman, for example, sends some of these securities to be sold in London and leaves the proceeds with a bank in London, that creates a foreign balance; in other words, some property which was owned by a Frenchman was transferred to somebody in England, and the proceeds of the sale left on deposit with an English bank.

The manner in which the largest amount of foreign balances is created is probably by the purchase by foreigners of bills on London. If the foreigner either holds these bills until maturity or discounts them in London (placing the proceeds on deposit in London), the effect is the same, and a foreign balance is created. If the bills are Treasury bills then the Government or the deposit bank owes that money to the foreigner. If the bills are commercial bills drawn against the imports into this country—for example, cotton—the cotton may have been paid for by the importer, but as long as the foreign seller or his bank leaves the money on deposit in London, the effect is exactly the same as if the English importer had bought the cotton on credit and had not yet paid for it. Although the individual purchasers may have paid, as long as the foreign balances remain in London on deposit the debt still exists; but the liability has been transferred from the individual who imported the cotton to the bank which holds the deposit.

Certain figures were supplied to the Macmillan Committee, but until then, there were no statistics dealing with

the matter, and nobody knew how important the balances were.

Estimates have been made of the amount of bills held in London for the account of foreigners; but there are no estimates of the amount held abroad by these foreigners, nor do we know the amount of our balances overseas. The matter is of importance, because we have no figures which tell us how much of our imports and exports, both visible and invisible, have been paid for, and we may wake up one day and find large foreign deposits in London without sufficient means of being forewarned of the fact. Unless the Bank of England has complete knowledge, it would appear to be impossible for them adequately to regulate their monetary policy in such a way that we can be sure to satisfy any claims for payment that may be made upon us. One of the important recommendations made by the Macmillan Committee was that much fuller statistical information should be given to the Bank of England by the banks, accepting houses, etc., so that they might have all the facts before them when settling their monetary policy. No doubt some progress has been made in this direction.

CHAPTER XIII

CONCLUSION

THE report of the Macmillan Committee was signed in June 1931, and we lapsed from the gold standard in September 1931. Although the conclusions and recommendations of the Committee will be helpful whatever system we may adopt in the future, there were no suggestions in the Report as to what that system should be, as it was not then contemplated that we should leave the gold standard. There has been since, however, no lack of suggestions, wise and unwise, informed and uninformed; and before we deal with the future it may be worth while to remind ourselves again what the functions are which we expect any monetary system to fulfil for us.

In the first place, it must provide us with a medium of exchange; secondly, it must give us a common denominator of the exchange value of commodities and services; thirdly, it must give us a standard of value which will remain as stable as possible over a long period of time. In addition, of course, we must find some means by which we can either pay or receive international balances owed by us, or owing to us from abroad.

The present currency—notes, shillings, and pence—could still continue to be our medium of exchange under any system. There is no reason why our notes, our subsidiary coinage, or the cheque system should be altered, nor is there any reason why the same notes and coins should not serve us in the future as a common denominator of exchange value of commodities and services.

The real difficulties arise when we come to consider a monetary system (1) which will give us a standard of value which will remain stable over a long period of years, and (2) when we have to find some means of regulating our international balances. There are four courses

which might be adopted: First, we might revert to the gold standard at the old parity; secondly, we might adopt a bi-metallic standard; thirdly, we might revert to the gold standard at a new parity; fourthly, we might reject any metallic standard at all, and regulate our currency according to index numbers of the general level of prices and other indices pointing to the necessity for an alteration in the volume of credit and/or currency. This latter might be done with two objects in mind. Our primary object might be to keep our exchanges stable, or it might be to let our exchanges take care of themselves and keep the internal price level stable. There is constant search for some means which will achieve both objects.

It seems, however, to be useless to attempt to revert to the gold standard at all, either at the old parity or at a new parity, unless we are sure that we and the rest of the gold standard world are going to play the game—that is to say, that creditor countries will allow an influx of gold to have its effect in raising prices internally, thus discouraging their exports and increasing their imports—and that they will not put tariff impediments in the way of such increase. Alternatively, that they will prevent an influx of gold by being willing to re-lend to debtor countries money which is due from these countries to them, and which would otherwise be paid by the shipment of gold.

If the international price level is to remain stable, then gold standard countries must be prepared to anticipate any shortage in world gold supplies by adopting all means to economize the use of gold, including minimizing the rigidity of their gold reserves. Most people would also agree that it would be useless for this country to re-enter the gold standard world until the question of reparations and inter-allied debts is finally settled.

It is not only a question of the other gold standard countries not playing the game. In a sense we ourselves failed to do so, in so far as we did not succeed in breaking down the rigidity of our money wages until they had reached a point where we should have been enabled to increase our visible exports. Such increased exports would have en-

abled us not only to pay for our imports, but also to have had a surplus towards our share of the development of the world by means of foreign investments. Therefore we cannot revert to the gold standard at the old parity unless we are prepared to reduce money wages. There are people who think that if our price level was so rigid as to prevent the increase of our export trade, the same object could have been achieved by limiting our imports. If we could have limited our imports without at the same time restricting our exports, that would have accomplished the object and re-balanced our trade; but it would have been achieved at the expense of an impoverishment of ourselves and the world generally, through a reduction in international trade.

We then come to the bi-metallic standard. This is a standard by which the Bank of England would be obliged to pay out—either at the option of the Bank, or, in the view of some advocates of this system, at the option of the recipient—silver or gold at a fixed ratio between the two metals, instead of gold only. One advantage claimed for this system is that it would obviate a disturbance of the general level of world prices in case of a shortage of the world's supply of gold. A report issued by the League of Nations in 1931 foreshadowed that within the next ten or twenty years the world might be short of the supply of gold, unless in the meantime it learned to economize the use of such gold. Another claim made by bi-metallists is that the purchasing power of silver-using countries has been diminished, and consequently the export trade of this and other countries has been dislocated by the enormous fall in silver which has taken place.

Some people say that this applies to India, but of course India is not a silver standard country. It is a country that uses a great deal of silver in its circulation but whose currency was formerly linked to gold and is now linked to sterling. The only way in which it can be said that it affects India is that the natives of India have large hoards of silver, and as the value of these hoards has diminished with the fall in silver (for the

price of silver has fallen in recent years like that of all commodities), it is sometimes maintained that this affects the purchasing power of the people. That is very difficult to believe; nor is there much support to be found from people who know India for the theory that the poor Indian, who must have a dhooty to cover himself, depends on the realization of his savings in order to purchase it. On the other hand, there are people who think that as silver declines in value it actually increases the amount of the savings, because the Indian can buy more silver with the rupees which he saves.

The chief country which is affected is China. Although China is a poor country, it comprises about a quarter of the population of the world, and is a country capable of great development. A fall in the value of their currency makes imports dearer for the Chinese but in exactly the same way it stimulates their exports, and if we juggled with the currency of China by raising silver artificially we would undoubtedly deprive that country of some of the increased exporting power which she enjoys through the depreciation of silver. China has reaped another benefit from being on the silver standard, and that is that her price level has remained very much more stable during recent years than that of gold-using countries.

We had a more intense bi-metallic agitation than the one of to-day in another period of depression, in the '80's and the '90's of last century, which came to an end, however, with the gold discoveries in South Africa. This gold took some time to mine in quantities, but directly the South African gold began to percolate into the world, the extra supply killed the bi-metallic agitation. There is no doubt that however long it may take before it is distributed, America and France will not be able to continue hoarding two-thirds or three-quarters of the gold of the world, and as that gold comes out of the hoards and is re-distributed throughout the world the present bi-metallic agitation will die a natural death.

We then come to the third alternative, that of a return to the gold standard at a new parity. If we are satisfied

that the gold standard countries are prepared to co-operate internationally, and if the question of reparations and inter-allied debts is settled, but we are not prepared to reduce our money wages, then there is the alternative to revert to the gold standard at a lower parity.

What does it mean, to revert to a gold standard at a new parity? Before 18th September, 1931, the Bank of England was obliged to sell standard gold at 77s. 10½d. an ounce. Standard gold is gold which is eleven-twelfths fine, or what we call twenty-two carat gold. Selling gold at 77s. 10½d. a standard ounce meant that the Bank of England would give 113 grains of fine gold or 123½ grains of standard gold for a £1 note. Since the Gold Standard Act of 1925 the minimum quantity of fine gold which the Bank would sell was fixed at 400 ounces. 4.86⅔ dollars in America will buy 113 grains of fine gold, as will 124.21 francs in France and 20.43 Reichsmarks in Germany, and, therefore, the parity of exchange between the United Kingdom and America, France, and Germany was respectively 4.86⅔, 124.21, and 20.43. The foreign exchange brokers and dealers have operators in contact all day by means of the long-distance telephone with all the great international financial centres. If at any time during the day francs become cheap and dollars dear in relation to sterling, these operators immediately buy francs and sell dollars until the rates again move towards equilibrium.* Such operations are called "arbitrage" operations.

If we assume that the £ is to be revalued at 25 per cent less than before September 18, 1931, a new law would be passed by which the Bank of England would be obliged to give only 85 grains fine (instead of 113 grains) for a £1 note; or, to put it another way, gold would cost 103s. 10d. per standard ounce instead of 77s. 10½d., so that our £1 would only be worth 85 grains of fine gold whereas 4.86⅔ American dollars would still buy 113 grains of fine gold. The Americans, therefore, instead of giving 4.86⅔ dollars for a pound note, would give only

* At no given moment can it be definitely asserted that rates are in equilibrium. They only *tend* to become so.

3.64½ dollars, i.e. 25 per cent less. We should then have fixed a new parity for the pound at 25 per cent below the old parity, and that would have two results.

The first result would be that, if we wanted to buy goods from foreign countries, we should have to pay 26s. 8d. for the same quantity of goods that we bought formerly for £1, assuming that prices remained the same. On the other hand, America, for instance, would only be obliged to pay 3.64½ dollars for the same quantity of goods that she previously bought from us at 4.86 dollars. Consequently our imports would cost us more, our exports would cost the foreign country less, and we should still be receiving £1 for our exports, but a depreciated one. Our competitive power in the export trade would be increased for the time being; possibly only for the time being, because as our imports, being largely food stuffs and raw materials, would cost us more, and as they enter into the cost of all commodities every one buys daily, our cost of living would rise. If the rise in the cost of living was followed by an increase in money wages in our export trades, then the increase in our competitive power would be correspondingly reduced.

There has been since 1928 a far greater fall in the cost of living than there has been in wages, and it is possible that we might allow our prices to rise again to the 1928 level without finding it necessary to raise our money wages. That is to say that people would enjoy the same standard of living as in 1928, but it would be a lower standard of living than that which they would enjoy to-day if they were fully employed. In other words, we should have broken down the rigidity of wages, not of money wages but of real wages, by which we mean the quantity of things we require which our money wages will buy. Money wages, although remaining the same, would buy fewer commodities and services than prior to September 18, 1931.

Since we left the gold standard prices have not risen in any degree commensurate with the depreciation of our exchange, but it must not be overlooked that since Sep-

tember 18th, 1931, there has been a substantial fall in the wholesale price level in gold standard countries, and in the long run what really affects our competitive power in exporting is not the actual price level in this country but the relative level in comparison with competing countries.

Our fourth solution would be to reject any metallic standard and to regulate our currencies with the object of keeping our price level stable, or of keeping the exchanges stable. If we are to keep the exchanges stable we must have some means of paying or receiving those international balances which under the gold standard would have been regulated by the transference of gold. Apart from Bank of England operations to which we refer below, the only means of rectifying our balance is by decreasing the total value of our imports or increasing the total value of our exports, including, of course, visible and invisible exports. We cannot reduce our imports by regulating our tariff with every threatened fluctuation of the exchange, because the dislocation of industry would be far too great, and we can only increase our exports by making ourselves more competitive in the world market. In the end, therefore, if we have to regulate our balance by the payment of goods, we shall find that in order to sell these goods we are up against the old problem of the rigidity of money wages.

The constant effort of the Bank of England to maintain our exchange stable would expose it to exactly the same criticism that has been levelled against it during the past few years, namely, that in the endeavour to maintain the exchange stable it had to adopt means, by raising Bank Rate or by "open market operations", which, although they may have been successful, were very detrimental to the interests of the internal industry of the country.

If we adopted the other course, that of making our principal objective the stability of our internal price level and leaving our foreign exchanges to take care of themselves, we should be subjected to all the disadvantages of a fluctuating exchange.

If our price level remained stable while those of competing foreign countries were reduced, the first effect would be that our exports would tend to decline, as we should be a dear country from which to buy. Consequently the demand for sterling would decline relatively to the demand for foreign currencies, and thus our exchange would fall. As our exchange fell our goods would become cheaper to the foreign buyer in his currency, and this tendency would increase until a new point of equilibrium was reached. While our exchange was falling our imports would cost us more in our currency, the effect being to provide a bounty for our export trade at the expense of increased prices to the whole population for our imported goods. In other words, we should have solved the problem of the rigidity of money wages by a camouflaged reduction in real wages. The disadvantage of this method is the uncertainty to which all business men would be exposed owing to the instability of the exchange and the adverse effect on our important international financial business of a fluctuating exchange, the drawbacks of which (as explained in Chapter X) cannot be entirely overcome by forward exchange operations.

Whichever of these four methods which we have now outlined for dealing with our monetary problems is adopted, somebody suffers. The burden prior to September 1931, under the gold standard when money wages remained rigid, was borne by the manufacturers and merchants whose profits were reduced or who incurred losses. It was also borne by a large number of the population who were unemployed because our export trade could not function normally as wages were too high to permit our goods to be sold in competition with those of other nations. Those people were unemployed in order to keep the remainder of the population employed at the rigid wages they were receiving. This was the burden which was imposed upon us by the former gold standard. In the case of other systems which we have discussed, the burden would be camouflaged by a reduction in real wages if money wages remained the same, for we should be pay-

ing more for our imported goods in order to provide a bounty for our exported goods. Thus we should have reversed the process. Under the former gold standard the people who were suffering were the unemployed people. In order to maintain the money wages under any of the other methods which we have discussed, the people who would suffer would be the whole of the population in the country, who would have to pay more for their imported goods in order to enable the unemployed people to be re-employed in the exporting industries. Ethically one might consider that the burden shared by the whole of the population is preferable to the burden imposed on that proportion of the people which is unemployed.

Between our lapse from the gold standard in September 1931 and the final debates on the Finance Act in June 1932, no explanation concerning the future of the country's monetary policy was forthcoming from the Government.

In the final debate on the Finance Act, a private Member, Mr. Albery, enunciated the policy of the Government as he understood it after carefully searching such statements as had been made. These statements indicated, first, a return to some form of gold standard, not barring a possibility of a gold-cum-silver standard; secondly, that the eventual return would be at a figure below the previous gold standard parity; thirdly, that such a return to a metallic standard was not expected to take place in the near future; fourthly, it was intended to control fluctuations in sterling exchange with a view to bringing about a higher price level for commodities, (he thought the 1929 level was indicated). Fifthly, that every effort would be made to prevent violent fluctuations in sterling in the meantime; and sixthly, that when the higher commodity price level had been attained, sterling exchange would be controlled with a view to the stability of commodity prices.

In reply, the Chancellor said that Mr. Albery "did not seem to have any difficulty in putting together from various utterances of the Chancellor of the Exchequer,

what seems to me to be an accurate account of the general considerations which have been in my mind from the first. The one correction which I wanted to make was that my honourable friend appeared to be putting into my mouth statements as to what would happen in consequence of the operation and management of this account (the Exchange Equalization Account), whereas, perhaps, I had rather stated aims, than committed myself to saying that it would be possible on all occasions, to achieve those aims. . . . The right honourable gentleman was right when he said that we want to see wholesale prices rise. But do not let him confine his attention solely to sterling prices. We cannot get away from the fact that we must be affected by gold prices, and we must also remember that an alteration in sterling prices may affect gold prices."

This seems to outline the probable future policy of the Government.

The year July 1931 to July 1932 covered the most extraordinary financial twelve months which this country has ever experienced in times of peace.

Between the 1st of July 1931, and the suspension of the Gold Standard on September 21st of that year, the Bank of England lost £30,000,000 of gold which was exported to foreign countries, and which sum was only £7,000,000 less than the Bank's total average stock of gold in 1913-14. In addition, the Bank of England and the Treasury raised gold loans in America and France to the extent of £130,000,000, the whole of which, with the exception of £10,000,000 falling due in August 1932, was repaid within a period of nine months.

Neither the loss of gold nor the gold loans raised in America and France were sufficient to keep this country on the gold standard.

In September 1931, it became apparent that there would be a deficit of £75,000,000 for the financial year ending April 1932. The Chancellor of the Exchequer introduced a Supplementary Budget on 10th September 1931. Certain economies were effected and these, together

with the new taxation imposed, were estimated to be sufficient not only to meet the deficit for the year 1931-32, but also to make good the anticipated shortfall for the year 1932-33 of £175,000,000. This sum would have been only £27,000,000 less than the whole expenditure in the financial year 1913-14.

In spite of this alarming situation there was no panic in the country. There was not a single case of a run on a bank. Deposits between August 1931 and October 1931 only declined one per cent, which was more than accounted for by the withdrawal of foreign money. The British people not only accepted the situation with that phlegmatic calm which they always exhibit in times of stress, but showed such eagerness to help to balance the Budget that in spite of the bad trade of 1931 the receipts for income-tax and surtax exceeded those of the previous twelve months by £40,000,000. And finally, during the twelve months, Bank Rate fell from 6 per cent to 2 per cent. Money became so cheap that Treasury bills were discounted at $\frac{5}{8}$ per cent per annum, and day-to-day money at one time was lent at $\frac{1}{4}$ per cent per annum.

This cheap money enabled the Government to convert the 5 per cent War Loan to $3\frac{1}{2}$ per cent. The sum involved was £2,000,000,000, almost a third of the whole of the National Debt, and three times the amount of the pre-War Debt.

This conversion, both in its magnitude and its boldness of conception, must rank as the greatest financial operation which has ever been undertaken.

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