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THE ELEMENTS OF FINANCE

BY
LIONEL MUNDY, O.B.E.



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PREFACE

THE members of the Brains Trust were once asked what changes they would have made in the educational curriculum of their school if they had had the choice of subjects.

Professor Joad replied that he wished he had been taught the elements of finance. He was criticized by some of his colleagues for desiring to be taught speculation, but, to at least one listener, this seemed to be a complete misunderstanding of his suggestion. It appeared to be more likely that he was commenting on the wide lack of knowledge of elementary finance, a subject which should be taught in schools as part of the education of every future voter.

There is still to be found a number of people who are considered educated but who believe that when you pay money into the bank, the cashier puts it away in a box with your name on it; and when you wish to draw money out, that the cashier goes to your box and takes out some of the very notes you have paid in.

This is not an exaggeration. It is another way of saying that ignorance of the way in which banks run their business and earn money is widespread, particularly among those of the community who are not compelled to understand the rudiments of finance in order to make a living. Teachers, doctors, scientific workers, engineers, and many others can pass through life in complete ignorance of the activities of the Bank of England, the Commercial Banks, the Stock Exchange and other institutions devoted to money itself.

Some years ago the author gave private tuition to men intending to "go on the Stock Exchange." His first pupil said: "I want to be able to read the City page of *The Times* with complete understanding." The course of instruction given was on the lines of this book, supplemented by guidance as to books to be read.

A little knowledge is, nowadays, reckoned better than none at all and this outline aims only at informing those who know nothing of finance or the machinery of the Money Market. There are many better and more comprehensive books, and the student will find a Bibliography herein. But all such books presuppose elementary knowledge and some of them, indeed, take pains to declare that their authors have not sunk to expressing themselves in elementary language! So far as the writer is aware, there is no book written at the level of the intelligent beginner, and it is this gap which he now tries to fill.

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TO

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CHAPTER I

THE MACHINERY OF BANKING

1. Introductory

It is sometimes alleged that finance is a sinister power which conceals its nefarious activities under a cloak of mystery; that financiers do not want the common man to understand their trade, for general knowledge of it would not only reveal its simplicity but also inhibit or reduce profitable business. To some, the very word financier, or even banker, has an unpleasant significance.

Most of these allegations are nonsense. There is no secret, good or evil, in finance. It may be that bankers are far too busy earning a living to write popular books describing the methods by which they make money, though it should be noted that most men of business are uncomfortable at the mere mention of their own profits. With one eye on his shareholders and the other, nervously, on a trade union, it is perhaps understandable that a company director finds profit a distressing subject. As a matter of common prudence, therefore, he often says as little as possible. Read the speeches of bank chairmen at their annual meetings and you will find that they have a lot to say about current politics and precious little about the activities of their particular bank.

And so, with caution on the one hand and little leisure on the other, business men, including bankers, are rarely authors.

In the past, there have been financiers here and there whose activities would not have been possible among a public better informed; the Mushroom share-pushing swindle is a case in point. There have been other men, equally fraudulent, who have capitalized the universal desire to get something for nothing but who have been

artful enough to deceive other professional money-makers. These are the men who have given finance a bad name and it seems probable that, sooner or later, there will arise other such men who will invent new and ingenious swindles. It behoves all of us, therefore, to be on guard when they appear. The rules of the Stock Exchange and the laws of the country are frequently under revision in order to check dishonesty in finance, but these restrictions are based on known frauds in the past, for it is not easy for honest men to foresee trickery of a new type.

In the following pages, the term "the City" will be found frequently. This has different meanings in different trades; to a shop-keeper, for example, the City means the large area round St. Paul's Churchyard where, until recently, the large wholesale warehouses did business. But to anyone concerned with money itself, the City means the district round the Bank Tube Station near which are to be found the Bank of England, the Stock Exchange, the head offices of the Big Five Banks, Lloyd's Underwriters, and a number of financial institutions to be mentioned later as consideration is given to their various activities.

For very many years the City was the centre of the world financially. This was not because of the greater wealth of London than of New York or Paris, nor of its geographical situation, but mainly for the reason that British bankers had perfected a method whereby, for example, a Chinese could ship goods to South America and be paid in his own currency because a banking firm in London guaranteed the transaction in pounds sterling. The goods never came within hundreds of miles of this country and yet bankers in London earned a small commission and other banks made profits also.

An explanation of the machinery of this facility will be found in Chapter III, but it may here be remarked that the very word "sterling" has acquired, perhaps by such use, a meaning of solid worth and honesty. It is beyond question that banking is, and always has been, supremely fair and honourable.

It has been suggested that London may lose its supremacy in finance because of our dependence upon the dollar loan from the United States. On a previous occasion when we were preoccupied with a major war and the attendant discomforts of peace, that is to say, between 1914 and 1921, New York had an opportunity to wrest the leadership from us. It was freely discussed in the newspapers on both sides of the Atlantic. The chance was missed partly because, as Americans said of themselves, "a Bill of Exchange might be a new breakfast food for all we know to the contrary," but also because, in the eyes of the world's bankers, the pound sterling had more stability than the dollar.

Nevertheless, a large volume of this profitable foreign business has been lost by us. Some of it has gone to New York, but the principal reason for the loss is that this country and others abandoned the policy of Free Trade. Some or all of what the City has lost may have been gained by merchants and manufacturers in other cities, but these are political questions and outside the scope of this book.

2. *Banking—Cash*

The history of banking is interesting, but it is not proposed to deal with it here, for it is not necessary to study it in order to understand modern practice. Anyone interested will find the story in Bagehot's *Lombard Street* or in Bernard Shaw's *Everybody's Political What's What*. Both of these books should be found in any public library. It will be sufficient now to note that Lombard Street is in the heart of the City and derives its name from the fact that, in the Middle Ages, the pioneer bankers came to London from Genoa in Lombardy.

Let us now consider the practical business of banking from the banker's angle: what happens behind the counter at which you pay money in or draw it out?

We will suppose that you have paid in some pound and ten shilling notes, some silver, and a cheque payable to yourself which you have endorsed. What does the cashier

(or teller, as he is called in the North and in the United States) do with your deposit?

The short answer is: very little. As to cash—notes and silver—he puts them away in a till under the counter. A second or two later he may hand them across the counter to someone else. It can happen, of course, that at the end of the day—or more probably at the end of the week—the cashier is all square, having paid out exactly what he has received. Ideally, this is what should happen, for the giving and receiving of notes and coin is part of the service which a bank gives to its customers, and large differences, either plus or minus, are a nuisance. Let us illustrate this.

Imagine, if you can, a small town in which there is only one bank; there is one factory which employs most of the able-bodied men and some of the women and there are the usual shops for food, tobacco, clothing and other necessities; there is a cinema and twenty public houses. For the purposes of this illustration it will be convenient to assume that the financial week begins on a Friday.

At about ten o'clock that morning, then, the cashier from the factory arrives at the bank with a leather bag and a few assistants similarly equipped. He presents an open cheque for £10 thousand. This cheque is called "open" because it is not closed by crossing and, theoretically, it can be cashed by anyone for it reads: "Pay Cash (or "Pay Ourselves") the sum of ten thousand pounds." In practice, the banker will not cash it immediately if presented by a stranger. He will excuse himself and disappear in order to telephone the factory to see if they have changed their cashier.

On the back of the cheque, the factory cashier will already have written down the number of notes and coins of each kind needed. The money is handed over the counter, the notes in bundles labelled with the quantity, the silver in £5 bags (coloured buff) and the copper in 5s. bags (coloured blue). The idea of coloured bags is to facilitate handling and verification both for the bank and for the customer.

The factory cashier returns to his office, where he finds prepared envelopes for each employee. The wages are put into the envelopes and paid out.

Many of the factory workers go home to dinner and hand over all or part of their wages to their wives. That afternoon many of the wives do their weekend shopping, and a large portion of the contents of the wage packet is spent in the shops. That evening money will be spent in the cinema and the public houses.

Before noon on Saturday the cinema, the shops, and the pubs will send notes, silver, and copper to the bank to avoid having too much money in their safes over Sunday. On Monday morning they will bank Saturday's takings.

By noon on Monday, therefore, the greater part of the £10,000 will have been returned to the bank by the food and drink shops and the cinema. Other notes and coin will be banked by clothing and ironmongery shops, doctors, piano tuners, and laundries. Some of the money received by the bank will represent previous weeks' savings now spent but this will be offset, or very nearly so, by new savings. The probability is that by Thursday night the bank will have received the same sum as it paid out the previous week. If not, it has a sufficient reserve in its vaults.

In theory, then, the same notes and coins circulate freely in the town. In actual fact, it may not work out quite in this way, for we have supposed a simple community. It is more likely that some of the money is taken out of the town by those visiting other towns. On the other hand, money is brought into the town by a variety of people, travellers, casual visitors including motorists, and even civil servants inspecting the factory who expend their meagre allowances for board and lodging.

On balance, in a quiet town, the cash paid into the bank is about the same as the cash paid out. In a less rural spot, the difference may be greater, plus or minus. In a large town with several banks the movements of cash in and out will follow very much the same lines

as those in our simple illustration. At the end of the financial week, one bank may be short and another over. Those which are short draw on their reserves either from their own vaults or, if the drain is heavy, from the nearest city. In all cases, variations will be seasonal and will depend on weather, holidays, and other factors which influence the town's trade.

A sidelight on the circulation of money in a still smaller community may be of interest.

A missionary arrives from England on an island in the Bahamas with five pounds in silver and copper. He buys poultry, fruit, and vegetables and pays cash for them; he also pays cash to his servant. The native seller of food and the servant have no use for this money at all and so they put it into the collection plate at the church on Sunday. If a native has no food to sell yet desires to contribute to church expenses, he must sell some seed grain to another native who has some of the parson's cash.

The missionary counts the money in the plate on Sunday and makes a note of the amount. Once a month he sends a cheque to his bishop in Nassau for the total collections. And so he continues to do.

The effect of this process might well be considered an exercise to test your knowledge. Who pays for the missionary's food? Give reasons for your answer.

If you have not realized it already, a little reflection will show you that this story illustrates the essential nature of the use of money. It is a true story, by the way.

3. Banking—Cheques

Having dealt with the question: what becomes of the actual cash you deposited? we now consider the handling by the bank of the cheque which you paid in. This can be a more complicated affair altogether for, if you remember, we are discussing it from the banker's angle.

Let us first dispose of you, the customer, for you disappear from this story almost immediately.

The cashier has checked the cash and marked the items off in your paying-in book and he proceeds to examine the cheque. He looks at the date for, after six months, a cheque becomes, by custom, stale; conversely, a cheque dated ahead, a post-dated cheque, is valueless to a bank. (No! Madam. The bank cannot look after the cheque for you until it becomes payable. Every inch of their space is valuable and is used. They have no place to keep post-dated cheques.) Then he compares the amount payable in figures with that written in words, after which he looks to see if the cheque is signed. If it is not drawn on his bank and at his particular branch, he will not know the signature, so this part of the examination is rapid. Then he looks at the back of the cheque to see if you have endorsed it correctly, that is to say, have signed it exactly as it is made out. If you are a man, you will know that a cheque made payable to "A. Roosevelt Jones" must be so endorsed and that "A. R. Jones" will not do as well. If you are a woman, you may share this knowledge but this may not deter you from endorsing it "Alicia C. R. Jones"!

As a sidelight on the matter of endorsement, it may be of interest to learn that companies who receive a great number of cheques each day, use a rubber stamp for endorsement with every known variation of their name on it. For example—

Selfridges
Selfridges Ltd.
Selfridge & Co., Ltd.
Selfridge
Selfridge & Co.
Selfridge

and so on. Their endorsement stamp covers most of the back of a cheque. It saves them endless time.

Finding the cheque in order, the cashier tears the counterfoil from your paying-in book for it is needed in the book-keeping department. Then he hands the book back to you, and that is that as far as you are concerned.

The cashier turns to drop your cheque and counterfoil into a basket behind him and then attends to the next customer. The counterfoil is taken from the basket and serves as a voucher, or justification, for the entry in your ledger account to your credit.

It should be said here that you are entitled to draw out immediately only the value of the actual notes and coin you have deposited, for a cheque takes some time to clear and it may be incorrect in some detail or returned unpaid for lack of funds.

Now let us follow the cheque on its journey until it returns to him who drew it.

If this cheque is drawn on the same branch as that at which you paid it in, it does not travel very far. The signature is cancelled in order that, if lost or stolen, it may not be presented again; it is then passed to a book-keeper who charges it against the drawer's balance and that is the end of it, except for the detail that the drawer gets it back on the next occasion when he asks for his Statement of Account.

If the cheque is drawn on a bank in the same town, it is sent by messenger to that bank and cleared (paid) by that bank at the end of the day. If drawn on a bank in one of the large cities which has its own local Clearing House and collected by a bank in the local clearing, it will go through much the same routine which is now to be described for London.

By far the majority of all cheques drawn are sent by the branch banks, at which they have been paid in, to their head offices in London. There they are sorted into pigeon-holes, or heaps, one for each member of the Bankers' Clearing House, which is situated in the heart of the City. Each heap is subdivided into three bundles—Town, Metropolitan, and Country.

There are eleven members of the Clearing House. First, the Big Five—Barclays, Lloyds, Midland, National Provincial, and Westminster—and six lesser banks, Coutts, District, Glyn Mills, Martins, National, and Williams Deacon. One or other of these eleven banks

represents all smaller banks and clears cheques for them.

In the Clearing House sits a representative of each member bank and each of these officials receives the bundles of cheques presented to him by messengers from the other ten members. For the sake of illustration, it is easier to think of one bank, Barclays, let us say. While the representative of Barclays is receiving all these bundles of cheques, a messenger from Barclays is presenting cheques held by Barclays against the representatives of all the other banks. And so for all the other members.

At the end of the day, Barclays' claims against other members are set off against those members' claims on them and each member pays or receives the balance due to or from him. The differences are settled by a cheque drawn on the Bank of England, where each member has an account.

The complication of the transaction is as nothing compared to the complication of describing it. A concrete example may make the working of this machinery clearer.

Let us suppose that a Mr. Jones has received and paid into his account at the Westminster Bank, St. Albans, four cheques drawn, respectively, on Lloyds (Brighton), Barclays (Manchester), Westminster (Hammersmith), and the National Provincial (Moorgate).

Jones's bank in St. Albans send these cheques, with many others, of course, to their head office. The head office of the Westminster Bank, as you have already learned, sorts all cheques received from all its branches into heaps, and each of these heaps is again sorted as between Town, Metropolitan, and Country. Town cheques are those drawn on head offices or branches within easy walking distance of the Clearing House; Metropolitan cheques are those drawn on banks in the County of London area, and all others are Country. This sorting is made easy for, as you may observe for yourself, all cheques bear the capital letter—T, M, or C. The volume of cheques each day is enormous, roughly £200,000,000,

and it will be understood that the subdivisions greatly reduce the work, for there are four separate clearings, two for Town, and one each for Metropolitan and Country.

Jones's cheques will be sorted thus—

On	Lloyds, Brighton	Country
	Barclays, Manchester	Country
	Westminster, Hammersmith	Metropolitan
	National Provincial, Moorgate	Town

The Clearing House clerks who receive these cheques will send them, with others, to their head offices. These head offices have now to sort out all the cheques received (all, of course, drawn on various branches of their bank) into heaps, one for each of their many hundreds of branches. (Barclays, Lloyds, and Midland have at least 2000 branches) and, having done so, Jones's four cheques will go from four head offices to Brighton, Manchester, Hammersmith, and Moorgate.

A moment's reflection will show that these cheques must go to the branches on which they are drawn, since it is only there that the signature of the drawer (the person who drew the cheque) is known, for it is there that the drawer keeps his account.

At the four branch banks mentioned, the cheques are examined to see that the date, signature, amount in figures and words, are in order. They are then debited (charged) against the balances of the drawers. If everything is correct, that is the end of the matter. The transactions between the drawer, the payee (the person to whom the cheques are payable) and the banks are complete. They have taken in all from one to three days, depending on the distance between the receiving bank and the paying bank.

In parenthesis, it is not proposed to apologize for dealing with the Clearing House at such length. This financial machinery is so important, so vital to modern business and government, that at least a rough idea of its working is necessary. A fuller description will be found in Bagehot's *Lombard Street* and in most of the books about money.

4. Banking—Returned Cheques

We said above that if everything was in order, that was the end of the matter. But quite frequently everything is not in order. It is no rare thing to pay in a cheque and, a day or two later, get it back again from your bank because there is something wrong with it.

On examining the returned cheque you will find on it one of the following remarks in red ink—

R/D or Refer to Drawer
Insufficient Funds
Words and Figures differ
Signature Irregular
Re-present next week
Uncollected Funds
No Account

The last of these red ink messages is the least pleasant. It means, generally, that someone has stolen a cheque form and drawn a cheque although they have no bank account. The writer of the red ink phrase believes it better to be cruel than kind and, although he may know the signature, he does not say: "Refer to Drawer," for he knows there is some hope in that remark. He says, tersely, "No Account." He means that you have been swindled, but there is a law of libel and he must not be brutally frank.

Many of us, at one time or another, have had such cheques returned to us by a bank, and we have memories of the pleasant fellows for whom we have cashed these "dud" cheques. Had they not been pleasant fellows, indeed, we might have found ourselves too short of cash to be obliging. We have occasional memories of pretty lies uttered by good mixers who had "forgotten" that their bank accounts were closed or who had drawn a cheque on the wrong bank. But these fairy tales seemed less ingenious as the years passed and we found them repeated by different individuals at different times. When we were very young we may have refused to be downcast by these red warnings and have been optimistic because

we were taught at school that mistakes can happen in the best regulated families.

Now you know why banks ask you to keep your cheque book locked up. You thought they were fussy, perhaps, but banks know all too well how high is the number of these pleasant swindlers who pass worthless cheques on gullible citizens.

Next in order of red ink unpleasantness is "R/D" or "Refer to Drawer." Here again it is the law of libel which inhibits a bank from complete frankness. The phrase means, more often than not, "The drawer has not sufficient money in his account to cover your cheque; we don't think enough of him to take a chance and let your cheque overdraw his account." Or the bank may mean: "The drawer was well introduced but he is no good; once bitten, as you have been, we hope you will be twice shy."

But it may not be as bad as this. It may be that the bank wishes to say to you: "The drawer is a pest, for he persistently draws cheques against cheques he has just paid in and which are not cleared; we have called his attention to this malpractice but he ignores us. We try to please and we refrain from judging that we be not judged. Otherwise we should have thrown him out long ago. We have tried to tell him that credit is a man's most valuable asset and that he is ruining his."

Obviously you do refer to the drawer and you will probably hear or read some stock lies, for the bank has given a lot of thought to your friend's case and would not injure him except only in the hope that he may be persuaded that scrupulous honesty in money matters, as practised by the bank, is also the best policy for its customers.

It is possible but unlikely that the drawer is perfectly honest and that the bank has made a mistake. If it should ever happen to you that such a serious reflection on your credit is made, then you have every right to ask your bank to apologize to you in writing so that you can

send a copy of their letter to the friend or firm who has been asked by your bank to "Refer to Drawer."

The words "Insufficient Funds" on a returned cheque speak for themselves, but they tell you something about the drawer. They tell you, either that he is careless in keeping accounts for he has miscalculated his balance, or that he is "trying to pull a fast one" on his bank by drawing a cheque in the hope they will let it through whereas the proper course for him would be to ask the bank for an overdraft.

"Words and Figures differ" is quite a common marking, for even business houses make such mistakes. It is the easiest thing in the world to transpose numbers—most of us wanting 6241 on the telephone have dialled 2641, for example. Similarly, a cheque may bear the words "Six hundred and thirty-eight pounds" whereas the figure inserted is £683. By law, the amount in words rules, but banks have found by experience that customers prefer to have the cheque returned so that their accountancy records may be corrected.

"Re-present next week" is not so common. It implies that the drawer had insufficient funds on the day the cheque was presented but that the bank had knowledge of funds arriving the following week; a regular allowance from a parent, for example. A case springs to mind which may be interesting, for it illustrates an important aspect of retail trade.

A store in the West End of London sold clothes to a customer against a cheque for £50. The lady accepted the store's explanation that as they had not had the pleasure of doing business with her before, they felt constrained to hold the goods until her cheque was cleared; she was not in a hurry for a day or two. The cheque was banked and came back marked: "Re-present next week." The store immediately released the goods for it seemed to them that the bank was almost guaranteeing payment. The following week, they presented the cheque again and this time it came back marked: "Account Closed."

Not for the first time, the store had lost its money. They sought to hold the paying bank responsible, but the bank claimed to have acted in complete good faith for they did, in fact, expect a large remittance to her credit from an important customer. It had not come, the lady had drawn out her balance and, they believed, had gone abroad.

It was a difficult situation for the bank. If they had marked her cheque "R/D" or even "Insufficient Funds," the lady might have been very angry and would surely have complained to an influential friend. He might have been aware that stores exchange information as to those who try to obtain credit by fraud and, in any case, might have made life miserable for the bank manager. He might have been a director of the bank.

"Signature Irregular" is common on returned cheques, particularly if drawn by women. It is by no means rare for a woman to register her signature with her bank as, say: "K. O'Malley" and then sign occasional cheques "Kathleen O'Malley." The bank will not accept cheques signed Kathleen because they have no instructions to do so. For all they know to the contrary such a cheque may have been extorted under a threat or under high-pressure salesmanship.

Mén also make this mistake but for a different reason. In order that his signature on a letter shall not be used by a forger for copying purposes, a man may decide to use a different signature on his cheques. If he is busy and preoccupied with affairs he can easily use his letter signature on a cheque and this will, of course, be returned by his bank.

You may now begin to realize why a bank may charge you a commission for keeping your account. Behind the counter at your branch and at the bank's head office, all the detail we have considered goes on daily and it must be paid for. If you are charged a commission, it means that your balance is too small for your bank to make any money out of you. We shall almost at once discuss how a bank does make money.

5. Banking—Crossed Cheques; Special Clearances, etc.

First let us consider one or two points which affect you as a bank's customer.

One of the most efficient safeguards for the transfer of money is the device of crossing cheques. It is a peculiarly English custom and is not current in the United States or on the continent of Europe. Like the safety-pin, the principle is very simple and the inventors of both are unknown to the public.

As you probably know, the effect of crossing a cheque is that the cheque must be paid into a bank. If the recipient is not the person for whom the cheque was intended, he can forge the endorsement and pay it into his own account. But it can always be traced to him and he can be prosecuted.

Unless marked to the contrary, a cheque is "negotiable." That is to say that a holder of it, for value, has a good title to the money even if a previous holder had no such title. In such cases, however, a holder must be unaware of a defect in the title.

A Postal Order is a good example of an instrument (formal document) which is not negotiable, for if you steal one and send it to someone else, he cannot argue that it is his, because, as it is printed "Not Negotiable," he took a risk in accepting it from you. A Bank Note, on the other hand, is negotiable for, if you receive it in good faith, it is yours although it may at one time have been stolen.

Banks do their best to persuade their customers to use crossed cheques because of their greater safety. If you want to cash one of your own crossed cheques or to enable someone else to get cash for it, all that is necessary is to "open" the cheque by writing in between the crossed lines: "Pay Cash" and adding your signature. If politeness is one of your habits, you may write: "Please Pay Cash."

So much for ordinary crossing. But there is a variant

of this device known as "Special Crossing." This means writing something special in the crossing in order to limit the use of the cheque. If you specially cross a cheque with the name of a particular bank, it can only be paid into that bank.

You may have observed that public utilities such as electricity and gas companies usually print on their bills a request that you shall specially cross a cheque with the name of their bank.

If you draw a cheque to C. J. Browne and write in the crossing "A/C Payee" you are insisting that Browne pays this cheque into his bank account and that he shall not ask a friend to cash it for him. You do this to prevent him from denying that he received the cheque.

A bank service which is valuable at times is that known as Special Clearance. By paying a bank a fee of half-a-crown you can short-circuit the mechanism of the Clearing House and have a cheque, received by you, cleared within the time taken by a messenger to visit the bank on which the cheque is drawn. This service is valuable to traders in large towns who desire, as publicity, to give the impression that their customer has an honest face and that his cheque is as good as cash. The trader says: "We will forward your goods by our van this afternoon." He then sends a boy to the bank with the cheque and a request for Special Clearance. If the cheque is in order, it will be debited immediately against the drawers' account; the receiving bank is notified and, in turn, advises the trader.

Up to this point we have considered only Current Accounts at a bank. The Americans call them Checking Accounts because they are accounts on which Checks (Cheques) can be drawn. This term makes the meaning clearer.

In addition, a bank will open a Deposit Account for you. Such an account will earn for you a small rate of interest, for you undertake to give the bank from one to three months' notice of your intention to withdraw money. Such accounts used to be popular with savers because

the commercial banks gave a higher rate of interest than the Post Office or the Trustee Savings Banks. But in these times a bank earns very low rates of interest itself and cannot compete with the rate of $2\frac{1}{2}$ per cent allowed by the Post Office. In consequence, Deposit Accounts are now used by trustees and others who wish to leave large sums where they will earn a little and yet be available at short notice; for example, after selling one investment and while seeking another. It would involve some risk if they bought Government Stocks, for these might fall in value at the time the money was required.

CHAPTER II

HOW A BANK EARNs ITS LIVING

1. Some Criticism of English Banks

BRIEFLY, a bank is a moneylender. It earns a living by lending the surplus of one customer to another who is short. In some respects a banker is a pawnbroker. One difference between the two is that a banker who lends money to a duchess on her diamonds may be a peer, whereas the pawnbroker who makes a loan to a charwoman on her engagement ring is of no account socially. But that is a subject for a sociologist.

There is a curious difference between the attitude of American and English banks to their customers. The former treat their clients with the same respect and deference as do other sensible traders. That is to say, they welcome them to the bank premises, make them feel at home and go out of their way to perform services of all kinds. The best comparison with them in this country is Messrs. Thomas Cook & Son, the travel agents, for they and American banks treat the smallest customer with the same consideration and thoughtfulness as the largest, and there is no limit whatever to the service which they offer to customers.

But some of the banks in England behave quite differently. It would be invidious to mention names but many of you will have noticed that a bank opens an account for you as if conferring a favour. The principal reason why they open an account for you is that one day you will want to borrow. Money, to a banker, is a commodity and he must sell his goods or go bankrupt. Why pretend otherwise?

Having handed out several compliments to banks in preceding pages, it is most gratifying to criticize such justly honoured institutions and we will follow this up

by suggesting that many a man of substance has forsaken the banker of his struggling days because he was treated with less amiability than a customer has the right to expect.

But in fairness it should be said, and underlined, that a bank's business is lending money with safety for short periods, weeks or months rather than years. There are other institutions which specialize in long-term finance. A merchant banker (see page 73) will arrange an issue of debentures for a company which has tangible assets, such as buildings or plant, to pledge; the new Industrial and Commercial Finance Corporation will lend money for years for the development or expansion of a business; a Building Society will finance the purchase of houses and land; a Hire-Purchase Finance bank will assist you to buy cars, furniture, and musical instruments; you can borrow a lump sum on permanent mortgage on your house through a solicitor or estate agent acting for a client who has money to invest.

A commercial banker, on the other hand, wants to keep his resources as liquid as possible. In plain English, he likes lending to those who will pay him back in a few weeks or months.

It should never be forgotten that banking is a business and that the object of all business is to earn as much profit as possible consistent with safety. Banks are peculiarly susceptible to political trends; panics, rumours of war, trade depressions affect them instantly and, in consequence, they will refuse to tie up money in long-term loans which cannot be repaid quickly. It is not safe for them; they are, in fact, trustees for their depositors' money. The last thing any bank wishes to do is to cause financial embarrassment to a customer, for it must be obvious by now that they earn a living by being of assistance. And so they will frequently refuse a loan because they foresee that they may have to ask for repayment at an inconvenient time. Your business, like theirs, may be adversely affected by scares.

2. Bank Loans

Let us now illustrate a bank's point of view by some examples. We will at present confine them to small loans.

First, some cases where banks are pleased to lend.

Assume that you are a retail trader and although you receive cash all day long you never have enough money to take advantage of the cash discounts which are offered you by manufacturers and merchants for cash in 7 or in 10 days. You realize that cash discount is clear profit (though you may not realize that the manufacturer is no more of a fool than you and, accordingly, has added something to his price to cover cash discount). So you consult your bank manager and say: "If you would let me overdraw up to £500, I could use that money by turning it over and over. I can get an average of 3 per cent every month which amounts to 36 per cent per annum. On £500, this amounts to £180 a year. If you charge me 4 per cent on my variable overdraft, the difference is profit."

The bank manager knows your turnover by the amount you pay into your account. He also knows, to within about 2 per cent, what rate of net profit is made in your class of business, but he has learned to be cautious and so he replies: "I'd like to see your last two audited balance sheets. If everything is satisfactory, I will gladly recommend my head office to advance what you need. I do not think, however, that they will agree to interest of 4 per cent. That is low for this sort of business." By which he means that the bank will chaffer with you over the rate of interest.

Actually, the bank likes this sort of business if the customer is sound. They hope that with the extra money you earn, you will advertise locally and expand your business so that next year you will ask for an overdraft of £1000. If money gets tight, they can always call in your loan gradually without damaging your business. All that this will do is to prevent your making as much profit in discount.

Before leaving this subject, it may be of interest to learn that many of the large shops cover the whole cost of their Accounts Department by the profit on cash discounts after charging the interest on the money borrowed.

Another example of a loan which a bank finds interesting. If you are the owner of what are called Gilt-edged Securities (securities on which there is no risk because they are guaranteed by the Government) or of debentures, or even ordinary shares of a first-class company, then a bank will gladly lend you a percentage of the market value, for they can do so with safety. The percentage they lend will depend on the security. Do not grumble at a bank for not lending you £97 on £100 worth of War Loan. If the market value should drop, they have the unpleasant duty of reminding you that the security you gave them is insufficient to cover their loan to you. By lending you £85 they avoid any embarrassment and they must presume that the difference of a few pounds means little to you. If, on the contrary, it means a lot, then they have the more reason for being cautious.

This type of loan, against good securities, is very satisfactory to both parties and it probably represents the majority in money of all bank loans granted. It is probable, too, that not the least of the reasons for investing in Gilt-edged Securities is the fact that a loan can always be raised on them. In the period between the wars everyone with £100 could dabble in finance. The method was as follows: with your £100 you bought War Loan which paid interest of 5 per cent. On this security you borrowed £85 and this sum you invested in a commercial company's shares which, although high in price, brought you 8 per cent or even more. This latter rate of interest was not a net profit for you because you had to pay interest to the bank on your loan from them. But you did realize about 8 per cent in all on your original capital of £100 as against 5 per cent if you simply drew interest on the War Loan.

But this practice is now frowned upon by the Government.

A final example of a loan which a bank favours. You are a farmer but you have no dairy business and, accordingly, you do not receive a monthly cheque from the Milk Marketing Board. On the contrary, you have to find money for seed and for wages until your crops are harvested. If your record is good, a bank will finance you until your crops or your beasts are sold. In fact, the greater part of loans by country banks are made to those engaged in agriculture which, of course, includes market-gardening and poultry farming.

Now for some examples of loans which a bank does *not* like. We have already explained that it does not like long-term loans although it does make them here and there.

Above all, it actively dislikes making loans without security. It would prefer to forgo the pleasure of making money out of you if, in the process, there were a grave element of risk. It must think always of its shareholders and of its other depositors, your brothers, sisters, cousins, and aunts. People say: "You have to leave one of your limbs with a bank before they will lend you a cent." Or, "a bank is like a man who will lend you an umbrella when it isn't raining." Such sentiments are uttered by the disgruntled and the author, in his day, pleads guilty to this charge. Reflection shows him, however, how right was that bank! He recalls with pride the bank manager saying on another occasion: "Listen. Without security I will lend you £1 for every year I've known you." Had the writer been a bigger fish; the manager might have made it £5 per year or even £10.

It is often said that in the old days, before the amalgamations which resulted in the formation of the Big Five, banks were smaller and more local; they knew their customers more intimately and, accordingly, could distinguish the honest from the not so honest. In those days, old men say, you could borrow without tangible security, simply "on your note of hand" as the money-lenders say but do not mean.

It is also true that bank managers do their best to know all their customers with the object of discovering, if possible, which of them are likely to weather a financial storm and which not. They are assisted in this process by local directors. If they have not quite as much knowledge as their predecessors in the days of local banks, it is due to the vast expansion of industry and commerce in the last forty years. Bank managers continue to lend, without security other than character, small sums for short periods to those whom they know and who are in established positions or who are members of professional bodies with a standard of rectitude. But they would naturally prefer it if such borrowers had some tangible security as well—the title deeds of a house or a life policy with a surrender value.

Before the recent war, Barclays Bank published an analysis of its advances to private individuals which was most informative and interesting, particularly to those with some wide knowledge of the needs of various professional men. Speaking from memory, the total of such loans was about fifty million pounds and the average loan £500.

Another type of loan which is unpopular with banks is an advance against shares in a commercial company which are not quoted on the Stock Exchange or, if quoted, are inactive or, worse still, speculative. You should understand the reasons for this.

It has already been said that a bank will gladly lend you money on first-class securities, the reason being that these are bought and sold on the Stock Exchange every day. They can drop in value, it is true, but even the ordinary shares of a first class company will only drop a shilling or two at a time in the event of bad news. The bank will not have advanced more than about 75 per cent of the market value when they made the loan and the shares have to drop a long way before the value of the security falls anywhere near the amount of the loan.

Now, if a security is not quoted on the Stock Exchange it is not always easy to find a buyer for it. If the value

should fall, it is not reported in the daily Press and a banker must rely on private information. If this should be inaccurate or out of date, the banker might find that he had lent £700 on securities worth £500 and that would make him very unhappy if the borrower's status was not of the best.

Very much the same may happen with securities which are inactive and only quoted occasionally. The banker knows the last price at which they were quoted before he made the loan, but he can have no idea what the price may be on the next occasion when a sale takes place. And that, again, is an embarrassment.

Speculative shares are good or bad security according to the political and financial state of the country and of the world. During the boom years of the late nineteen-twenties, banks lent freely against the shares of all manner of queer companies. It is easy to be wise after the event but it should be noted that well over a hundred million pounds were raised from the public for new companies at about that time. As evidence of the haste with which investors buy "Gold Bricks," a company was formed to manufacture gramophone records to a total of more than all the other gramophone companies together. Yet the public bought these shares freely. In 1931, when the slump was well upon us, the value of these shares of new companies dropped to fifty millions. The banks had lent very freely on some of these shares and they lost millions. Yes, millions.

An actual example will illustrate this. A certain citizen of another country was associated with others as a company promoter. As the result of one flotation, this individual received £350,000 worth of shares as a reward for his kindness in letting the public in on a good thing. As the market prices of all shares were rising at that time, he arranged with a bank to lend him £280,000 on his shares—80 per cent you will observe. He did not want to sell them for, as he said, it would be throwing money away to sell something for £350,000 which would be worth half a million in a few weeks or months.

Having borrowed this sum, he left a few thousand pounds in his bank account and transferred the balance, little by little, to his own country. A year later, the value of the shares fell, and fell, and went on falling. The bank became nervous and asked for more security or for the repayment of his loan. He replied that the drop in the market had wiped him out; he was broke.

He explained to an acquaintance that all he possessed of value in this country was his gold cigarette-case, all his money was in New York. In consequence, as he said, "he was sitting pretty." Some would say that he was not a very pretty man.

You may have formed the idea that a bank manager had erred in lending so much on so little. It is possible. But there is another explanation. Hearken to the words of one of the managers of the bank at its head office: "I must admit that these swindlers are clever psychologists. There isn't a bank manager in the country who would lend them a cent and they know it. So what do they do? Buy a Rolls and go over our heads to the directors."

The heavy losses incurred by the banks in the slump of the early nineteen-thirties were not all due to trickery. By no means. Most of their loss was occasioned by the very fact of the slump occurring. All over the country, traders and manufacturers who had borrowed found they could not sell their goods and turn their stocks into cash. In consequence, they could neither pay their expenses nor repay their bank loans. It says much for the solidity of the English banks that they could lose millions and yet maintain their strength.

This is, perhaps, the right place to explain that the strength of our banks is due partly to their enormous reserves, partly to their caution in lending, but mainly to the diversity of their money-lending activities. If Lancashire does badly, the banks there suffer but this does not damage the bank as a whole. The Midlands may be doing good business and this may more than offset the bad state in Lancashire. An illustration of the safety of diversity is the Birmingham area. In and

around that city there is a vast number of entirely different and unrelated trades. If one trade is down, some of the others will be up. In consequence, Birmingham does not feel hard times as badly as those places or areas which depend mainly on one industry.

In the United States, banks are purely local. Each state makes its own laws and each forbids the banks of another state to do business there. This follows naturally from the American doctrine of unrestricted private enterprise! As an example, a New York bank cannot open a branch in the State of New Jersey, which is just across the river Hudson and is connected with New York by a tube railway. As a result, except in the large cities where there is diversity, a local bank lives entirely on local industry. If that industry slumps the bank follows suit. That is why there were so many bank failures in 1930 and thereafter. The large banks in New York, Chicago, and other big cities are, of course, as solid as any bank on this side.

President Truman has chosen to forget these bank failures for he is reported to have said, in May, 1946, that he would rather see a thousand little banks than one National City Bank. This is typical of the irresponsible and dangerous nonsense which is uttered by politicians when an election campaign is ahead of them. The President is clearly telling the Little Man precisely what he wants to hear. Mr. Truman relies on the profound and widespread ignorance of finance which this little book seeks in some small measure to correct.

Let us return to unpopular loans from a bank's point of view. A bank does not favour a loan to one person guaranteed by another, someone much richer than the borrower. On the face of things, banks should be pleased to make such loans and, in fact, they do make many in order to please a customer. Their objection may be illustrated by the statement that a loan on a guarantee is moneylenders' technique. If you need money badly and have no security to offer a banker, you may be forced to visit one of those people who advertise: "Loans from

£10 to £10,000 on your simple Note of Hand." It would not be accurate to say that such an advertisement is untrue for, if you are a Big Shot who lacks tangible security, a moneylender will accept your Promissory Note (Promise to Pay) with your signature alone on it. He relies on the fact that a well-known man will not risk a scandal and will pay up one day. But if you are nobody in particular, he will ask you to get a friend to endorse his name on the back of the bill, "just as a formality." You must then find a friend who is relatively rich in that he owns property of some kind. If you should be unable to pay, the moneylender can demand payment from the friend who has "backed your bill" by writing his name on the back of it. If the friend should make difficulties, he can be made to sell or mortgage his property in order to repay the moneylender.

Now, a bank would be in the same position as the moneylender, but whereas the latter would have no compunction in enforcing payment from your guarantor, a bank would do much to avoid such unpleasantness. Rather than risk the compulsion to be so severe, a bank would prefer to avoid this apparently good business opportunity. A moneylender, because of the risk he runs and the trouble that may be involved, charges a high rate of interest. A bank never does this.

Another unpleasant position for a bank is being asked to lend money against Savings Certificates. You see, these are not good security, for if you are sufficiently dishonest you can pledge your Savings Certificates with a bank and then write to the Post Office to say you have lost them. The Post Office issues duplicates which you can sell and the bank is holding worthless pieces of paper.

No business man likes to suggest to a customer that he may be a crook, and a banker is, above all, a business man.

3. A Run on the Bank

A question often asked is: "If a bank earns its living by lending the surplus money of A and B to C and D,

how would it cope with a situation where everyone wanted to draw his bank balance out at the same time?" The answer is quite simple. It could not cope with such a demand because it keeps in cash only a sum equal to about 10 per cent of its deposits. In March, 1946, for example, the Clearing Banks had a total of £4749 millions of their customers' deposits and only £493 millions in cash. The rest of the customers' money was invested or placed where it earned interest, for interest is a bank's life-blood.

It may seem quite inadequate that a bank should only keep 10 per cent of your money in the till, but experience over many years has proved that it is more than sufficient. The point is that large amounts in notes are an embarrassment to everybody for they may be lost or stolen and it is, therefore, only panic which causes what is called a "run on the bank." The modern way of averting such a run is to close all the banks altogether until the frightened ones recover their equilibrium. It is many years since such action had to be taken by a British bank.

The story is told of a run on the Bank of England in the days of Queen Victoria when gold sovereigns were in current use. Some bright young man had a flash of inspiration and suggested that the gold should be heated in the bank's vaults and served hot to the customers. He was a good, natural psychologist, for the physical pain of picking up hot sovereigns was the finest cure for the mental distress of those who feared to lose their money. Apart from which, of course, the difficulty of handling, literally, hot coins gave the Bank of England time to send out for more gold while conveying the impression that the coins were being made on the premises.

Another question which is asked is: "How can a bank make money out of a small private account in which a very small balance is kept?" Here again, the answer is that it cannot—theoretically. That is why a bank charges a commission for keeping a small account. In practice, it can make a little, for the total of these small accounts is very large.

4. A Bank's Investments and the Money Market

Let us now consider some actual figures of the money lent by banks on a large scale; figures extracted from the *Government Statistical Digest* for April, 1946. It will be simpler to leave out the six noughts as does the *Digest*.

	£ millions	Percentage of Deposits
TOTAL DEPOSITS	<u>4749</u>	
Notes, Coin, and Balances with the Bank of England.	493	10·4
Balances with other banks	154	3·3
Money at Call and Short Notice . .	253	5·3
Bills Discounted	379	8·0
Treasury Deposit Receipts	1443	30·4
Investments	1246	26·2
Advances to Customers	853	17·9
	<u>4821</u>	

The difference between the two sides, for those who are interested in balance sheets, is made up of shareholders' capital and reserves on the Deposits side, these two items together with Deposits constituting Liabilities and, on the Assets side, the value of bank premises.

The above items are listed by the Government Statistician in the order of their liquidity, that is to say, the order in which they may be converted into cash most readily. They are also in the inverse order of interest-earning capacity, for Cash, at the top, earns nothing, Money at Call very little, and Advances quite a lot. Government Statistics have much value but they usually omit the most important figures. Forgetting, or being unaware, that figures have little meaning except in their relation to other figures, they omit to mention the ratio in percentage which each item bears to the total. The percentages in this case have, therefore, been added by the author because they are more important than the figures of money.

If we are to understand, with any detail, how a bank earns money for itself and how the business of money

in large amounts is managed, it is necessary to discuss each of the items on the table printed above.

Notes and Coin obviously earn nothing for a banker. They are the reserve he must keep in order to satisfy the daily demands of his customers for cash. It will be equally clear that if a bank kept a smaller sum in the till and lent the difference, it would earn more money. In the United States, banks are compelled by law to maintain fixed percentages of cash in the till and balances with other banks, and this is a wise provision for, as already noted, the banks there are purely local and, lacking diversity through branches, are susceptible to local conditions. The figures are about the same as in this country but our banks are free to fix their own percentages of cash. In practice, however, they all maintain about 10 per cent, which is well in excess of their normal requirements.¹ By sacrificing the opportunity of greater profit they increase their stability and the safety of their customers' deposits. The banks' balances with the Bank of England can be drawn out at any time in notes and coin, and so are included under this heading.

It may seem a little strange that banks should have balances with other banks. In the table, the percentage of deposits so placed is 3.3. The main reason arises from the fact that at all times a bank has hundreds of cheques in process of collection through the Clearing House. Such cheques may be in transit to head office from branches or they may be at head office, or they may have passed the Clearing and be on their way to the various banks on which they are drawn. There is the reason also that banks use their rivals in small places where they have not established a branch themselves.

And so a bank has cash in the till, cash across the road, so to speak, in the Bank of England, and cash in transit through the Clearings.

Next in order of realization comes Money at Call and Short Notice. In our example the percentage of deposits is 5.3. This introduces the first of what are sometimes

¹ Reduced in December, 1946, to 8 per cent.

considered as "complications" but which are quite simple when they are understood. By far the larger part of this item consists of loans to what is known as the Money Market. It is composed of banks, discount houses, and bill-brokers. As you will hear, they need large sums for short periods. The lesser portion of the money market consists of the Stock Exchange.

As its name implies, the Money Market is a market for money but money in large lumps. You have doubtless glanced at the City page of a newspaper and turned away from such a news item as "Money was so easy yesterday that balances became unlendable in the afternoon." (The quotation is from the money market column in *The Times*.) To most of us money has never been easy but we are not money merchants. We may be in the tea market or the wool market because we buy and sell those commodities. Similarly there is a money market for those to whom money is a commodity to be bought or sold but not to be spent or consumed by them. But whereas the tea merchant and the wool broker has a market place housed in a particular building the money market is a symbol, a figure of speech. It has no building, no staff and no telephone. It is merely a convenient term for a small number of men who buy and sell money.

The reader is here warned that the working of the money market is a little obscure for those whose arithmetic is poor.

It is not intended to deal here with the very large and contentious question: What is money? for there are many books, large and small, devoted to the subject. But you must know that money is very much more than notes and coin or stocks and shares. It is all the things which are convertible into notes and coin. Chief among these things are pieces of paper that are known as bills of exchange or, shortly, bills. A cheque is a bill of exchange at sight, meaning that it is payable as soon as the bank on which it is drawn sees it. But a bill can be drawn at a number of days' or months' sight, that is to say, it can be made payable at a later but specific date after it is

drawn. When such a bill is "accepted" (see page 46) it is the most convenient way known of raising money for, if your credit is good, you can get money at once and have from one to six months in which to repay it.

By far the largest borrower is the Government. It needs millions of pounds every day. You will remember during the recent war being told that we were spending seventeen millions a day. A bank would be delighted to lend money to the Government by way of an advance on a current account, but this would be expensive for the taxpayer. And so the Government issues bills, Treasury Bills they are called. This is the cheapest way to borrow, for there is always good security behind a bill and there is a steady demand for them. At varying dates, the Government offers these bills for sale and on each is printed its face value and its maturity date, this being the date on which it is repayable.

No money merchant can afford to pay the face value for a bill because he has to put the money down when he buys it and wait a month or two for repayment. So he buys the bill at a discount, at a figure less than the face value. In effect, this discount is interest, the interest which the Government pays for the loan of money for a few months. The current rate of such discount is about 10s. per £100. As evidence of the great demand for these bills and the consequent keen price, it may be noted that a recent bid for Treasury Bills was at a discount of 10/1·85d. A simple calculation will give you the result that a buyer of these bills makes roughly 1s. 8d. from an investment of £100 for two months. The difference between discount and interest in practice is that discount is deducted at the time the loan is made or the bill bought, whereas interest runs from day to day until the loan with interest is repaid. If you make another calculation of the total of all banks' Bills Discounted you will see what 1s. 8d. can amount to when multiplied by millions.

You will now understand why this large borrowing is termed a market, a place where bargaining over price takes place.

Another type of bill is that drawn by one bank on another or by a trader on a bank. Most of such bills are drawn on merchant bankers such as Rothschilds or Barings, or on the London branches of foreign banks, for foreign trade is financed in this way. It would be too long a digression to explain the machinery of foreign trade; it is described in Chapter III. The discount rates are very much the same as for Treasury Bills, for London merchant bankers, as mentioned in the introductory chapter, are considered as solid as the Government. There is, moreover, saleable merchandise as security for the bills.

There is yet another kind of bill, the Fine Trade Bill. Fine in this case means first-class. Such bills are also drawn to finance trade, mainly foreign, but instead of being drawn on a bank are drawn on first-class merchants, manufacturers, or traders. The rates of discount are slightly higher; at the present they range from 1 to $2\frac{1}{2}$ per cent varying with the maturity of the bill (the date at which it is payable), the 1 per cent rate applying to one month and the $2\frac{1}{2}$ per cent rate to six months.

The principal bidders for these three types of bill are the discount houses. There are only a few of them, less than half a dozen, and the figures they deal in are enormous. To finance their business they borrow from the banks. They never want the money for long—long enough only to re-sell the bills at a higher price. That is why the money lent to them is "At Call" or "Short Notice." They are, so to speak, wholesalers of bills and their customers are the banks. You may wonder why a bank lends money to a discount house and then buys the proceeds of its own money back again. The answer is that "it is just one of those things," but a better answer may lie in the fact that a bank needs bills which mature every day in order to have a constant influx of cash and, accordingly, that it prefers to deal with specialists in such matters. And there is no doubt that discount houses are specialists with a technique of a high order. Just as there are brokers of stocks, tea, and wool, so there are brokers of bills who

form the link between buyer and seller. If the profit of a discount house is fractional, as it is, the commission of a bill-broker is "infinitesimal."

This brings us to the next item, Bills Discounted which, in our example, are equal to 8 per cent of the deposits.

By now, this item should explain itself, for you have already learned that banks are the buyers of bills. But it should be noted that every deposit bank can, and does, have demands on it in excess of the normal demand for wages and salaries, payments by traders to their suppliers and regular remittances. Almost every day, one company or another pays a dividend, buys securities or makes payments to contractors under building and other agreements, to mention only a few of the many exceptional payments that a bank has to meet in respect of customers' cheques. Accordingly, every bank must have funds coming in every day and the surest way to achieve this is to have bills maturing every day. This condition is brought about by buying bills every day at varying dates of maturity. A bill broker can supply these quite easily, though he may not be able to find the exact amount required. For example, a bank may have five thousand customers who pay interest on their debentures on 1st July. They know what the total interest is and they know that interest warrants will be presented to them through the clearings for large amounts on the 1st, 2nd, 3rd, and 4th of July and that the flow will then diminish until it becomes a trickle. Accordingly they will buy bills maturing on those dates for the amounts they expect to have to meet. Some of these bills will be freshly drawn, others will have changed hands several times, but they will all mature in the early days of July. If one bank has such payments at that date, you may be sure that the others have also, and it is here that the skill and judgment of the dealers in bills is shown. As in other markets, demand sends the price up and so a dealer must conceal his intentions and buy little by little as the occasion arises.

It should be explained that the above is mere theory

to explain the daily need for money and the method of getting it. The actual placing of a bank's money in bills and other investments is managed by a committee of directors and managers in each bank, and their methods are unknown to the public, including the present writer.

The next item on the table of bank funds is "Treasury Deposit Receipts." You will see that the sum is the largest of all and represents 30·4 per cent of the deposits. These are, in effect, Treasury Bills but they are longer dated. Such an item did not appear in pre-war balance sheets of the banks and it is a special arrangement due to the war. Some financial journalists speak of this method of financing the Government's needs as a convenient investment for a bank which has surplus money. It would be interesting to learn from a bank if it agreed with this opinion in view of the fact that the Government pays about six shillings in interest for a loan of a hundred pounds.

The items in the table of bank funds which have been described above comprise the money market. The procedure in the market may be summarized, briefly, thus: each day the total of a bank's money varies; each bank has either a surplus of money or a need for more. If a surplus, a bank buys bills through a broker from a discount house. If a need, it calls in some of the money which is "At Call." It sounds simple but it is, in reality, a complex affair requiring great skill and judgment.

The last item but one is Investments. The percentage under this head was 26·2, the second highest figure. Part of a bank's capital and reserves of undistributed profit may be said to be included herein but much of its customers' money is also placed in this way. The banks are easily the largest buyers of War Loans and other Government securities and they can safely invest in them because they are readily saleable. A bank's investments are mainly Gilt-edged but they include also some Colonial and Municipal Stocks. To a very small extent, also, banks invest in the shares of commercial companies which pay a higher rate of interest, and these assist them to earn a

slightly higher average rate of interest than the prevailing rate on Gilt-edged.

Last of the ways in which a bank invests is in Advances to Customers. The percentage in our example is 17·9: the total sum so invested was £853 millions. Part of this figure is represented by overdrafts on which interest is calculated from day to day; part in loans of a fixed sum for a definite term. No bank, to the author's knowledge, has published figures of these two types of advance and statisticians are therefore prevented from calculating the percentage of each to the total. Nor is it known whether a bank charges more, or less, for a fixed loan than for an overdraft.

In the past, advances represented as much as 50 per cent of a bank's deposits and a study of some pre-war balance sheets might reveal even higher percentages. The drop is due to the enormous expansion of Government spending which, justifiably or not, must make our grandfathers turn continually in their graves. The banks are the sufferers for, whereas they can earn 5 per cent or more on an advance, they can get only five-eighths of 1 per cent on Government business. It must be said, however, that the figure of deposits is very much higher than anything known in the days before the war and this must be taken into account. It is said by financial writers that the low figure of advances is evidence of the low demand but, here again, it seems possible that a banker might have a different explanation.

A bank earns a higher rate of interest on advances than on other investments, but in all matters of finance a higher rate of interest presupposes a greater risk. We have considered some of the risks which banks run but it has been made clear, we hope, that this risk is minimized by diversity and spread. We have discussed advances made by smaller branches of banks because this book is written for those who are comparatively small financially. But exactly the same principle applies to larger branches. It is only the amounts which are larger. In cities, very large sums are lent to traders in every kind of commodity

including money itself. Money may be borrowed by those who wish to buy goods when the opportunity is favourable but who cannot turn these goods into money at once either because they are the raw materials of manufacture or because, though ready for sale, they must be distributed through the slow process of "trade channels." As we have illustrated in the case of the man who borrowed £85 on £100 War Loan, it is obviously better finance in stable times to borrow temporarily against your securities than to sell them and use the money for your activities. Is it so obvious? Perhaps not. Let us, therefore, illustrate the two alternatives.

The XYZ Co. is offered 10,000 cases of tinned food at £1 per case which is 2s. per case cheaper than the last lot offered. Food always sells (a free tip for the Stock Exchange), wars and panics notwithstanding, and so they cannot be wrong. But £10,000 is a lot of money for anyone to find instantly. They have £15,000 of reserves which are invested in securities which earn for them $4\frac{1}{2}$ per cent or £675 per annum. They can either take £10,000 from their reserves by selling securities or borrow against them by a bank advance. Let us consider the comparative effect of these alternatives.

The commercial side of the transaction is the same in both cases but the financial aspect differs, thus—

	Alternative 1 <i>Selling Securities</i>		Alternative 2 <i>Borrowing</i>
	£		£
Loss of interest on Reserves liquidated: 4½% on £10,000 for 6 months.	225	Bank interest on loan	225
Less Income from Invest- ments.	112		337
Deduction from profit.	<u>£113</u>	Addition to profit	<u>£112</u>

This illustrates the fact that banking and finance are a matter of interest, the gain or loss of it. One day's loss of interest on a large sum is a considerable figure and that is why interest is calculated at so much per day. A bank can, and often does, lend a million pounds to another bank for one day, and on this it can earn from 10s.-15s. per cent depending on the shortage of funds in the money market.

We hope it is clear to you by now that the money market exists not for speculation but is a necessary piece of machinery for banks who, owing to the uncertainty of their customers' demands, must have funds available at short notice and yet must earn some revenue from this money in order to pay their expenses.

It should be clear also that money in large amounts is no more than an assortment of pieces of paper and that these represent no more than book-keeping entries.

CHAPTER III

FOREIGN EXCHANGE AND FOREIGN BANKING

1. Basic Principles—Cheques in Foreign Currencies

WE have dealt in outline with the main features of banking in deposit banks and now we must consider the machinery of Foreign Exchange, which is another side of banking.

This subject frightens the majority of people. It is regarded as abstruse and intricate. It need not be either. It is true that it is a technical subject and that actual operators in the foreign exchange market need as much knowledge and ability as any other first-class technician, but that is not to say that the subject need be as little understood as, for example, nuclear fission. On the contrary, its general principles should be understood by all who profess and call themselves citizens. Not to understand is to make a portion of each day's news unintelligible.

And so we shall attempt to explain the basic principles in simple language and refer students to larger and more important books for a comprehensive exposition.

The necessity for foreign exchange arises from the fact that each country insists upon maintaining its own kind of money. In the United States, although each state has its own laws, every state accepts the dollar as its currency. In Europe each state has a different kind of money, for whereas the states composing the United States are united under a central government, the states of Europe are neither united nor responsible to anyone except themselves. That there is something ridiculous in these differences of money is illustrated by the fact that near the borders of most countries, the money of its neighbours is freely, even if illegally, accepted.

It is said that if politicians did not suffer from arrested mental development, the world would be a different place.

But they do and so it isn't. We have to face the fact, then, that the citizen of each country can use only the money which he can spend in that country. If we buy tobacco in America it is not the slightest use sending pounds sterling to the grower. They are useless to him for he cannot pay his wages nor buy anything with them. Similarly, an English tailor selling a suit to a Frenchman needs pounds because he cannot pay his wages in foreign money.

It follows that every import and export between one country and another needs financial machinery designed to give spendable money to the seller. The buyer gets the goods and he can exchange these for the money of his country.

That is the basic principle of foreign exchange and you will agree that it is simple. There are many complications and you will hear of them shortly.

The foreign exchange market, like the money market, is a symbol only. It is not housed anywhere but consists of individuals scattered fairly closely in the City. It consists of officials of the deposit banks, merchant bankers, foreign and colonial banks and, like markets for other commodities, of brokers. Since the early days of the war, the foreign exchange market has been controlled by the Government. Such controls may one day be removed or modified and so we will describe the market as it was prior to 1939, and as it may be again.

The head office of every British bank in London had an account open in every country which might be visited by Englishmen or with which English firms and individuals did business. This meant that at any time they could supply anyone with foreign money by drawing a cheque on their account in the appropriate foreign bank. If a customer wanted a sum larger than their balance, they bought some more of this money from another bank which had plenty. It might seem obvious that a branch bank of the foreign country whose money was needed would be the cheapest place to buy such money but, for reasons to be described later, this might not be so.

An illustration may make the previous paragraph clearer.

The X Y Company has for years bought gowns (the trade name for women's dresses) from France and from the London branches of French firms. One day a Hungarian calls on the company and displays some models which are very attractive and cheap. An order is given and, as it is the first transaction, the Hungarian asks for payment when the goods are shipped from Budapest. The Hungarian needs payment in his own money, pengoes, and he tells X Y that he will ship the goods on 1st February on receiving the sum of 20,000 pengoes. X Y informs his bank in good time that he will need 20,000 pengoes about the 25th January. An English bank does not speculate and so it will ensure that its balance in the Budapest bank is enough to cover the cheque it will draw on X Y's behalf. If it has a substantial balance of pengoes, it will still earmark 20,000 to cover the cheque. If it has not, it will telephone to a broker to inquire the price of its needs. There are two courses open to the broker (actually there are three but the third is complicated and will be dealt with later). He can either buy the pengoes from a bank which has plenty (because one of its customers has just sold thousands of pounds of machinery to Hungary), or he can buy a bill drawn in pengoes. His choice will be determined by the price and he will choose the method which gives the right number of pengoes for the smallest sum in pounds. And every party to the transaction is satisfied. The broker gets a tiny commission; the seller of the pengoes earns a little, for he supplies X Y's bank at a price which is fractionally higher than his own cost; X Y's bank makes a small "turn"; the Hungarian is paid for his gowns in money he can use for wages and materials, and X Y gets the gowns which he can sell in the dress shops for pounds sterling.

Let us now return to the broker. It would appear that the cheapest place to buy pengoes would be a branch of an Hungarian bank in London, for its head office would

have unlimited numbers of such currency. But it could easily happen that money was tight in Budapest and all available funds were lent at high rates of interest. Accordingly, the Hungarian bank would not be anxious to sell pengoes for pounds for which it might have little use at that moment. It would prefer to keep its money in Budapest. And so its price for pengoes would go up, for the price of all commodities not under control is ruled by the law of supply and demand. Thus you will see that another English bank or a discount house might easily have pengoes which it wished to sell at a cheaper rate than that quoted by the Hungarians.

It should be noted also that a bank builds up its balances in foreign banks not only by buying other banks' balances but also through exports, as mentioned on a previous page.

FORWARD EXCHANGE. And now for a complication. To discuss this we must go back to the X Y Company, the importers of Hungarian gowns. If they had given the order for these goods some months before they were to be delivered, as was probable, for all goods take months to manufacture, they might have worried themselves as to the price they might have to pay for the pengoes in February. If the rate of exchange went up, they would make an exchange profit, for it would take a smaller amount of pounds to buy the 20,000 pengoes. If the rate went down, they would have to pay more pounds. Being expert in gowns and not in foreign exchange, they wisely decide to avoid speculation and so, at the same time as they buy the gowns, they buy the pengoes to pay for them. This they arrange with their bank which will quote them a price for the delivery of pengoes on February 1st of the following year. Such a transaction is known as "Forward Exchange" and it was common practice. It ensured that the price at which you bought goods was the same as the price to be paid when they were delivered. Knowing the cost to a penny, the merchant could fix his selling prices.

We have mentioned that the X Y Co. could have "taken

a view" which is a City term for speculation. From which it will appear that speculation in foreign exchange can be indulged in. More correctly, it *could* be done freely before the Government controlled the market. Between the wars very many thousands of people speculated in this way to the profit of banks which earned a turn on every transaction. From the time when countries ceased to link their currencies with gold the margins to be won, or lost, were wide and this also encouraged speculation. Anyone could join in, for it was no business of a bank to ask why you should want foreign currencies. At any time you could go to your bank and ask for a cheque on any foreign city for the equivalent of, say, £100. You held this cheque and watched the foreign exchange rate of the currency you had bought. At a moment favourable to yourself you sold the cheque and pocketed the difference. You were unlikely to make much on an investment of £100 but you had a run for your money and, unlike gambling on horses, you did not lose your stake. There were operators who went to great pains to compile statistical charts of the movements of the exchanges and some of them invested many thousands of pounds with a corresponding profit, or loss. Between the two wars Amsterdam attracted deposits from all over the world by the simple expedient of declaring that interest earned by a foreigner was free of Dutch income tax. As a result, the demand for guilders was strong everywhere. A speculator could invest large sums in the purchase of guilders when the demand was relatively weak and sell them again when it was strong.

ARBITRAGE. Let us now introduce another complication known as Arbitrage. As an example, a bank needs a large sum in French francs for one of its customers and, as already described, it consults a broker who quotes a rate. This seems a little high to the bank and the broker is asked to quote a better figure. As we have often remarked, the money of any country is a commodity and it by no means follows that banks in England are the only sellers. New York or Brussels may have exceptionally

large balances of francs in Paris and be glad to sell. A ready seller has to lower his price and so it may be cheaper for the English bank to buy dollars and with them purchase francs; or, to buy Belgian francs and exchange these in Brussels for French francs. It sounds, and is, a little complicated and an operator needs to be a lightning calculator, for rates change from one deal to the next and, by the time a dealer has worked out the cheapest price, the value may have changed in the first market which he approached.

2. Telegraphic Transfers and Bills

So far we have dealt only with foreign exchange transactions by means of cheques because this seemed the simplest way of explaining the principles. In actual fact, however, the largest volume of such business is done by Telegraphic Transfers (T.T's.) and by bills.

By means of a T.T., money can be transferred by telegram or cable to any place on the globe which has a bank and the transfer is made in a matter of hours. A bank is being asked every day to remit by T.T. various sums to a variety of cities on behalf of traders in this country. The bank carries out such instructions by sending a telegram which is in code in order that the receiving bank may be sure it is genuine. Such a telegram decoded might read: "Pay Jules Papotier sixteen avenue Trucq forty-two thousand three hundred francs stop Pay Comptoir rue Chose account Henri Martin eighteen thousand five hundred and twenty six francs stop Both for account of Belfridge London stop".

The bank in Paris which receives this T.T. will understand that it has to pay a Monsieur Jules Papotier the sum mentioned and it will send him a cheque. It will also understand that it has to pay to the Comptoir National d'Escompte (a large French bank) at its branch in the rue Chose the stated sum, to be placed to the credit of Monsieur Henri Martin; both recipients will be advised that the payments are made at the request of

Belfridges of London. The Paris bank will then debit, or charge, the account of the English bank in their books, and that completes the transaction except for the detail that the English bank will send confirmation by post of the T.T. Belfridges of London will be charged with the cost of the francs in pounds sterling plus the charge for the telegram.

By far the largest item of foreign exchange is represented by bills which we have already referred to when discussing a bank's investment in this medium. And this is the place to describe the important role of the merchant banker, for he is (or was) the greatest dealer in foreign bills.

In the introductory chapter we mentioned that for very many years London was the financial centre of the world and that this was due to the merchant banker who had perfected a method of financing foreign trade. Merchant bankers comprise such names as Rothschild, Baring, Hambro, Lazard, Kleinwort, Schroeder, and others which stand to everyone in the City and to very many everywhere for the highest level of integrity. A hundred years ago this country manufactured goods for more than half the world and the pound sterling in consequence became the best known of all currencies. Cheques are a comparatively modern method of transferring funds and in those days both home and foreign trade were financed by bills. The special attraction of the bill to a merchant banker is that he earns a small commission not by lending money but by lending his name. Similarly, the advantage to a trader or merchant is that for a very small fee, or commission, he can use the name of a famous merchant banker as security for his transactions abroad. An illustration may make this clearer.

A lumber company in Florida (lumber is the American word for timber) plans to erect a sawmill and equip it with machinery from Birmingham, England. The Birmingham manufacturer has mentioned in his catalogue that he will be pleased to sell to foreign buyers for "cash

against documents in London," for this saves him the time and expense of making inquiries as to the credit standing of each foreign customer. The Florida Lumber Company, having placed its order for machinery and received acceptance and a delivery date by cable, gets into touch with its bank and asks them to "open a credit" which in plain American means: "Fix it for us." The bank then writes to a merchant banker in London, either direct or through a correspondent in New York, and asks him to accept a bill drawn by the Birmingham manufacturer on their valued customer "The Local Lumber Co. Inc." The merchant banker has reports from his agents in Florida that the Local Lumber Co. is a flourishing concern and he has done business with the Florida Bank for many years because they have been a party to the shipment of a lot of lumber *from* Florida; their name has been on the bills covering such shipments. The merchant banker agrees, therefore, to accept such a bill and he writes to the Birmingham manufacturer to say that when the machines are shipped to Florida he will be pleased to accept a bill drawn on him at 60 days' sight for £x, with shipping documents attached. (The sum of £x, will be made up of the invoice value of the machinery plus freight and insurance.)

The Birmingham manufacturer proceeds to manufacture the machinery with complete confidence for, although he knows nothing of the Local Lumber Co. in Florida, he has known the name of the merchant banker since he was a schoolboy. When ready, he sends the cases of machines to the ship designated by the buyers or their London agents and at the same time he makes arrangements for the goods to be insured against risks in transit. From the shipping company he receives a bill of lading, which is not only a receipt for the goods but also the title deed to them. From his insurance broker he receives an insurance policy. He then draws a bill for the sum of £x, as above, and sends it with the bill of lading and insurance policy to the merchant banker who accepts it. The bill looks something like this after acceptance—

Sixty days after Sight of this First of Exchange pay to ourselves or order the sum of £x for value received.

To Merchant Banker
541 Threadneedle St. London.

Birmingham Machine Co.

The bill has a stamp which is *ad valorem* (varying according to the amount of the bill). It is called a First of Exchange because a duplicate (Second of Exchange) is made out in case the original be lost.

After acceptance, the bill is sent to the Birmingham manufacturer.

As we noted when dealing with the purchase of bills by a bank, such a bill accepted by a merchant banker is "First Class Paper" and the Birmingham manufacturer can sell it readily to his bank under a small discount. And so the manufacturer is paid as soon as he ships the goods.

When the merchant banker accepted the bill, he wrote to the Florida bank advising them that he had done so, and enclosing the bill of lading and insurance policy and also the invoice and statement of the total due. Such an advice would be formal but, reading between the lines, the merchant banker would be saying: "I have done as you asked so please arrange that I have £x paid to me in London by the time the bill matures in a couple of months. When effecting payment, please add the few shillings which I charge habitually for the use of my name."

The Florida bank receives the documents and forwards them to the Local Lumber Co. so that that company can claim the machines when they arrive. The last act of the transaction is the purchase of pounds sterling by the Florida bank in order that the merchant banker shall have the money by the day on which he has to pay it out to the holder of the bill, the Birmingham bank who has discounted it.

That describes the part of a bill and merchant banker

in an export transaction. For an import into England, the procedure is the same with the parties reversed. The English buyer, through his bank, arranges for a merchant banker in London to accept a bill with documents attached. When accepted and returned to the seller, the latter can easily discount such a bill with a name on it as well known abroad as here. The merchant banker receives the documents and will not part with them until he receives the money from the English importer or an assurance from the importer's bank. This gives him the money to meet the bill he has accepted at its date of maturity. A small point should be noted: a bill is not actually payable until three days after its maturity. These days are known as days of grace.

Quite apart from imports and exports to and from this country, a merchant banker earns many commissions on bills covering goods which never come within hundreds of miles of London. In the old days of free trade, the sterling bill was the commonest on every money market in the world and it was always negotiable with good names upon it. As a result, the Brazilian, for example, who shipped coffee to Italy found it easier to finance his shipment from Santos if he drew a bill in pounds sterling on a merchant banker in London. The coffee came no nearer to England than the Mediterranean, but the bill came here and an English merchant banker earned a commission for accepting it. And similarly for other countries shipping goods abroad. In the example given, the Brazilian received milreis for his coffee for which the Italian paid in lire but, as stated, the bill was drawn in pounds sterling. It should be noted that such bills and foreign bills in general are also drawn by seller on buyer and only accepted by a merchant banker on behalf of the buyer.

A very large volume of this business has disappeared owing to the impediments raised against foreign trade by our own and foreign governments—tariffs, quotas, and so on—but it must have been highly profitable while it was at its height. (Of recent years, merchant bankers have

utilized their knowledge of foreign countries to establish themselves as "issue houses." This subject will be dealt with later.) Let us repeat that most of the high esteem in which London has been held for centuries as a financial centre is due to our merchant bankers, sometimes called acceptance houses. Each of them specializes in one or more countries and has its own agents there. The accumulated knowledge of the merchant bankers must be encyclopaedic and it is a thousand pities that it cannot be written.

For the sake of clarity, the business of foreign bills has been described only as affecting merchant bankers but, in comparatively recent years, the deposit banks have competed with them in the business of acceptances and, indeed, the general business of financing foreign trade.

Before leaving the subject of foreign bills, you should be informed of a method of "flying a kite" which is known as an Accommodation Bill. A bill can be drawn by a firm in one country on a firm in another which does not cover any goods at all. It is sent with a parcel of bills for acceptance to a banker by a known correspondent. With the banker's acceptance on it, it becomes first-class paper and easily discounted. The drawer must, of course, have the connivance of the drawee and the usual bait dangled by a firm drawing "for its own accommodation" is the offer to act as drawee later if required. The drawer of such a bill is under an obligation to provide the drawee with funds to meet the bill at maturity. It is a trick of borrowing by using a known name as acceptor of a bill but a bank will not touch such a bill if it knows what is happening, apart from exceptional cases where, for instance, an English subsidiary of a foreign firm discounts a bill drawn on itself as a cheaper method of finance than taking a bank advance.

3. Why Exchange Rates Change—The Gold Standard

And now we come to the greatest "complication" of foreign exchange, namely, the reasons for variations in

the value of a country's money apart from the law of supply and demand. It is a contentious subject and we shall touch only the fringe of it, sticking to actual facts as far as possible, though it is impossible to avoid mention of theories which are still the subject of dispute.

Before the war of 1914-18, the money of nearly all countries was based on gold because its value was relatively stable—its output was balanced by its demand in the manufacturing industries and as metal for coinage.

Being based on gold meant that a country had adopted the Gold Standard or, in plain English, that its money could be exchanged for gold on demand. Accordingly, a calculation was made of the value of an ounce of gold in terms of foreign currencies. It was found that £1 worth of gold cost the French about 25 francs, the Germans 20 marks, the Americans 4 dollars and 80 cents, and so on for other currencies. This was called the "Par of Exchange," that is to say, the rate of exchange between £1 and foreign moneys. It was a horrible calculation because of our unique system of weights. This is mentioned to stress the fact that a gold standard is based on weight.

As you have learned, money is a commodity and when there are no controls, a commodity price is regulated by supply and demand. But just as a railway fare for a short distance may be more expensive than the fare by tube or bus, so a rate charged for foreign exchange could be higher than the price of gold. In the one case you could save money by taking a bus; in the other you could save by shipping gold. Let us consider an example: You owed a debt to a firm in Paris of 250,000 francs and a bank quoted you a rate of 24 francs to the £. This would cost you £10,417, whereas at the par of exchange it would have been £400 less. You then inquired how much it would cost to ship gold and found that the freight and insurance would not cost more than £125, that is to say your shipment altogether would cost £10,125. And so, if you could not get the bank to come down in price, you shipped gold. But this example is only given to illustrate the principle. The banks who dealt in foreign exchange

took care that their rates were close enough to the price at which it did *not* pay to ship gold. The result was that the exchanges varied within narrow limits and gold was rarely bought by individuals. It was used by banks for very large transfers of money. In the autumn, for instance, the surplus from the harvests of America were shipped to us and the demand for dollars was enormous. It was often cheaper to ship gold, for dollars were too expensive to buy. The gold was no use to the American or Canadian farmer but his bank gave him spendable money for it.

(Mr. H. G. Wells, in a broadcast some years ago, said that it seemed just as dishonest to give varying amounts of pounds for a fixed sum of foreign money as to give 98 yards of cloth to a person who ordered 100 yards. On the face of it, it is absurd that a frequent traveller, to Paris, for example, should pay a different price for the same hotel room each time he goes there. The answer is that he does not pay a different price but that, as an Englishman, he is thinking in terms of English money. The room is a commodity for which he pays, say, 200 francs a day. Francs are also a commodity but they are dealt with on a market and they are consequently more affected by supply and demand than hotel rooms.)

Early in the 1914-18 war, most countries abandoned the gold standard. They had to because there was so little gold in their vaults; it was all in New York, sent there to pay for goods which the warriors had bought in the United States. The proposal to abandon gold altogether as a medium of exchange was freely discussed in the English newspapers. It was suggested that the United States would thus be landed with a mass of useless metal. But we will not go into that. It is mentioned only to show that gold as a means of exchange is a fiction, a concept in that gold is valuable only because a large number of people agree that it shall be deemed valuable. (Do not rush to sell your gold shares. British Dominions and the United States produce most of the world's gold and your fellow shareholders will see to it that gold as a medium of exchange is not hurriedly abandoned.)

When gold no longer served as a medium of exchange, the foreign exchanges found new levels and these were based partly on supply and demand, partly on confidence but mainly on relative purchasing power. This last was a theory which postulated that if £1 bought x items of necessities in England the foreign exchange rate should be the equivalent amount of foreign money which purchased similar necessities abroad. For example, if £1 bought 3 days' food for a workman in England and the same food cost 175 francs in France, the French rate of exchange should be 175 francs to the £. If you ever contemplate living abroad, do not be misled into converting your foreign salary into English money and saying, for instance: "£600 a year sounds all right either in New York or in Italy." In fact you would be poor in New York and fairly comfortable in Italy. The right thing to do is to inquire of someone who has lived in these countries recently and is of your own social level, asking: "How much do I need to earn in dollars or lire to live in the style to which we are both accustomed?"

You may say: Why should it not be arranged that the £ is always equal to fixed amounts of foreign moneys? The short answer is, firstly, that England and other countries may alter the internal purchasing power of their money by inflation or deflation and, secondly, that you can only ensure a supply of foreign money by offering an attractive price for it. If our Government, for example, said: "In future, pounds will be convertible into foreign money at fixed rates" then, in the absence of international agreement, you would have black markets. Those who own foreign moneys will refuse to sell them at our price, and that will be that. It is happening in France at this moment. The official rate is about 480 francs to the £, this being the estimated relative purchasing power. But if you have a pound in Paris you can get 900 francs for it. It sounds an easy way of having a cheap holiday but it should be noted that on leaving England you can only take a limited number of pounds with you.

4. The Exchange Equalization Account

There is a very important factor of the Foreign Exchange Market which we have not yet discussed—the Exchange Equalization Account. When as mentioned, we were forced to “go off gold” and could no longer iron out exchange differences with it, there was a risk that the demand for foreign currencies might be influenced greatly by speculation. For example, a French speculator might instruct his agent in London one morning to offer francs for sale slightly below the market price overnight and to go on selling them. The price for francs would drop in terms of English money and go on dropping. The operator would then begin to buy at the reduced price. Having bought enough to cover those he sold in the morning, and many more, he would profit by the difference, for as he bought the price would rise. A speculator could only make money by dealing in enormous sums, for small amounts would not influence the price; and it was these enormous sums which were an embarrassment.

In the early nineteen-thirties it was decided that speculative operations and the ebb and flow of “funk money”—see below—would unduly influence the price of foreign currencies which we needed to pay for our imports and, accordingly, that the Government, through the Treasury and the Bank of England, should establish a fund to minimize the fluctuations in exchange rates. When foreign money came to London, it created a demand for sterling. Conversely when it left, there was a demand for the foreign currency to which the transfer was to be made. When the flow of foreign money became sufficient to cause a noticeable fluctuation in the exchange rate, the Exchange Equalization Account came into operation and bought the foreign currency offered or supplied what currency was wanted. It was able to do so, for it disposed of a capital of £500 millions. The purpose of this fund was to iron out temporary rises and falls, and to keep exchanges as stable as possible; it was not the intention to arrest long-term changes. The

Government made arrangements with some other countries to establish similar controls and, between them, some stability was assured. Details of the management of this fund were kept secret.

The term "funk money" arises from the fact that the rich in every country become very nervous for their wealth when political conditions in their country appear unstable. In consequence, they transfer their money from their own country to another which they consider safer. For a very long time, London was considered safe and funk money flowed there continually. Then, owing to rumours or to political happenings, London might be considered uncertain and the funk money would be transferred by T.T. to New York. If conditions in the United States seemed unstable, the money would be whisked away to Amsterdam. It was very big money and consequently the demand for foreign exchanges was great, for you will, it is hoped, be aware by now that you can only transfer money from one country to another by buying the currency of the country to which you wish to transfer.

Of recent years, most countries have stopped the export of funk money by the expedient of insisting on permits for the purchase of *all* foreign currency.

5. Letters of Credit and Travellers' Cheques

There is one further aspect of foreign exchange affecting the banker. If you wish to travel abroad you can obtain a Letter of Credit which enables you to cash drafts (cheques) almost everywhere. The letter of credit is printed on bank-note paper so that it cannot easily be forged; it is for a fixed sum and, as you draw your drafts and cash them abroad, the amount of the draft is inscribed on the letter by the bank which cashes them. Your signature is on the letter and the bank cashing a draft would require you to sign it in the presence of their representative. In a somewhat similar way, you can obtain Travellers' Cheques which can be cashed almost anywhere.

CHAPTER IV

MISCELLANEOUS BANKING SERVICES

WE have now dealt with banking in its main aspects, but there are a number of services which a bank offers to its customers other than accepting deposits, clearing cheques, and providing them with foreign money.

A bank will, on a customer's behalf, make regular payments such as instalments on houses, furniture or cars; it will pay rents or insurance premiums when due. In fact, by means of a Banker's Order, which is a request to a bank to make specified payments at certain dates, you can avoid the necessity of remembering all your regular payments.

A bank will effect payments for a business house by means of Traders' Credits. This constitutes an ingenious method of avoiding the stamp tax on cheques, of saving postage and stationery, and of removing a lot of work from the shoulders of a business house on to those of a bank. Briefly, the procedure is that a trader asks his suppliers to agree to payment by means of a bank transfer from the trader's bank to their banks. On acceptance of the scheme the trader, at or towards the end of each month, makes separate lists of payments to be made, one list for each of the Clearing House Banks. This list gives the name of each supplier, the branch at which he banks, and the amount to be paid. These lists are summarized and the trader draws one cheque for the total.

Thus he saves the stamp duty of 2d. on a number of cheques, the envelope and the postage stamp on sending them, and the time in writing cheques, signing them and posting them. In addition to his suppliers, a trader can pay rents, office salaries, and any other expense items, so long as the recipients are agreeable to this mode of payment.

A bank does a lot of work effecting these payments.

The branch on which the traders' credits are drawn will have a separate list for its own customers but it must send all other lists to its head office, who will distribute them to its various branches and to other banks. A bank makes no direct charge for this service and it is a safe assumption that a trader who pays in this way carries a "satisfactory" balance.

A bank will initiate inquiries for you as to the credit standing of a firm or individual. It is often said that a bank reference is worthless because they say so little. But the fact that a bank is cautious and will normally say no more than that Mr. X's account is satisfactory, does much to reassure an inquirer, for he is assured that Mr. X is known to the bank and plays no tricks with them. Avoiding superlatives altogether, a bank's positive becomes higher in scale.

A bank will buy securities for you through a stock broker and it will take care of your securities and other valuables which you wish to place in safe keeping. It will also buy securities for you in its own name if you wish to avoid your name appearing as the holder of the shares or stock.

A bank will act as executor or trustee under a will or settlement. It will also advise you as to Income Tax and other taxes and, in fact, there is no financial transaction which a bank will not carry out as part of its service to its customers.

CHAPTER V

THE BANK OF ENGLAND

IN most books of this nature, the work of the Bank of England is dealt with first, presumably because it is the central bank and the machinery of commercial banks hinges upon it. But this being an elementary book, it was thought better to leave discussion of the Bank of England (hereinafter referred to as the Bank) until the ordinary day-to-day banking had been described, and its terminology defined or explained. Moreover, the machinery of a central bank is complicated and difficult to comprehend unless general banking practice is understood.

This chapter will be quite short because the subject is complicated; it has been the author's endeavour throughout to confine his material to a description of finance which can be understood by every newspaper reader.

The Bank dates back about 250 years and similar banks were established in other countries much earlier. The history of our central bank is interesting and the student is advised to consult larger books, in particular, Bagehot's *Lombard Street*, edited by Hartley Withers.

First and foremost, the Bank is responsible for the issue of money in the form of notes which we use daily; it is also the banker for the Government; it acts as banker to the commercial banks which are members of the London Clearing House; it is in charge of the (Foreign) Exchange Equalization Account. But its complication arises from its position as the managers of our national monetary policy.

Let us first discuss the Bank's activities as regards the issue of notes.

Until the war of 1914-18, the prevailing money consisted of coins, including gold sovereigns, but the Bank issued notes of from £5 to £1000 and these were our only

form of paper money. These were "backed by gold," that is to say, you could exchange them for gold sovereigns. During that war, however, our gold was needed to buy supplies abroad, for all the foreign exchanges were against us. Treasury notes of £1 and 10s. were then issued. Towards the end of the nineteen-twenties, this issue of Treasury notes was combined with the issue of Bank of England notes and, ever since, the note issue has been made by the Bank. It is backed by Government and other securities and there is now only a very small proportion of gold behind the note issue. Nevertheless, our notes are still accepted everywhere.

The figures of the Note Issue are published once a week and a condensed form of this statement (extracted from *The Times*) may be interesting.

BANK OF ENGLAND

ISSUE DEPARTMENT

Notes Issued .	£1,450,247,833	Govt. and other securities .	£1,449,991,364
		Silver Coin .	8,636
		Fiduciary Issue .	1,450,000,000
		Gold Coin and Bullion .	247,833
			<u>£1,450,247,833</u>

NOTE. *The value of the gold is calculated at 172s. 3d. per oz.*

The term Fiduciary Issue should be explained. It is the total value of notes which are not backed by gold. It will be seen that the gold exactly equals the difference between the Fiduciary Issue and the total issue. This is because of a legal provision that any notes in excess of the Fiduciary Issue must be backed by gold.

The subject is more than a little difficult, but it belongs to the realm of scientific economics, for questions of inflation and deflation are bound up with it. These are highly contentious questions on which most experts

disagree. Like many sciences, the mechanics of economics have outstripped the knowledge. As Dr. Joad frequently remarks, scientists can tell you *how* something works but not *why*.

It is interesting that on the face of a £1 note is printed "I promise to pay the Bearer on Demand the sum of One Pound." This promise purports to be reinforced by the facsimile signature of the Cashier of the Bank, but how can the Bank pay the bearer £1 except by giving him another note? This illustrates that much of the jargon of money is nonsense. It is a fiction or, at least, an abstraction in that money is only usable so long as a sufficient number of people agree that it shall be so. The conception behind all money is barter, the exchange of goods or services. If you have a pig in excess of your needs you can exchange it for rent, bread, beef, and groceries. Similarly, if your assets are services rather than goods, you can exchange your knowledge or work for the necessities of life. To avoid going from house to house trying to find someone who wants a pig or legal advice, we have money. Owing to the complication of a world in which we all "take in each other's washing," money has become a commodity also. But it must never be forgotten that, in its essence, money is no more than a convenient token for goods and services.

In addition to its responsibility for the note issue, the Bank is the Government's banker. All receipts from taxes are handled by the Bank which also disburses all Government payments, including interest on its various loans. In practice, as some of you will have observed, the Government's ordinary payments are not made by cheques drawn on the Bank but by Payable Order issued by the Paymaster General.

But the Government rarely carries a large balance, for its daily commitments are enormous. It is often "in the red," meaning that its balance shows a red figure of overdraft. It is certain that the Bank could not earn a living out of the Government bank accounts but, as mentioned earlier in this book, every Clearing House Bank

carries a large balance out of which it can settle its differences in the Clearing House. The balance remaining is the Clearing Banks' reserve which can be drawn in cash at will. Such deposits by Clearing House Banks form by far the major part of the Bank's business, as its weekly Balance Sheet shows. Thus, on 3rd October, 1947, the figures were as follows—

		£
Government Deposits	. . .	9,702,890
Bankers' Deposits	. . .	297,430,057
Other Accounts	. . .	94,900,467
		<u>£402,033,414</u>

Against these deposits, the Bank keeps cash of approximately 20 per cent. The remainder is invested in securities, discounts, and advances. You will see that the Bank not only holds deposits of the Government and the Clearing Banks but has other depositors with total balances of £94 millions. These are the deposits of foreign and Dominion banks and foreign governments.

The Bank's responsibility for the nation's monetary policy will only be briefly touched upon for, as stated in the beginning of this chapter, it is a complicated and contentious matter affecting the purchasing power of the £ both internally and abroad, the control of interest and discount rates and the provision of a basis for credit. It is a matter for experts who, however, are frequently proved wrong by events.

It seems certain that the Socialist Government's haste to nationalize the Bank of England was due to a fear that if it remained in private hands, it might pursue a policy inimical to Socialist plans. Some argue that a free Bank of England would have acted as a brake on Socialism in large doses. You are free to form your own opinion on this question and to come down on one side or the other or, even, to remain on the fence. One thing which appears sure is that our experts are in the banks and not in the Cabinet. It is a polite fiction that a Chancellor of the Exchequer is the author of a Budget. He

may, by chance, know something of finance, but he may equally well be quite ignorant of everything except the jargon. If this be deemed an exaggeration, you have only to recall the pronouncements of politicians who announced insane schemes for making Germany pay for the war of 1914-18. Again, in 1939, there were Cabinet Ministers who declared that Germany could not fight a long war because she was bankrupt.

CHAPTER VI

THE STOCK EXCHANGE

1. The Securities that are Bought and Sold

BEFORE dealing with the machinery of the market for stocks and shares, it is necessary for you to know the various types of security which are dealt in on the floor of the Stock Exchange, "The House," as it is known to its members.

There are four main divisions of security—

Stocks and Bonds	Ordinary Shares
Debentures	Preference Shares

The first group is the most diversified, for it comprises British Government Funds such as War Loan, Savings Bonds, Defence Bonds and other loans, all of which represent money that the Government has borrowed from the public. These are a part of the National Debt. After these come the bonds or stocks of municipalities and such publicly owned corporations as the Metropolitan Water and Central Electricity Boards. These are followed by colonial government stocks and then foreign bonds.

All such securities have two things in common; they pay a fixed rate of interest and they are guaranteed by the governments or boards who borrow the money. Such a guarantee is secured by the fact that all such borrowers have very large incomes, the governments from taxes and the boards from the sale of water and electricity.

Debentures are bonds of commercial and industrial companies. They are not normally guaranteed by a company, but they give a mortgage on the whole undertaking which borrows, and debenture interest is payable before any profits are distributed to shareholders.

The above general description is almost excessively brief. The student would be wise to visit a public library

to consult the Stock Exchange quotations in a financial newspaper or *The Times*. If he refers to the *Stock Exchange Year Book* he will find detailed descriptions of all securities quoted.

The third division of securities is Ordinary Shares which, in the United States, are known as Common Stock. These are the shares of every kind of industrial, commercial and financial company, ranging from railways and banks to stores, oil, tea, rubber, and mines. The shareholders of a company are its proprietors. The ordinary shareholders' interest (dividend) is not fixed but varies with the profits.

The last and smallest group is Preference Shares. A preference share, as its name implies, gives the holder a preferential right to a fixed dividend which is payable before the ordinary shareholders receive any payment. It is usually cumulative, that is to say, that if there is insufficient profit in a year to pay a dividend, twice the dividend is payable the following year; and so on each year until the arrears are paid up. The fixed rate of return on a preference share is usually higher than that for a debenture, for preference shareholders have no mortgage on a company's property and, accordingly, their security is not so great. Sometimes, preference shares are Participating, which means that in addition to a fixed dividend, the holder has the right to participate in the profits of the company which would, otherwise, go to the ordinary shareholders. In return for a fixed and cumulative dividend, the preference shareholder frequently gives up his voting rights as a proprietor and has no say in the company's management. This is not giving up very much, for the ordinary shareholder, unless very large, has the rights of a proprietor in theory only, and he remains quiescent so long as a satisfactory dividend is forthcoming.

2. How the Market Operates

The London Stock Exchange is a market for the bonds, stocks, and shares outlined above. It is a company

itself and almost all of its shares are held by members. It is housed in a building near the Bank of England and it cannot be found except by those who know the entrances to it, for it is in the centre of a block surrounded by other buildings. There are several doorways leading into the House but there are no signs or name plates to indicate where these entrances lead to. Only members and their authorized clerks may enter the House and trade therein. Strangers who may stroll in from curiosity are liable to be ejected forcibly. As you may have seen in advertisements, members are forbidden to advertise for business. Membership is an expensive matter and is said to cost about £2000 initially in entrance fees and the purchase of shares.

The market consists of brokers and jobbers. The former enter the market to buy or sell securities for their clients who are members of the public. They buy from, or sell to, the jobbers who are, so to speak, wholesalers or dealers. Each jobber specializes in a particular type of share or stock, though some jobbers may deal in more than one type.

You will find in a financial paper or the City page of *The Times* that all stocks and shares are classified under headings, such as British Funds—Home Railways—Banks—Insurance Companies—Textile and Chemical—Iron Coal and Steel, and so on. Each of these is a separate market and has its own group of jobbers who occupy a definite floor space on which they have long been accustomed to trade. Abbreviations of the names of securities are common and you will often read them in the Press. Thus, for example, Canadian Pacific Railway shares are known as CanPacs; British American Tobacco as Bats, Imperial Tobacco as Imps, South African Mines as Kaffirs.

Let us imagine a broker being handed his post one morning and finding a number of orders from clients to buy and sell various shares. Making a note of these and of any conditions insisted on by the clients, such as the approximate price (e.g. "Buy 800 Harrods at 80. Sell

1000 British Match at 50") he goes to the Stock Exchange and visits in turn the jobbers who deal in the shares or stock in which he is interested and he asks for prices. The jobber does not know whether the broker is a buyer or a seller and he quotes two prices; the lower is the price at which he will buy, the higher is his selling price. Thus, for an ordinary share of a commercial company he might quote 34s.-34s. 6d., or for a debenture 94-98. The jobber's aim is to sell immediately whatever he has bought or to buy immediately whatever he has sold, and his margin, or "turn," varies according to the probability of this achievement. For an ordinary share which is continually dealt in he will be satisfied with a turn of 6d., for he earns it quickly. If, however, he buys debentures at 94 (below their par value) he may not be able to sell them at once and may have to borrow from a bank to pay for them. The bank will charge him interest and he must provide for this in addition to his provision for the risk that another jobber may be a seller at 96.

But the prices a jobber quotes may not be his last word. The House is a market and, as in other markets, the dealer may accept a lower price rather than let the business go to a competitor.

Having effected all his purchases and sales, the broker will notify the Stock Exchange authorities of his transactions and then return to his office with a note of the prices. There, his clerk will prepare and dispatch contract notes to the clients. These inform the client of the amount bought and sold, the price at which the bargain has been closed, and the date on which the cash is payable. To this price, in the case of a purchase and from it, in the case of a sale, is added or deducted the broker's commission, which is a scale laid down by the Committee of the Exchange.

It should be noted particularly that a broker is responsible to the jobbers for his client. He buys on credit and is not paid until the purchase is completed. On behalf of a client he may buy many thousands of pounds of stocks and then find that his client cannot pay. If

the broker also cannot pay, he is "hammered." That is to say, that an official of the House mounts a rostrum, hammers on it to call attention and then announces that Mr. X has not complied with his bargains. Such a thing can happen easily after a boom when speculators use paper profits to go on buying.

The volume of transactions on the floor of the House on a busy day is enormous and, as it would obviously be foolish for each dealer to pay or be paid for each separate bargain, the Stock Exchange has a clearing department which functions somewhat similarly to the Bankers' Clearing House so that only differences are accounted for.

Before the recent war, settlement was made fortnightly and a smooth, simple routine was established. Since the war, frequent efforts were made by members to return to Fortnightly Accounts and they were resumed from 11th December, 1946.

The hesitation was due to a fear that a return to what was known as "The Account" might encourage speculation. This subject calls for a special section.

3. Speculation

It is often said that a broker could not live on the commissions he earns from what is sometimes called "legitimate business," by which is meant the business of the investment of spare capital or savings or the realization of an investment. The point is academic, for no broker depends on such business unless he be fortunate enough to act as broker for a bank. Even then, the customers of the bank may be speculating and a broker who suffers from a sense of superiority, in that he never gambles, is deceiving himself.

It is a fairly safe assumption, therefore, that in normal times the majority of all bargains made on the Stock Exchange are concerned with speculation. This is no place for a discussion of gambling, though it may be remarked that it is far easier to preach against it than to stop it.

In any event, there is no kind or form of investment which is not speculative, for no one can predict the future value of money.

A part of this gambling on the Exchange is done by members of the Stock Exchange themselves, for they are "in the know" or believe themselves so to be. They can watch the trend of prices and a fractional margin will net them a few pounds of profit, for they have no commission to pay. Such professional speculators usually follow the golden rule of speculation which is that you can never be wrong in taking a profit. In other words, it is better to pouch a certain profit of 3d. a share than to wait for the 6d. rise which may not occur.

It is said that the private speculator, who is responsible for the majority of transactions, has increased in numbers enormously since the first world war. It is sometimes claimed that the professional and administrative classes who earn much about the same as formerly but have been more heavily taxed in proportion, speculate in the hope of making enough to live in the style to which they are accustomed. Rather than live on their capital, they prefer to risk a part of it in the hope of earning sums which are not taxable. Thus, a profit of £500 on the Stock Exchange is equal roughly to an £800 increase in salary.

Speculation can, or could, be indulged in by two methods. You might be told, and believe, that the shares of the XYZ Co. would rise because this company had received large orders. In this case you bought for a rise and you were a "Bull." On the other hand, you could hear stories of a heavy drop in the profits of a company and you would guess that the value of these shares would drop as soon as this information became public. In which case you sold its shares although you did not own any. You sold shares which you did not possess in the hope of buying them more cheaply by the time you had to deliver them to the buyer. In this case you were a "Bear."

If as a Bull your shares did not rise by Settlement Day, your broker would arrange to carry them over to

the next account if you paid him "Contango." In active shares the contango was very cheap, being sometimes as little as $\frac{1}{2}$ d. a share. If, on the other hand, you were a Bear and the shares you had sold refused to fall in price, the broker might similarly arrange to carry them over. In either case, you were able to wait another fortnight on the chance that your dreams might come true.

To be a Bull is moderately safe for, although the expected rise may not occur at once, you can carry over or you can sell the shares and be out of pocket no more than the difference between the selling and the buying price and the commission. Alternatively, you might pay for them either from your own resources or by borrowing from a bank. To act as a Bear, however, can be highly dangerous to a large operator for, if the market discovers he is short of the shares, a group of Bulls may raise the price against him. For example, if a Bear sells 10,000 shares at 30s. each in the hope of buying them back at 25s. he loses £500 for every shilling that they rise.

Another form of speculation was to buy an Option,¹ a "Put" or a "Call," two further examples of Stock Exchange terminology. By this means you neither bought shares nor sold them. What you bought was an option to buy (a Call) or an option to sell (a Put).

4. Variation in Stock Exchange Prices

And now we come to the factors which influence the prices of stocks and shares. Some of these are real, some imaginary and some the result of speculation. Every stock, bond, or share has a par value. Shares may be of any value; stocks and bonds may be in any multiple of £1. Without reference to the *Stock Exchange Year Book* or a stockbroker's printed list, you cannot tell the par value of a security. Thus, a 5s. share which pays 30 per cent dividend may be quoted at 30s., whereas a £1 share which is less profitable may be quoted at 23s.

¹ Option and Contango dealings were prohibited during the war and have not yet been resumed.

The value of a stock depends on the security behind it and the highest security is to be found in our own Government stocks. Thus, the rate of interest on Government stocks influences the market price of all other stocks and shares, for these cannot have such an effective security behind them. For many years the interest on Government stocks was 5 per cent and it followed that companies wishing to raise capital by an issue of shares had to show past profits of from 6 per cent to 10 per cent, depending on the risk attached, for if they did not, investors would buy Government stocks instead. But of recent years a policy of Cheap Money (low rates of interest for borrowing) has been followed. Government loans, when due for repayment during the nineteen-thirties, were converted into $3\frac{1}{2}$ per cent loans. During the recent war, money was borrowed freely at 3 per cent and now the prevailing rate is little more than $2\frac{1}{2}$ per cent.

As to whether cheap money is an advantage, opinion is divided for, if it is argued that cheap money is a good thing, the question arises (or should arise)—good for whom? In theory, a Government which borrows at a low rate of interest benefits the taxpayer, for it is he who provides the money to pay the interest. But it can easily neutralize this advantage by spending the money unwisely and thus having to borrow more than someone skilled would have done. A company which raises £1 million by debentures at 4 per cent instead of 6 per cent saves £20,000 a year. But this saving is for the benefit of the ordinary shareholders who may easily be, and often are, the same individuals as the debenture holders. Similarly the recipient of interest on Government loans is a taxpayer and thus pays part or all of such interest himself.

That cheap money does not mean cheap living is obvious, for living is far dearer now than when money was on a 5 per cent basis. Cheap money hits very hard at those who have saved in order to provide themselves with an income on retirement. For many years, such men could draw £1 a week for every £1000 saved. Now

they draw 10s. and this is reduced again by the fact that the cost of everything is higher.'

The above remarks are inserted to show you that the subject is by no means simple and that you should be careful to avoid laying down the law about it.

To return to Stock Exchange values. Although the interest on Government stocks determines the market price of other securities basically, it will be found that other fixed-interest stocks and debentures vary in the return they give. Some examples may make this clearer.

<i>Security</i>	<i>Price</i>	<i>Yield</i> %
Consolidated Stock (Consols), $2\frac{1}{2}\%$. . .	97	2.58
War Loan 3%, '55-59 . . .	106	2.83
Great Western Rly. 4% Debentures . . .	116	3.45
Great Western Rly. 5% Guaranteed . . .	125	4.00
L. & N.E. Rly. 3% Guaranteed . . .	92	3.26

The main reason of variation is Supply and Demand. If a large buyer, such as a bank or insurance company, buys many thousands of a particular stock, the market price will go up. Similarly, the fact that Great Western 5 per cent debentures show a yield of 4 per cent implies that there are few who wish to sell them. Another reason for the price may be the date on which the security is to be redeemed or paid off. Genuine investors seek for long-dated securities because they cannot foresee what money may be worth at the time of repayment. Thus, for example, a hospital which owned £10,000 of 5 per cent War Loan formerly received £500 a year. When this loan was converted to $3\frac{1}{2}$ per cent, the hospital's income dropped £125 every year thereafter.

The value of ordinary shares varies with supply and demand, but this law itself is regulated by a number of factors. The ordinary shareholders of a company are entitled to such a proportion of its profits as the directors deem it prudent to distribute and, in theory, the higher the average rate of dividend paid in the past, the higher should be the market price, but it does not always work out in that way. Some shares are more popular with

speculators than others; a company's future prospects, either known or guessed, will influence the market price; a newspaper may mention in its financial column that a particular security seems cheap at its current price; the possibility of a new issue of capital on favourable terms will send up the price. In the final analysis, the management of a company determines its success or the reverse, and the price of a share will thus reflect the ability, or otherwise, of its directors.

This is a wide subject and worthy of a book itself. In fact, there are excellent books on the subject; in particular, *Scientific Investment* by Hargreaves Parkinson and *Investment in Stocks and Shares*, by Kissan and Williams, are strongly recommended as a follow-up to this outline.

Many stockbrokers maintain statistical departments which collect all manner of facts from many sources in order to advise their clients on the relative merits of securities. Some clever brains are set to work to extract from balance sheets some of the information which directors are not anxious to reveal. By this means brokers find profitable "switches" for their clients. Thus, Company A in a particular line of business may appear, after analysis, to be a better proposition than Company B. If the client approves of the switch, the broker earns a commission on the sale of the B shares and another on the purchase of the A.

In addition to the machinery for obtaining information, the Stock Exchange is a hive of gossip and it very often happens that a company which intends to declare a higher or lower dividend, finds that the information has leaked out and that the price of its shares rises or falls *before* the official declaration of a dividend. You will often read in the financial columns of a newspaper that certain happenings are "discounted" by the market. This means that the market has anticipated the event and has marked, up or down, the shares likely to be affected. Thus, for example, rumours of an increased tax on tobacco would adversely affect all tobacco shares.

Members of the Stock Exchange are not allowed by their rules to advertise and, in consequence, a large amount of business is lost to them. A list of the names of brokers willing to deal for new clients will be supplied on request by the Committee of the Stock Exchange. Many intending investors or speculators who do not know a broker consult their bank managers who, in turn, instruct brokers and share the commission with them. This is a sore point with some brokers but those who enjoy the patronage of a bank will have no reason to complain. A bank is essentially cautious and for a true investor its advice will be sound. For a speculator, however, a broker will be more helpful for, if the broker knows that his client is able to suffer a loss, he will share some of his special knowledge with him and thus "put his client on to a good thing" when the opportunity occurs. A broker will also have advance information of new capital issues which are to be "privately placed." An explanation of this feature will be found in the next chapter.

Although members of the Stock Exchange may not advertise, there is nothing to prevent a man, or group of men, from advertising and offering to deal in shares. Some of these outside brokerage firms are known as "bucket shops."

This chapter would not be complete without a brief reference to the Committee of the Stock Exchange. This body not only frames and enforces rules for its members but also lays down strict conditions which must be observed by every company which desires a market for its shares on the Exchange. The Committee does not, and cannot, guarantee any of the statements made by a company, but it does ensure that the Company Law has been observed and that all the information and explanation that an investor needs are provided.

CHAPTER VII

ISSUING HOUSES AND OTHER FINANCIAL INSTITUTIONS

1. Issuing Houses

WE have now dealt with the major part of the machinery of money, but there are several types of financial institution which hinge upon the money market. Let us first discuss Issuing Houses.

These institutions make a speciality of introducing issues of new capital to the public. Sometimes they are stockbrokers but the largest of them are merchant bankers. There are also a few companies which have been formed for the special purpose of making new issues and conducting miscellaneous financial business.

The issuing houses have formed an association for their mutual protection and interest. Should they combine with a similar association formed by the investment trust companies (see page 77) their joint influence would be great, for the combined investments of the two associations is a very large figure.

New issues of capital may be made for various purposes but the principal issues will be in one of the following categories—

(a) A foreign government or large commercial undertaking (e.g. a colonial or foreign railway) may wish to spend large sums in England in the purchase of rolling stock, ships, trams, or complete engineering plants. To buy pounds for each shipment might be a strain on their resources and, as they can offer good security by pledging the income from the capital goods they hope to acquire, they approach, for a loan, a merchant banker in London who, as has been noted before, has agents in the foreign country and a comprehensive experience of conditions there.

(b) A foreign company wishes to manufacture or start a branch in England. They have sufficient funds to provide working capital for the new undertaking but a large sum will be needed for the purchase of land, buildings, machinery, and equipment. As their name and record of profits has been good for some years, they approach a merchant banker as to an issue of capital on the London market.

In the above cases the banker will probably arrange for an issue of bonds or debentures secured on the income from the assets which the new capital purchases.

(c) A commercial company wishes to increase its capital to provide money for expansion by buying and equipping a new factory or trading premises. Or it may have the opportunity of buying the shares of a rival or affiliated business.

The majority of new issues are of this kind. The smaller are made by stockbrokers, the larger by merchant bankers or one of the newer companies formed specifically for new issues.

Issuing houses raise new capital either by buying the whole amount of the issue and then offering the shares to the public (this method is known as an Offer for Sale) or they may issue the shares, or debentures, as agents for the company concerned, in which case they usually "underwrite" the issue. That is to say, that in exchange for a small underwriting commission, they guarantee that the whole of the money will be found. If the public does not subscribe in full, the issuing house will supply the balance. This is a valuable service for a company seeking new capital, for it needs just so much but no less. It is, for example, useless to obtain enough to buy land and buildings and then have insufficient for the plant or equipment.

It will perhaps be clearer to consider two actual issues and, briefly, to analyse their conditions. For the sake of clarity, the figures used are approximate.

In the summer of 1946, the English Electric Company with a share capital of £3½ million and debentures of

£1 million, announced that it had extensive plans for expansion, including the purchase of the shares of Marconi. For these plans it needed £9 million, of which it intended to raise £5 million in a permanent form, leaving the remainder to be found from its current resources and from its bankers. It proposed to offer rather more than a million ordinary shares of £1 each to the existing shareholders at a price of 57s. 6d., which would produce £3½ million, and to issue to the public £1½ million of 3¼ per cent cumulative preference shares of £1 each at par (one pound each).

This issue of preference shares was an "Offer for Sale" made by Lazard Brothers, Ltd., merchant bankers, who purchased the whole issue at par for £1½ million. For their services in connection with the issue and with the placing of the ordinary shares, Lazard received a fee out of which they paid commissions to underwriters and brokers and all the expenses of both issues. It was estimated that Lazard eventually paid 19s. 7½d. per share; the net amount receivable by the English Electric Company for the preference shares was £1,400,000.

The second new issue to be considered is one which is "Privately Placed" and you will find many of these. Unless very large sums are involved, such issues are made by stockbrokers.

Instead of offering securities to the public, the First National Housing Trust, owners and managers of various housing estates, announced a private placing of debentures. It had a very small share capital and it had financed its operations by raising mortgages on the properties it had acquired. It now proposed to raise approximately £2 million by the issue of 3¼ per cent debentures and to use this sum to repay the mortgages. A firm of stockbrokers, acting as an issuing house, contracted to purchase, or to procure responsible purchasers for, the whole issue at par in consideration of a commission of 1½ per cent.

A private placing was made among the clients of the brokers and, usually, large blocks of shares are bought by

investment trusts and insurance companies whose activities we shall consider later in this chapter. The general public did not get an opportunity to buy these debentures except those who were already clients of a broker with whom the issuing house were in relations. This illustrates the advantage to an individual of buying securities through a broker rather than by the intermediary of a bank as mentioned previously.

All new issues of capital must, in these days, be approved by the Government which even insists on regulating the price to be paid for the new shares. In addition, the Committee of the Stock Exchange can give or refuse "Permission to Deal." It will permit dealing only if its conditions are complied with. These are stringent, particularly the rules concerning accurate accounting and disclosure of relevant information to enable a prospective buyer to form a judgment. In the case of private placings, the Committee usually insists that the jobbers shall be allowed a certain number of shares so that there shall be a market. If permission to deal be refused, the issue is likely to be a failure, for there will be no market and investors will not subscribe money for securities which are not readily saleable.

The low rate of interest offered in both cases was undoubtedly due to the advice of the issuing houses which is based on special knowledge and experience. You may be sure that no successful company makes a present to a financial house. On the contrary, in exchange for the fee or commission they pay, the company is certain of getting the capital it requires and it also gets expert advice as to the rate of interest to offer and the date at which the offer should be made.

We have mentioned Bulls and Bears; the subject of new capital introduces another animal, the Stag. This individual is a speculator who subscribes for a new issue in the hope that the value of the shares may rise when a market is opened for them on the Stock Exchange. He then sells his "rights" to the shares at a profit.

2. Investment Trusts

Investment Trust Companies must now be discussed. The majority of these companies are of relatively recent origin. They came into being to cater for the general desire of investors to avoid putting too many eggs into one basket. Before their advent, a man who wished to invest £10,000 and spread his risk might buy £500 worth of twenty varied securities or £250 worth of forty. In either case he had to watch the market continuously. But by buying the shares of an investment trust he spread his risk over a hundred or more securities and had the advantage that they were watched by experts who would profit by market rises to sell out and re-invest.

Apart from these advantages, the investor earned a slightly higher rate of interest, for the managers of these companies were very shrewd investors. Moreover, being in touch with issuing houses they were able to take advantage of private placings to "get in on the ground floor." (This term implies buying at the lowest price.) The capital of these companies is very carefully placed in securities ranging from Government stocks to the ordinary shares of commercial companies. Any profits made by selling out are not distributed to shareholders as dividends but are kept as a reserve against depreciation in the value of their securities. Such reserves were badly needed by some of these companies in the slump of the nineteen-thirties when the value of most securities dropped heavily. Many of these trusts are collected in groups owing to the fact that they share the same management. As they control large holdings, the activities of such groups when buying or selling can affect a market considerably.

More recently, a form of investment trust known as a Unit Trust has appeared. Some of these specialize in one type of security such as insurance shares; others have a varied list. It is claimed that these unit trusts give an advantage to the small investor since he can buy a unit of as little as £10 and share in the range of investments.

It may be of interest to note that these companies were the subject of a special investigation from which they emerged successfully.

3. Insurance Companies

A description of the activities of insurance companies is often omitted from books on money and finance but insurance is a financial matter and the companies engaged in it dispose of such enormous sums that their influence in the money market is considerable. Twenty-seven of them have an income from premiums of £164 million.

Just as banking is, to some extent, pawnbroking so insurance is akin to bookmaking. In effect, an insurance company lays you £100 to 5s. that you will not have a fire or suffer a burglary. And just as a bookmaker can arrange that his book must show a profit, so the insurance company fixes premiums which must, by mathematical laws, give them a profit over a long period.

Only the very rich can afford to do without insurance and a moment's reflection will show you that enormous sums pour into the hands of insurance companies every day, for each day thousands of new policies are taken out and old policies renewed. Some of this money will be needed to pay claims, some must be reserved for expenses, but on certain days, particularly at the beginning of a month, the companies will have large sums to invest in order to earn interest. This interest is part of their annual income and is additional to their premium income, much of which is absorbed by claims and expenses. To the extent, then, that insurance companies earn interest they are purely financial companies. They often buy large blocks of new issues and thus assist a broker with a private placing. This is particularly the case with debentures for, as these constitute a mortgage on a company's assets, the insurance company has greater security and this factor is as important to them as to a bank. It should be noted that our leading insurance companies are just as strong

and solid financially as are our banks. Accordingly, they cover a large amount of foreign business.

A certain amount of misconception is prevalent as regards Lloyd's. This is not an insurance company. It is a collection or assembly of underwriters who, in groups of individuals, issue an insurance policy. Thus, for a small amount, a dozen underwriters may share the risk and the premium between them; for a large amount, there may be fifty or more who are responsible collectively to the insurer. The business done at Lloyd's is mainly marine insurance, but the underwriters will lay you a price against almost any risk—against having twins or a wet holiday, for example.

CHAPTER VIII

INFLATION AND DEFLATION—HOW TO READ A BALANCE SHEET

1. Financial Policy

IN this chapter we shall endeavour to cover any financial conditions or transactions not already discussed so as to ensure that the reader shall be able to read not only the financial columns in the Press with understanding but also the political matter. There are few questions of politics that are not, sooner or later, concerned with money and it is a dangerous condition in a democracy that such a large number of people should be so ignorant of money and should shrug its shoulders and leave it to the experts. As we have already argued, there are no experts in financial policy. There are plenty of very clever men who are expert in the machinery and management of money, the engineers, so to speak, but up to the present every reputed expert in financial *policy* has been proved wrong by events, not even excepting the late Lord Keynes. The theoretical aspect of money is farther down the evolutionary stage than most of the sciences, and the correct method of approach to it is by the method of trial and error. The best men of science qualify their statements by adding: "so far as our present knowledge goes." Politicians, presumably relying on public forgetfulness, are not so cautious. It is not to be supposed that even if you read all the books recommended herein you will be in a position to argue with those who profess and call themselves experts, but you will at least act as a brake on them if they realize that you are not to be fooled by mumbo-jumbo; that you insist that there may be, and probably is, another side to the question.

A little knowledge of finance will also help to protect you against unscrupulous financiers. In this you will have

the support of all the banks and financial institutions we have so far discussed, for they need your assistance in weeding out undesirables.

And this seems to be the place to refer to the accusations against those who deal in money of "rackets," "ramps," "wheels within wheels," "high finance," and all the rest of the jargon employed by journalists and novelists. What they forget, or choose to ignore, is that the primary duty of every company director in finance, as in other enterprises, is to make as much money as is consistent with the safety of his shareholders' property. It is no part of his duty to consider the welfare of the public at large. That is the business of Government. And if you consider that it should be an easy matter for a Government to prevent a ramp or racket, consider that for every duke with an income from property of half a million pounds a year, there are hundreds of thousands of "landlords" whose main or only source of income is a house or a piece of land. Similarly, for every large "capitalist," with enormous shareholdings here there and everywhere, there are hundreds of thousands of widows and small people owning a few shares each. Accordingly, it is difficult to hurt the big man without ruining the small. Please, therefore, do not gnash your teeth with rage when a successful company declares a little higher dividend. Do not worry about the plutocrat, for he does not want the money anyway; think rather of the little people who can spend the windfall on something long desired or who can indulge in a little luxury now and again.

2. Inflation and Deflation

The financial conditions which affect all of us the most are Inflation and Deflation.

Money being a token for goods and services, the amount of money in the country should equal the total value of the goods and services. If there is money in excess, you have inflation. But no one has yet calculated, with any accuracy, the total of the nation's goods and services. In

consequence, no one can say at what point inflation has begun. You will often find reference to the "vicious spiral of inflation." This phrase implies that every time there is a noticeable increase in the cost of living, workers demand more wages to meet it. Higher wages without greater production per man hour bring the cost of living higher still and this, again, brings a further demand for higher wages.

Although no one knows at what point inflation begins, many of us know where it ends. Recently, the Hungarians suffered a violent inflation culminating in their money, the pengo, becoming valueless. A new money, the gulder, has taken its place. One of these gulder is equal to four hundred thousand pengoes. The effect of such an inflation is that all savings and debts are wiped out. Those whose capital consists of land, buildings or machinery can earn the new money with them; those who have their health can exchange their work for guilders also; the rest have nothing. The exact opposite of this condition is deflation. We had an example of this in the early nineteen-twenties when the Government of the day decided to deflate in order that we might "get back to gold." It was stated by the Government that the process would cause widespread distress and unemployment, but that did not deter them.

Deflation such as was practised then, and again later, proved disastrous, for just as inflation increases wages so deflation reduces them. Moreover, the wage earner who has undertaken, by instalments, to pay for a house, a car, furniture, or a life insurance policy, finds that he cannot keep up these payments on his reduced or non-existent wage. This hits the building societies, the car and furniture dealers, the finance and insurance companies. All these enterprises are forced to reduce staff because of the drop in business and thus increase the distress and unemployment. This, too, is a vicious spiral.

It was alleged that the policy of deflation was engineered in order to make invested incomes safer. The contrary view was that it had no other object than to increase

the purchasing power of the £. We now seem to have learned, from bitter experience, that it is not much good increasing the purchasing value of the pound if millions of people have not got a pound to spend.

3. How to Read a Balance Sheet

It is impossible to understand financial affairs fully without some small knowledge of balance sheets for, in these, all the financial transactions of a company are crystallized. It is quite impossible in a small book, especially one dealing only with rudiments, to deal properly with this subject. To "read" a balance sheet effectively (to analyse it) needs years of experience, although some have a natural talent for it.

It is by no means necessary to understand the principles of double-entry book-keeping. Many skilled critics "do not know a debit from a credit," as the saying goes, but they must be aware of the general structure of business and of the financial operations which have been outlined herein. Although the author is an accountant, he will endeavour to outline the method of reading a balance sheet followed by a non-professional analyst for, by this means, technicalities concerned only with accounting may be avoided.

A balance sheet is a statement of the approximate financial position of a business at a particular date. It has two sides, Liabilities and Assets. The Liabilities comprise the debts due to outsiders and the debt of the business to its proprietors. The Assets consist of the property of all kinds which those proprietors own. The two sides balance because the difference between the Assets and the debts due to outsiders must equal the proprietors' real capital, or Net Worth, as it is sometimes called.

Both Liabilities and Assets are subdivided under headings on the balance sheet so as to give as much information as possible to the proprietors (shareholders) and at the same time conceal information which might be valuable

to rivals. It may here be noted that a lot of pressure is being brought to bear on companies to force them to disclose more information in the accounts which they present annually to their shareholders. In particular, the Cohen Committee, which was set up to consider changes in the existing company law, made a number of recommendations as regards balance sheets and most of these suggestions have become law. If you watch the trend of printed balance sheets, you may observe that a number of companies are anticipating changes in the law in accordance with the Cohen Committee's report and the new Companies Act.

It is not possible to cover all the various types of asset and liability which appear in thousands of various trades and occupations, and we can only deal with one sample balance sheet for purposes of illustration. But as it would be of little value to analyse the financial position of one company we shall use this balance sheet to comment briefly on general principles. It cannot too often be repeated that the subject cannot be covered adequately here, but it is hoped that the student will be sufficiently stimulated to read a book on the subject.

The figures shown on p. 85 have been extracted, with some modifications, from the printed balance sheet of an engineering company.

The first question to ask is: What has become of the capital originally subscribed by the shareholders? Normally, shareholders provide money for the purchase of a factory or warehouse together with the machinery and equipment necessary to start manufacturing or distributing. In addition, a company needs working capital, that is to say, the money necessary to buy raw or finished materials, and to pay wages and expenses up to the time when customers begin to pay for the goods sold to them. (An important point arises here. Many companies forget that the more business they do, the more working capital they need. The original capital was calculated for the original amount of trade expected.)

This balance sheet does not help us much with the

THE XYZ ENGINEERING CO. LTD.

Balance Sheet as at 31st December

LIABILITIES

Share Capital

50,000 6% Cumulative Preference Shares	£
of £1 each	50,000
1,200,000 Ordinary Shares of 5s. each	300,000

£350,000*Reserves*

	£
General Reserve	370,000
Provision for Contingencies	56,000
Profit and Loss Account—Balance	300,000

726,000*Current Liabilities*

Creditors and Accrued Expenses	220,000
Reserve for Taxation	90,000
Ordinary Dividend less Tax	42,000

352,000

£1,428,000

ASSETS

Fixed Assets

	£
Freehold Land and Buildings, at cost less Depreciation	50,500
Furniture and Fixtures, at cost less Depreciation	22,000
Plant and Machinery, as valued	22,700
Loose Plant and Tools, as valued	20,200

£115,400*Investments in Subsidiary Companies, at cost* 41,200*Current Assets*

	£
Stock and Work in Progress	775,000
Sundry Debtors	404,200
Tax Reserve Certificates	50,000
Cash at Bank and in hand	42,200

1,271,400

£1,428,000

first question. Many do not. For which reason the Cohen Committee has suggested that every balance sheet shall show the *original* cost of each of its fixed assets (property consisting of fixed items such as land, buildings, machinery and equipment) and shall show the Depreciation (the estimated amount by which a fixed asset depreciates in value below its cost) against each.

If this had been done, we should have had something like this—

	<i>Original Cost</i>	<i>Deprecia- tion</i>	<i>Balance Net</i>
	£	£	£
Land	5,000	—	5,000
Buildings.	60,000	14,500	45,500
Furniture and Fixtures	50,000	28,000	22,000
	<u>£115,000</u>	<u>£42,500</u>	<u>£72,500</u>

The figures are estimated, of course, for we have no idea of the age of the buildings nor of the depreciation provided.

If the assets had been shown in this way it would have helped to show where the shareholders' money had gone, for the above table shows where £115,000 of it went, whereas the balance sheet tells us only that £72,000 is the present estimated value.

Land does not normally depreciate. On the contrary, it generally increases in value but this is not taken into account in a balance sheet, since the object of a manufacturing or distributing company is not to sell land but to use it.

As the balance sheet does not tell us what we want to know, we must search in a reference book for the company's history. In the *Stock Exchange Year Book* we find that this is an old-established business which was carried on as a partnership for many years until, in 1925, it was converted into a public limited company. This raises all manner of questions which considerations of space prevent us from exploring and it shows the difficulty of dealing with such a subject in a few pages. It is now

clear, however, that the shareholders invested money to buy a "going concern" (an existing business earning profits) and that they were satisfied at the time that they were not taking an unreasonable risk. They must have been given figures showing the value of the assets at the time they bought them and also some statement of the expected profits.

Let us turn, therefore, to the next item on the Liabilities side—Reserves. Here we have a remarkable condition. Reserves are accumulated out of profits, for the prudent director knows that slumps and political conditions may adversely affect his business. Thus, if a company earns a profit of £100,000 it is prudent to distribute, say, 90 per cent of it in dividend and leave £10,000 as a reserve. He will be guided by many considerations, however, which cannot be discussed here. It should be noted that a director is usually a shareholder and his interest is to give as much as possible to his fellow shareholders and at the same time preserve the security of the business, a matter calling for experience and good judgment.

Reserves are, therefore, undistributed profits for the most part. The balance of profit and loss is quite definitely composed of profits in the past; the General Reserve can be used for any purpose and is often used in a bad year to make up a dividend; a Contingencies Reserve is usually a general reserve, since it can be argued that almost any happening was anticipated as a Contingency. There is another kind of reserve, a Specific Reserve. This is sometimes made to cover a known liability which cannot yet be calculated exactly, e.g. Excess Profits Tax. Or a reserve may be made for a Pension Fund. Such would be Specific Reserves.

In our example, the reserves are more than double the share capital, which means that the company could give a free share to every shareholder and still have ample in reserve. At present, such issues of free shares (Bonus Shares) are forbidden by the Capital Issues Committee, which is ruled by the Treasury. The reason for this ban is not clear. It will probably be removed one day and it

seems certain that the shareholders of this company will expect an issue of bonus shares, for there is no reason at all to pile up reserves. They will probably expect higher dividends also.

Current Liabilities is the next item, but these are mainly of interest in relation to Current Assets which we shall discuss shortly.

Turning to the Assets side of the balance sheet, we find the first item, Fixed Assets. We have already discussed one aspect of this form of property when we inquired as to how the shareholders' money had been spent. One of the objects of such an inquiry is to discover if the capital is "watered." This expression signifies that instead of solid, income-earning assets, the capital of a company is diluted with assets which do not produce the income desired. It is often said that our railway shares are full of water and this usually means that far too high a price was paid, years ago, for the land over which the railways run. The effect of watered capital is that some of the assets must be included at a higher price than their worth, or the two sides of the balance sheet may be balanced by an item of "Goodwill." This has been defined by a Judge as the probability that the old customers will return to the old place, but if such an item appears in a balance sheet it should, for safety, be a small proportion of the total assets. If, however, a partnership decides to convert itself into a company and bring in public money, it is quite reasonable that the partners should have free shares in exchange for their goodwill, for it would be quite unfair that they should be expected to hand over their assets at current balance sheet figures.

Quite obviously, there is not a drop of water in the balance sheet under review.

To return to the Fixed Assets. The figure for Land and Buildings seems very low. From various items in the accounts, we should estimate that the turnover (total sales for a year) is at least £2 million and it seems remarkable that so much business should be done in a factory

worth so little. But we do not know what it cost originally and it is a fair assumption that depreciation has been provided in excess of need. Prudent directors, if the profits suffice, allow more for depreciation than is necessary, for this forms what is known as a Hidden Reserve. The object is that if bad times are experienced, depreciation can be ignored as an expense for a year or two and this will increase the profit. Such a reserve also increases the shareholders' security, in that the fixed assets are worth more than the balance sheet figures.

The next item on the assets side is Investments in Subsidiary Companies. Such a heading may cover property which is valuable, or wholly or partly worthless. Some companies, if such a figure is relatively large, give the details of such investments on their balance sheet. As an example of a valuable investment, a foreign branch of a bank may be mentioned. Sometimes it is found that a company has bought the shares of one of its suppliers so as to ensure the supply of a key material or commodity; or it may buy out a rival and suppress his products. In the latter case, the value of the investment is a matter for inquiry.

Our reference book tells us, in the case of the XYZ Engineering Company, that they have bought the shares of rivals and have benefited by their trade. This merely makes good better for, with a strong financial position, these investments could have been worthless without impairing the company's situation.

Our next inquiry is to determine if the company has sufficient working capital. Here again we find a remarkable picture, for a balance sheet which shows a ratio of $2\frac{1}{2}$ to 1 between its current assets and current liabilities is very strong, but here we have a ratio of $3\frac{1}{2}$ to 1. (A bank will usually lend money to a concern which shows 2 to 1.) A further analysis is of interest: the ratio of quick assets (Cash and Debtors) to Current Liabilities. If these were equal the position would be good, because it would mean that the company could pay off every one of its creditors in about two months. In this case, however, the position

is still better, for the ratio is $1\frac{1}{2}$ to 1, and the proceeds of the stock are, so to speak, up its sleeve.

It should be noted that there may be Hidden Reserves in the working capital also. For reasons of prudence, directors value their stock and work in progress as low as possible, for some of it may deteriorate or become obsolete, and some may have to be reconditioned and repacked. Similarly, provisions for expenses may be included at a higher figure than is necessary in order to provide against unforeseen claims.

At this point we search again in our reference book for particulars of the company's earnings. We find that it has paid a regular dividend of 25 per cent for some years and it is clear that if not a penny of profit is earned for a year or two, it can continue to pay this dividend out of its reserves. In these days, 5 per cent is a very good return on industrial shares with good security behind them and we should, therefore, expect the market price to be at least five times their par value of 5s. On examining the current quotation, however, we find that the price is 30s., or six times the par value, which means that a buyer is willing to earn $4\cdot16$ per cent $\left(\frac{25 \text{ per cent}}{6}\right)$ on his money in view of the clear possibility of earning more later.

It is interesting here to note that the Stock Exchange values the company's shares at a total of nearly £2 million as compared with the Net Worth according to the balance sheet of just over £1 million. This illustrates the principle that the market "discounts" the price of a share with profit possibilities.

We now search deeper and take pencil and paper to calculate the company's *earnings*. We know how much profit they have distributed in dividend, but how much did they make? We discover that for some years they have made a profit of, roughly, £120 thousand a year or 40 per cent on their ordinary share capital; and this *after* allowing for taxation. This is a very high figure and we now know how this company has built up such high reserves. As a final measure, we turn up one or two

rival companies' figures and find that none has earned anything like this percentage.

In every respect, then, this company is first-class and its shareholders are most fortunate. They receive a good dividend with a promise of more at any time and they have very strong security.

It seems worth while to call attention to a misconception which is prevalent among trade unionists. At the thought of a company earning 80 per cent on its capital they are often inclined to argue that they have been exploited. This is not so. In the first place, the share capital of a company does not always represent the real capital, as our illustration shows; the real capital is over £1 million and a dividend of 25 per cent on the actual capital is only 7 per cent, which is a fair return on capital invested in commerce. In the second place, they are confusing capital with turnover. To make 80 per cent on turnover would probably be a shocking ramp, but such a percentage is almost unknown, for competition prevents it.

Before we end this very brief sketch of the method of reading a balance sheet, let us recast the figures of the XYZ Engineering Company in a more modern form, thus—

	£	£
Fixed Assets. . . .		115,400
Trade Investments . . .		41,200
Current Assets	1,271,400	
Less Liabilities	352,000	
		919,400
Net Assets		<u><u>£1,076,000</u></u>

It will be seen that this figure of net assets is equal to the capital stock and reserves of the company.

4. Conclusion

We have now dealt, albeit sketchily, with the machinery of the money market and have discussed the activities

of the banks with their attendant discount and acceptance houses, the Stock Exchange, and the issuing houses. We have tried to explain technical terms as they occurred and, as far as possible, theories of money have been avoided, for the subject is debatable and difficult. Generally, in technical matters, theory is based on practice. By trial and error, practical engineers, for example, have learned how to surmount difficulties of construction and manufacture so that the best practice has become the accepted theory. But this is not so with money, and it may be conjectured that many of our financial imbecilities of the past have been due to the fact that theorists have been allowed to initiate policies which were either based on outworn practice or on no practice at all. This is by no means intended as a statement of fact; it is, as it were, thrown out as a subject for discussion. But the mistakes are facts. The fantastic claims on Germany for reparations after the first world war, the ridiculous Buy British campaign, the Economy Drive, and many other instances of folly may be cited. We can smile at them in retrospect but they were disastrous for a number of people when they were current.

It is very much hoped that sufficient interest has been aroused to induce a number of readers to study the subject of finance seriously. One of the reasons why we lack experts in monetary policy may be that so few people make a study of it. Those who do are accounted wizards of finance and, although they mostly disagree with each other, they are able to maintain this reputation because there are not enough men with sufficient knowledge to criticize their findings.

The field is open, then, more open than that of any other Science. There is room for research workers and students in every branch of the subject and, most importantly, there are great opportunities for discovery ahead.

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