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THE MEANING OF MONEY

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THE MEANING OF MONEY.

STOCKS AND SHARES.

MONEY CHANGING.

WAR AND LOMBARD STREET.

POVERTY AND WASTE.

INTERNATIONAL FINANCE.

THE BUSINESS OF FINANCE.

WAR-TIME FINANCIAL PROBLEMS.

OUR MONEY AND THE STATE.

Edited by HARTLEY WITHERS.

LOMBARD STREET. A Description of the
Money Market. By WALTER BAGEHOT.

THE MEANING OF MONEY

BY
HARTLEY WITHERS

“Grau, theurer Freund, ist alle Theorie
Und grün des Lebens goldner Baum.”

GOETHE.

“The principles of banking are dynamic and not static, and will have to be developed and frequently modified.”

MR. MONTAGU NORMAN,

*in Evidence before the
Indian Currency Commission.*

LONDON
JOHN MURRAY, ALBEMARLE STREET, W.

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PREFACE TO THE FIFTH EDITION

IN 1908 this book set out to show—

(1) that bank deposits are created by loans and advances made by banks ;

(2) that some of the banks did not keep enough cash ;

(3) that London was the monetary centre of the world ;

(4) that the task of the Bank of England, in maintaining the gold reserve of the country and the reserve on which all other countries to some extent relied, was made difficult by the lack of any connexion between Bank rate and the rate at which other banks lent to bill-brokers, which was an important influence on the market rate of discount.

Proposition number 1 is now generally accepted as a truism.

Number 2 has been practically killed by the consolidation of banking and the absorption of goats by sheep.

Number 4 has been falsified by the introduction of the link, advocated in 1908, between Bank rate and market rate.

Number 3 has been modified by the rise of the United States and the American money market to a position of commanding wealth and strength.

The Bank of England's control over the position has thus been greatly strengthened at home, but the international money market is still in a highly unsettled condition, having been lately disturbed by a struggle between the new United States Federal Reserve system and the New York Stock Exchange and also by vagaries performed by the Bank of France and the Reichsbank. These events, leading to dear money all over the world, have encouraged the critics of the gold standard, and make the need for better co-operation among central banks imperative, if the gold standard, with its immense benefit to trade and so to all consumers, is to be maintained.

The monetary problem has thus been radically altered, and many of its details have also been changed. The British sovereign is replaced (after an interval of Treasury notes) by a Bank of England £1 note, the Bank of England has increased the information furnished by its weekly return, made revolutionary changes in its Board and, apparently, acquired a permanent Governor; and the other banks have reduced their numbers by amalgamations from sixty to twenty. But bankers still deplore and practise the habit of window-dressing.

These things are, I hope, more than sufficient justification for a Revised Version of *The Meaning of Money*.

HARTLEY WITHERS.

RIDGEWAY, GUILDFORD,
July 14, 1929.

PREFACE TO THE FOURTH EDITION

MUCH has happened in the Money Market since this book was written. The stress of the greatest war that ever deluged Europe in bloodshed has strained the strength of our credit system without breaking it; we know now that if the financial power of the country is husbanded with care and statesmanship, it will be our trusty weapon until a secure peace is won, and our mainstay among the new problems and difficulties that peace will bring with it. There never was a time when a clear understanding of our monetary system was more necessary to all who wish to form a reasoned judgment about matters of great moment to the nation's well-being; and if this book can help to throw light on this dark subject in this time of crisis, its writer will have earned a reward of which he little dreamt when he wrote it—most of it in Kensington Gardens—in the peaceful spring and summer of 1908.

It may be added that the chief thesis worked out in the book needs a slight extension in the light of the war's experience. That every loan by a bank to a customer increases the volume of banking deposits is now an acknowledged truism. But owing to the great extent of the investments

viii PREFACE TO THE FOURTH EDITION

made by the banks, in their patriotic readiness to finance the war by buying Government securities, we now have to recognize that investments made by banks have the same effect on their deposits as loans advanced by them. In days of peace their investments were a comparatively small and constant item in their balance sheets, and so the fact that additions to them would swell deposits was of little importance. Now they have been rapidly increased owing to reasons given, and have produced a corresponding increase in bank deposits, which has startled and puzzled some observers, who have regarded it as an evidence of a wonderful growth in the nation's wealth amid the stress and waste of war. It is, in fact, an increase of paper credit, and might have produced serious inflation, but for the care and self-restraint with which the bankers dealt with the danger, correcting it by a reduction of their loans and advances.

HARTLEY WITHERS.

6 LINDEN GARDENS,
February 13, 1916.

NOTE.—Since the above was written the policy of financing the war by banking credits has been continued, very much against the wishes of the bankers, on an increasing scale; and serious inflation has followed.

H. W.

November 20, 1917.

PREFACE TO THE FIRST EDITION

THIS book is designed to meet the difficulty experienced by the average reader in understanding that part of a newspaper City article which deals with the money market. It has been compiled with as little reference as possible to other books, and chiefly expresses views and facts gathered from practical men at work in the great machine which it describes, one of whom has kindly read the proofs and made valuable suggestions. The difficulties of the subject are very real to its writer, who has consequently aimed earnestly at clearness, risking platitude and iteration to achieve it. Its shortcomings will be pardoned, by considerate readers, on the ground of the limited leisure in which it was written.

January, 1909.

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CHAPTER I

INTRODUCTORY

THE meaning of Money is not a question of economic theory. The object of this volume is to explain a matter of plain, positive, practical fact, which is very important, very dull and very little understood ; and to do so as clearly as may be, and with the least possible use of the alarming apparatus which generally affrights the casual reader who opens a book on a monetary subject. No columns of statistics will be paraded and deployed, the use of diagrams will be sedulously avoided, and as far as possible figures will be ruled out.

The word Money is associated with much confusion and difficulty in the minds of those who have not been obliged to think the matter out, because of the different senses in which it is used. In one sense it is perfectly simple, without the least reflection or examination. Everybody understands money in the sense of the pounds, shillings, and pence that we pay in the shape of coin, notes or cheques for everyday wants. But the other most common use of the word leads to complication, because in its second sense money means not money, but the loan of money.

This is the sense in which the word is used when we speak of a money market or a price of money, phrases which are wholly incomprehensible to those to whom this difference of meaning is not made clear. Anyone who defines money roughly as a pound in his pocket, with which he can buy whatever he wants up to the extent of its purchasing power, does so quite naturally, for this is its most obvious meaning. But having got this meaning into his head, he is unable, and again quite naturally, to understand strange expressions in the newspapers which tell him that money is cheap or that the money market is tight. He knows that the price of a thing is the number of pounds, or fractions of a pound, that it will fetch. He also knows that no one will give him more than a pound for the pound that he has in his pocket, and he is equally convinced that the most cunning sophistries of the most skilful dialectician would never induce him to part with it for less. He therefore proceeds triumphantly to the conclusion that it is nonsense to talk about a price for money, and his argument is perfectly sound on the premises from which he starts.

His mistake arises from the fact that, as has been stated, money is often used in a quite different sense, namely, the loan of money ; or perhaps the matter can be made still clearer if we express it by saying that (the words " price " and " market " are applied in a different sense when applied to money from their meaning in connection with any

ordinary commodity. The price of a hat is the pound that you pay to become its owner; the price of money is the pound or pounds that you promise to pay some day for the loan or temporary use of it. The market in wool or wheat is the place where you can buy these articles from the assembled merchants or dealers. The money market is the place in which you can borrow money.

It thus becomes apparent that the phrase which has proved a stumbling-block to so many generations of schoolboys and more mature students—that money is a commodity which can be bought and sold like any other—is not true. Money is certainly a commodity, but it cannot be bought and sold like any other, for that would imply exchanging it for itself, since buying and selling are nothing but the exchange of commodities for money, as distinguished from barter, which is exchanging commodities for one another. Money can be borrowed or lent, and this is at once a perfectly reasonable and comprehensible transaction, which would never cause the least bewilderment in the mind of the most unmathematical schoolboy. It is perfectly clear to Jones, minor, that it might be to his advantage, in the lean and hungry days towards the end of term, to take five shillings in hard cash and to promise to pay seven-and-six after the holidays, when everybody's pocket is bursting with printed or metallic evidences of family affection. And this transaction, allowance being made for local and psychological variations, is a

fair specimen of the business done every day in Lombard Street and in the other money markets of the world.

The money market, then, is the place in which money down is exchanged for the promise of money some day. And as the borrower, the man who wants money down, must obviously offer the lender an inducement to let him have it, it will always be found that the amount of money promised some day by the borrower is bigger than the amount of money paid down by the lender. The difference between the two figures is the rate of interest, which is often loosely and confusingly described as the price of money.

This rate of interest, as every one knows, is calculated "per cent.," so much on each £100 borrowed. If you borrow £1000 for a year from your banker, and he charges you 3 per cent., or £3 per £100 for the advance, he will give you the right to draw a cheque now for £1000, or to withdraw this amount in coin or notes, and at the end of the year you will owe him £1,030. But this simple statement of the matter is complicated slightly in usual practice, because the interest is probably payable periodically at the quarter or half-year. This complication becomes important in the case of loans for long or indefinite periods, but the broad fact remains that the chief operations of the money market consist of giving cash down in return for the promise of a little more cash some day, or of annual or half-yearly cash payments.

Time is thus the distinctive element in the most ordinary and obvious transactions of the money market, and clears away the difficulty which besets those who cannot understand how a money market can exist. To exchange money for money would be absurd; to exchange money now for more money some day is evidently a quite reasonable convenience to a borrower who hopes to make a profitable use of the sum borrowed, and to earn more by its employment than the price that he will have to pay for it. And space is the other element which accounts for the rest of the market's operations. Besides giving and taking money down in return for money some day, it is also engaged in giving and taking money here for money somewhere else. Hence arises the complicated and difficult mechanism of what is generally called "exchange," which also becomes a comparatively simple matter when it is clearly expressed and freed from confusing technicalities. The broad meaning of it is clear enough, if you reflect that when you buy a postal order you are conducting an exchange transaction. You receive a communication from a tradesman in a town in which you formerly lived to the effect that his account, amounting to five shillings, has been long outstanding, and that he would be glad to have it settled. The five shillings are ready enough in your pocket, but the question is, how to get them, for example, from London to Bristol. You can put two half-crowns in an envelope, register it, and so send your

money at the cost of $4\frac{1}{2}d.$ But the cheaper and more convenient method is to pay some one who has money in Bristol something to induce him to pay your debt for you there. That some one is ready in the person of the Post Office, which sells you an order for five shillings, payable at any office in the United Kingdom, for five shillings plus $1\frac{1}{2}d.$ You put the order in an envelope and send the money at a total cost of threepence, and your tradesman presents it at the Bristol post-office and receives cash. Thus you have carried out an exchange transaction, which may be technically expressed by saying that you have bought a draft on Bristol, and forwarded it to your creditor, and that it has been met on presentation.

Monetary transactions may thus be divided into three main divisions :—

(1) Those in which money is exchanged for any kind of commodity or service ; ordinary buying or selling operations.

(2) Those in which money down is exchanged for the promise of money some day ; these include all kinds of loan operations, from the discounting of a bill due sixty days hence to an issue of a war loan by the British Government.

(3) Those in which money here is exchanged for money somewhere else ; and these are exchange operations, which have been crudely exemplified by the purchase of a postal order, but are by far the most complicated kind of monetary business, including such transactions as turning pounds into

Shanghai taels, composed of silver, or into inconvertible paper notes, issued by some Central American Republic.

It will be observed that in all three there is one constant factor, which is money here and now, or cash. In ordinary buying and selling cash is exchanged for goods or services, as when we buy a pair of gloves across the counter of a shop, or send a reluctant cheque to pay a dentist's account or a lawyer's bill of costs. In loan operations cash is exchanged for some form of security or promise to pay. In exchange operations cash is exchanged for drafts representing a right to money in some other place. And before we can go any further, it will be necessary to give some explanation of the different forms taken by cash, or money here and now. Everybody knows that when a payment is to be made in England it will take the form of coin, Bank of England notes, or, most probably, a cheque drawn on a banker; and the stages by which these forms of payment came into being are a well-worn story, which must be summarized briefly in the interests of clearness and completeness.

CHAPTER II

COINED CASH

WHEN this book was first written, it said that “the most obvious of the forms of cash is the coined currency that we carry in our pockets, consisting of gold, silver, and bronze discs, stamped with the image and superscription of the king, and milled round the edges to prevent enterprising bullionists from shaving metal off their rims. This precaution, it will be observed, is not considered necessary in the case of the penny. The most potent of these, in extracting goods and services from mankind, is gold.”

Since then we have had a great war, and the handsome gold coins of which we used to be so proud have vanished from everyday use. Now we carry Bank of England £1 and 10s. notes, introduced at the end of 1928. Until then the lowest denomination of Bank of England notes had been £5, and they were chiefly used as cash reserves by the other banks and were rarely seen in circulation, except on racecourses and in other purlieus frequented by persons whose credit was doubtful. The £1 and 10s. notes were created to take the place of the gold coins of pre-war days and of the Treasury

notes which had been invented in 1914, when our gold coins "went to the front" and did not come back again.

We shall see, however, that though we have ceased to carry gold in our pockets, the notes that have taken its place are still convertible, on certain conditions, into gold on demand; and this fact makes gold, as will be shown, still part of the basis of credit in England and in economically civilized countries. And it will help us to understand what money does for us, if we look at the reasons which have raised gold to this position, and make it necessary to maintain this convertibility of our paper money into gold.

Buying is distinguished from barter by being an exchange of goods for money instead of an exchange of goods for goods. The inconvenience of a state of barter is evident on a moment's reflection, and it need not be said that as long as it prevailed commercial progress was almost impossible. The sad state of the hungry hatter, unable, in the days of barter, to get meat because the butcher wants not hats but boots, is a commonplace of the economic textbooks, and it is clear at once that a long step forward has been taken when a community agrees to recognize one commodity as always acceptable in payment for others, so that any capitalist who is possessed of a store of it may always rely on being able to convert it into whatever he needs that is produced by his fellows. It is also evident that the commodity selected had

to be endowed with certain qualities, chief among which were that it should be lasting, easy to pass from hand to hand, and fairly uniform, that is with not too great a difference in size and desirability between its various examples. The Old Testament story shows that in the primitive society depicted by it a man's wealth was gauged by the size of his flocks and herds and the number of his changes of raiment, and in the Homeric poems fine suits of armour are valued by the number of kine that they would fetch. Other instances of the use of articles of common consumption as currency include tobacco, hides, shells, bullets and nails. But the prevalence of beasts was sufficient to lead etymologists to consider at one time that the Latin word for a beast, *pecus*, had been enshrined in the name for money, *pecunia*, which has come down in English in the forms pecuniary and impecunious. This derivation is now abandoned, comparative philology having decided that *pecunia* is the same word as the English "fee," and is chiefly memorable for having prompted a passage, full of vivid fancy and inspiration, in Carlyle's *Sartor Resartus*. "A simple invention it was," says Herr Teufelsdröckh, "in the old-world Grazier—sick of lugging his slow Ox about the country till he got it bartered for corn or oil—to take a piece of Leather, and thereon scratch or stamp the mere Figure of an Ox (or *Pecus*); put it in his pocket, and call it *Pecunia*, Money. Yet hereby did Barter grow Sale, the Leather Money

is now Golden and Paper, and all miracles have been out-miracled : for there are Rothschilds and English National Debts ; and whoso has sixpence is sovereign (to the length of sixpence) over all men ; commands Cooks to feed him, Philosophers to teach him, Kings to mount guard over him—to the length of sixpence.”

The ox was certainly at one time a standard of value, though it may be doubted whether it passed generally as currency, even stamped on leather, for Carlyle's hypothesis really requires a rather advanced stage of credit organization, with token money issued by graziers, and apparently accepted by a trusting and economically civilized public. But in any case the ox must have been singularly ill-adapted for currency purposes ; not only was it not lasting, but it was certain to deteriorate after a certain age, and finally to perish ; it was very far from portable, as Carlyle's Grazier found ; and the difference between one ox and another in size, value, and other respects is so great that the kine circulation must have been singularly liable to the action of the great economic principle known as Gresham's Law, under which, as we shall see later, bad currency drives out good.

All this has been somewhat laboriously set forth, because in these respects the ox is the very antithesis of the gold-piece, and having seen wherein the ox failed, we have already grasped the advantages of the sovereign.

The sovereign was permanent,¹ portable, and of universal acceptability, either in its own shape or melted back into its original bullion. As it emerged from the Mint, there was no appreciable difference between it and its fellows, and its long use as the standard money of the leading commercial nation had given it a position which was unrivalled at the beginning of the century and unparalleled in the past. The different experiences to which one sovereign and another might be subjected made a difference to the length of time during which they preserved their full weight, but weight rarely became a question of practical importance to holders of the sovereign considered as cash, though it was always watched carefully by bullion dealers, who regarded the sovereign merely as a piece of gold that might be melted into bars. The coinage was so well cared for that for purposes of inland and retail exchange one might be taken to be as good as another, as long as we were certain that it was a real sovereign, duly stamped and milled. We were apt to take this inestimable convenience as a matter of course, but it was only secured by constant vigilance on the part of the responsible authorities, and throughout the Middle Ages untold loss, inconvenience and uncertainty was caused by the chronically chaotic state of the currency in this and other countries.

¹ Comparatively permanent, that is. It was not wholly impervious to wear and tear, and M. de Launay, in his work on *The World's Gold*, estimated that a gold coin would entirely disappear in eight thousand years.

In those good old days, monarchs who did not actually debase their own currencies by decreasing the amount of true metal in them, and then passing them to their unsuspecting subjects, were regarded as enlightened and disinterested reformers ; and the imperfect methods of coinage employed even by the best-intentioned made it easy to sweat and clip the coins, that is to say, to shave bits off them, and then pass them on. Here came in the opportunity of the bullion dealer, and the process arose which went on undetected for centuries until it was enounced and denounced by Sir Thomas Gresham, Queen Elizabeth's great monetary adviser, who stated his famous economic law on the subject. The gist of which is, that if two coins are in circulation, one better than the other, the good one will be held back by anyone who is wise enough to recognize its merits, and the bad one will be passed on ; so that after a time only the clipped and sweated coins will be circulating in the hands of the public, and the full-weighted ones will be either in the vaults of the bullion dealers or melted into bars. To protect themselves against the working of this law, our forefathers used sometimes to carry a small pair of scales, with weights representing a guinea and a half-guinea, fitted into a neat case to be tucked into the pocket.

It has been claimed for gold, that one of its great advantages, which helped to raise it to its position of predominance as circulating medium and basis of credit, is its steadiness in value. It was, in fact,

a common delusion that the value of gold is fixed and never varies. The value of gold appeared to be fixed by the law which compelled the Mint to take any gold that was brought to it and coin it into sovereigns at the rate of £3 17s. 10½*d.* per oz., but that was only another way of expressing the fact that a coined sovereign was equivalent to so much gold; but because we were accustomed to value everything in sovereigns many of us were led into the assumption that gold which could always be made into so many sovereigns per oz. must therefore be unchangeable in value. But if we keep fast hold of the fact that the value of a thing is what it will fetch, it will be seen at once that the sovereign or the gold from which it was coined, had no such charmed prerogative. When wheat was 35s. a quarter the buying power of the sovereign, in the pocket of the miller who wanted to buy wheat, was different from its value when wheat was 25s. But though the value of gold can be no more fixed than that of anything else, at the same time its comparative indestructibility, and the enormous amount of it in existence in one shape or another, make its value depend much less than that of most other things on the amount of the output at the moment.

Wheat, which is grown to be consumed straight-way, depends for its price on the prospects of the present crop and the amount left over of the last; gold, which is mined in order to be kept in the form of plate, ornaments, coins and ingots, and is rarely

abolished by consumption, is obviously much less dependent on the chances which may be tending to increase its amount more or less rapidly than usual. For whatever its form, it may always be brought out and melted, and so come into the market in the shape of cash, as was recognized by the prudent Athenians¹ when in the days of their prosperity they overlaid the statue of Athene with gold, giving it a gorgeous appearance for the time being and leaving a reserve which could at any time be stripped off and turned into the sinews of war. Gold thus may be regarded as less likely to fluctuate in value than most other commodities owing to the huge accumulated supply, which renders the new output for the time being a matter of comparatively little importance; and this fact, which has sometimes been exaggerated into a statement that its value is fixed, certainly contributed with its beauty as decoration and its commanding merits as currency, to the universal acceptability of gold, in economically civilized countries, in payment for goods and services.

Since the war, we cannot afford a gold currency. Our gold has to be all, or practically all, in the shop-window, that is in the vaults of the Bank of England, and the jolly old Yellow Boys, that used to make a tip from an uncle an artistic joy as well as a practical gain, are seen no more. The prestige of the British sovereign, welcomed all over the world, has been passed on first to the Treasury

¹ Thucydides, ii. 13.

note and now to the £1 Bank of England note, and the need for gold as money has ceased to be apparent to the man in the street.

But though we do not see gold nowadays, it is still the foundation of our currency and credit system, because, as will be shown later, every bank-note that is issued above a certain limit has to have a gold backing behind it. The need for this gold backing has been questioned not only by the large number of people who still think that every one can be made happy by pouring out fresh supplies of money, and forget that what we live on is not money but goods and services, but also by high economic authorities on high scientific grounds. They argue that stability in prices is all-important, and that it would be easier to secure it if we no longer based our currency on gold, but regulated its amount so as to prevent fluctuations in the prices of commodities. This theory, together with the Quantity Theory of Money with which it is closely connected, will be examined later. At this point in our investigation it is enough to say that the only money which can do its work, of giving its holder the power to buy what he wants, is money that will everywhere be taken in payment. "How full of briars is this working-day world," says Rosalind, and it is just as full, and fuller, of conventions and prejudices. Owing to the hold that gold has won over the mind of the trading community, for the reasons shown above, paper that is based on gold has now inherited this virtue

of universal acceptability, and no most scientifically evolved substitute will take its place until it has won its way to the possession of the same virtue.

And so we shall find, when we come to deal with the more interesting problems of the manufacture of credit, that the convertibility of credit into gold is a matter that its manufacturers always have to consider and allow for carefully, and that consequently the amount of gold that they may possess in order to meet credit instruments that come in for conversion, is necessarily a very important factor among those which regulate the amount of credit that they can create.

The small change that we carry in our purses need not detain us long. It must be noted that silver coins are not “legal tender” to the extent of more than £2; that is to say, if you owe your tailor £5, you cannot legally satisfy the debt by handing him one hundred shillings or any other arrangement in silver. Probably it would not occur to you to do so, and if you did he would probably accept it, and the restriction is not apparently of much practical importance. Actually it is most important, for the dreary record of currency history is a long tale of the uncertainty and inconvenience which arose in the days when people tried to keep gold and silver circulating on equal terms at a fixed ratio, with the result that the one which happened for the moment to be less valuable as bullion continually drove out of circulation the one which was more valuable,

thanks to the operation of Gresham's Law ¹ and the quick and cunning bullion merchants. Bi-metallists maintain that the confusion and difficulty of the two-metal system only arose because it was not scientifically and universally applied, and Bi-metallism has been endorsed by eminent theoretical authority. The simplicity of the single standard, however, has obvious practical advantages, and it may at least be claimed that England, by making silver legal tender only up to sums of £2, and adopting what is called a gold standard, solved a problem which had puzzled the civilized world for centuries.

It may also be observed that our silver coins are mere tokens ; that is to say, they do not pretend to contain as much of the metal as would, if melted down, fetch as much as the value at which they circulate.

Bronze coins are legal tender only to the extent of one shilling.

¹ See page 13.

CHAPTER III

PAPER CASH

THE exchange of a hat for a sovereign was a quite commonplace proceeding, but when we began to exchange a hat for a piece of paper, which was only accepted because it was believed to be convertible into gold, the element of belief, that is to say of credit, entered into the transaction, and we had moved up a step on the ladder of economic civilization.

The first stage, as we have seen, was from barter, by which goods were exchanged for goods, to purchase, by which goods were exchanged for one commodity of universal acceptability. And a process of painful evolution finally decided that gold was best fitted to be that commodity. But an enormous expansion of trade was made possible when it was discovered that gold could be economized by the use of paper which represented and multiplied it, and when confidence in a banker became sufficiently established to induce the community to circulate his promises to pay instead of pieces of metal.

The process of this evolution, also, was painful enough, and the loss and uncertainty caused by the bad and debased coin currency of the Middle Ages were rivalled by the ruin and disasters of the early

days of banking, when notes were issued without any regard for the assets which were behind them, or the ability of the issuer to meet them on presentation. Nevertheless, the appearance of the bank-note marks the first step in the development of banking as we understand it nowadays, that is, of a machinery for the manufacture of credit.

Before the bank-note won its way into circulation, such bankers as existed were chiefly goldsmiths and bullion dealers; they were sometimes loan mongers, collecting coin from one set of customers to lend it to another, or to discount bills for another, but it was only when they began to induce those who borrowed from them to take the cash advanced in the form of notes that the economy of metal became possible and the wheel of the credit machine began to turn to any purpose. The original goldsmith's note was a receipt for metal deposited. It took the form of a promise to pay metal, and so passed as currency. Some ingenious goldsmith conceived the epoch-making notion of giving notes, not only to those who had deposited metal, but to those who came to borrow it, and so founded modern banking.

As long as the bankers took care of coin and ingots for Jones and lent them to Smith, the commercial community was given a certain convenience, by knowing where dealers in money were to be found, but the convenience was severely restricted. When the bankers lent Smith not coin but a promise to pay coin, they soon discovered, since

their promise to pay did not at once come back to them for presentation, that in the meantime they might safely accommodate Brown, Robinson and Williams with a similar number of similar promises to pay; and so they hit on the great device by which modern commerce transacts its business by means of evidence of mutual indebtedness between it and its bankers.

At first sight there is something whimsical in the process of stimulating production and expanding trade by an agreement between two parties to owe one another something; but this agreement is an important part of the structure of the modern edifice of credit.

Let us see it at work in the case of the primitive bank which we are now supposing to be emerging from the bullion-dealing to the note-issuing stage. At first, we supposed it engaged in taking care of metallic money for Smith and lending it to Jones, and its balance-sheet would stand thus, if we leave out its capital for the sake of simplicity:—

Due to Smith . . . £10,000 Loan to Jones . . . £10,000

After it had made the momentous step of inducing Jones to take its notes instead of metal, the balance-sheet would show the following development:—

Due to Smith . . .	£10,000	Cash in hand . . .	£10,000
Notes outstanding	10,000	Loan to Jones . . .	10,000
	<hr/>		<hr/>
Total	<u>£20,000</u>	Total	<u>£20,000</u>

You will observe that since Jones has taken his loan in notes the cash originally deposited by Smith remains in the bank's hands, and the loan to Jones is represented by a liability of the bank to meet the notes which it has passed over to him. These notes, being a promise to pay by the bank, are in effect a loan by Jones to it, and thus Jones and the bank have become mutually indebted. The bank has lent £10,000 to Jones, and he, by taking payment in the bank's promises to pay, is lending it £10,000 as long as he refrains from presenting the notes and demanding cash for them. Jones and the bank are thus mutually indebted, and by their agreement to owe one another money the currency has been increased by £10,000, and to that extent Jones is enabled to hire and load a ship for foreign trade, or otherwise to engage in productive enterprise.

When the bank finds that the notes which Jones borrowed are not quickly presented, but are accepted by the commercial community for the payments that he makes in loading his ship, and passed on from hand to hand and remain outstanding, it proceeds to the next step of making advances to Brown, Robinson and Williams, and the balance-sheet will be amplified as follows:—

Due to Smith . . .	£10,000	Cash in hand . . .	£10,000
Notes outstanding	40,000	Loans to customers	40,000
	<hr/>		<hr/>
	£50,000		£50,000
	<hr/>		<hr/>

The great principle of currency based on mutual indebtedness has thus been extended ; the bank is liable for £40,000 of its promises to pay on demand, and its customers are indebted to it for £40,000. And this £40,000 is in circulation, quickening the wheels of trade, increasing production and profitable commerce. And the mutual indebtedness of the bank and its customers has brought this new currency into being.

But it will be observed that the bank now owes £50,000 in all, and holds only £10,000 in metallic cash against all these liabilities on demand. This will probably be a safe proportion for it to work on in ordinary circumstances, but if it continued to increase the amount of its note issue without a proportionate increase in the amount of cash held against it, the day would come when some unforeseen accident brought in an unusual number of notes for presentation, and its fate would be sealed. In the early days of banking this sort of disaster was common enough, and folk found that they had sold their goods and services in return for notes which they had believed to be as good as gold and discovered too late to be worth only the paper that they were printed on. The manufacture of currency out of mutual indebtedness had proved too easy and simple a process, and the necessity for a proportionate backing of gold had been ignored.

Disasters of this kind not only reduced the number of note-issuing banks in England, but

produced a body of opinion which aimed at making the bank-note a mere bullion certificate, only to be issued against a backing of gold to its full value. In London, the Bank of England had, since its very early days, possessed the monopoly of note issue as far as joint-stock companies were concerned, and the private banks had already ceased to issue notes when the question of the regulation of the note issue was taken in hand in 1844.

The body of opinion above referred to then prevailed, and it was decided by the Bank Act of 1844 that in future any expansion in the Bank of England's note circulation must only be based on metal. Up to £14,000,000 it might issue notes against securities, and it was arranged that if any country note issues lapsed, two-thirds of them might be added to the amount of notes that the Bank of England might so issue, and this arrangement had raised the amount of bank-notes based on securities to nearly 20 millions in 1928, when the Currency and Bank Notes Act revised the whole position and provided for the fusion of the Treasury notes—a Government issue which had been created in 1914—with the Bank of England's note issue, and their replacement by Bank of England £1 and 10s. notes. Under this Act the Bank of England may issue notes against securities to the extent of £260 millions. This constitutes what is called its "fiduciary," or "confidential" issue. Above that line, every note issued must be backed by gold. Since, however, the disappear-

ance of gold coins from ordinary use, and the appearance of £1 and 10s. bank-notes as cash in the pockets of the public, have made large fluctuations in the circulation of bank-notes much more probable, it was necessary to give greater elasticity to the fiduciary issue. It was accordingly provided by the new Act that the Bank may increase the amount of the fiduciary issue at any time with the consent of the Treasury. Under the old Act of 1844, the limit on the fiduciary issue could only be exceeded after the Bank had got a promise from the Chancellor of the Exchequer, which was only granted at times of acute crisis, that he would ask Parliament to indemnify the Bank for its breach of the law. The new Act thus provides for its own suspension, if the Bank and the Treasury think this advisable, by a much simpler and less formidable method than was possible under the statute of 1844.

By the Gold Standard Act of 1925, the right to convert Bank of England notes into gold, which had been suspended after the war, was restored in a modified form. Conversion into sovereigns was not given back to holders of bank-notes, because the country clearly could not afford the luxury of a gold circulation; though in practice the Bank does give sovereigns for its notes at its discretion. But it is obliged by the law to sell gold bullion to anyone who pays for it in legal tender (which in this case means bank-notes), at £3 17s. 10½*d.* per ounce standard, but only in bars containing approxi-

mately 400 fine ounces. Free convertibility of the bank-note for those who want gold for export is thus secured, and the golden link is firmly riveted between the English pound and the currencies of other countries that are on the gold standard, or are more or less closely hitched to it. This golden link between the currencies of the chief countries of the world is of immense benefit to international trade, by keeping fluctuations in rates of exchange within moderate limits.¹

Such are the conditions under which Bank of England notes are now issued. The value of a bank-note arises from the belief that it can be converted into gold and will be accepted as payment for goods. It therefore follows that since the Bank of England note is legal tender in England, it will be accepted in payment for goods as long as the British Government is strong enough to enforce the law of the land; and it is obvious that it can be converted into gold as long as the Bank of England is solvent, that is to say, keeps sufficient gold in its vaults to meet its notes on presentation; and it is compelled to keep the gold equivalent of every note that it issues above the £260,000,000 which it is allowed to issue against securities. The strength of the Bank of England note thus depends on the power of the British Government to enforce the law, and on the solvency of the Bank of England. It is thus as strong as any mere promise to pay can be made, and

¹ Rates of Exchange will be explained in Chapter X.

is, for practical currency purposes, as good as gold.

The consideration of the bank-note has thus already taken us over the wavy and very ill-defined line which separates cash from credit. For a bank-note is both. It is cash in that it is immediately convertible into gold, and it is credit in that it is a promise to pay, and is only acceptable in payment for goods because it is believed to be as good as gold. Its use, in economizing gold and multiplying the effectiveness of the gold retained in the hands of the banker, has already been demonstrated, and it has also been recorded that the disasters which followed from its abuse, in days when bankers had not grasped the necessity for keeping an adequate proportion of gold to meet notes presented, and for keeping the rest of their assets liquid and realizable, led to a reaction. This reaction prompted the passing of measures in England which prohibited this economy of gold by means of the bank-note, and laid down that any increase in the Bank of England's issue was to be based on an equal amount of gold in its vaults, each £5-note being actually represented by £5 in gold.

If the apparent intentions of the Act of 1844 had been carried out, the subsequent enormous development of English trade, if it had been possible at all, must have been accompanied by the heaping up of a vast mass of gold in the Bank's vaults. But its intentions were evaded by the commercial

community, which had already appreciated the advantages of a currency based on mutual indebtedness between itself and the banks. The commercial community ceased to circulate bank-notes under the new restrictions, developing the use for daily cash transactions of a credit instrument which had already acquired some popularity, namely, a draft or bill on its bankers payable on demand, and now commonly called a cheque. The drawing of cheques was not in any way limited by the Act of 1844, and the cheque was in many ways a more convenient form of currency than the bank-note. For the strength of the Bank of England note was in itself an inconvenience in one respect; since the nature of the note was such that anyone who held it could present it and be paid in gold for it at sight, a roll of them in one's pocket was as valuable a burden as so many sovereigns or gold bars, with the additional merit of being more easily carried by the owner and the serious disadvantage of being more easily carried off by anyone else. This danger was avoided or enormously reduced when the community adopted the habit, not of carrying or sending bank-notes, but of drawing a cheque on its bank for every transaction that it wished to complete by payment.

The use of the cheque, however, involves the element of belief to a much greater extent than that of the bank-note. We have seen that the latter is certain of being taken in payment for goods or converted into gold as long as the British

Government stands and the Bank of England is solvent, but the exchangeability of the former depends on the solvency of the drawer of the cheque—probably a private individual—and of the bank on which it is drawn. A shopkeeper who takes a cheque in payment for a pair of boots is liable on presenting it through his banker to have it returned marked with ominous signs, which are interpreted to mean that the customer's alleged bank refuses to meet it, because his account is overdrawn, or perhaps because he never had an account with it at all. Or it is barely possible that he may be informed that the bank on which the cheque was drawn has put up its shutters, though this possibility is happily one that need not be practically considered now in England, owing to the stability which centuries of experience and the light of publicity have given to British banking.

But these two risks, one a practical one and the other theoretically in being, make the extensive use of cheques possible only in a community which has reached a high stage of economic civilization and is also blessed with a high level of general honesty among its members. And these features in the character of a cheque also made it obviously impossible that it could be given the privilege of legal tender, that is, that anyone could be bound by law to accept a cheque in payment for goods delivered or services rendered. No one could be compelled to take a piece of paper signed by an unknown person and purporting to be an order on

a bank of which perhaps he had never heard. So that the cheque has had to fight its way to its present supremacy without this advantage, and to drive gold and notes out of circulation, except in small and special transactions, in spite of the fact that they were legal tender and it was not. This it was enabled to do by its safety and convenience and the power of the drawer, by varying the form in which he makes it out, to hedge it about with safeguarding restrictions, or to leave it convertible into cash by anyone who presents it. A cheque is merely an order on a bank from one of its customers to pay some of the money which it holds on his account to a third party, or to himself if he wants to take out cash. It can be manufactured with a piece of notepaper and a twopenny stamp, but it is much more usual to use one of the well-known regular forms supplied by banks to their customers.

The convenience of the cheque follows from its safety ; if bank-notes are being sent, it is necessary to note all the numbers and register the packet ; a cheque, protected by being crossed and marked "not negotiable," goes safely in an ordinary envelope. The words "not negotiable" do not make a cheque not negotiable, but their effect is, that no holder of a cheque so marked can pass on a better title to it than he has himself ; consequently, if it is stolen, anyone who takes it from the thief cannot claim on it. Further, the fact that it can be drawn to the exact amount required is a great

advantage, and its return to the drawer through his bank, when it has done its work and been cancelled, is an additional convenience, and makes the cheque a record and receipt, as well as a form of payment.

But in considering the qualities of the cheque it must never be forgotten that it is a certificate immediately convertible into legal tender cash, which to-day means Bank of England notes. It need hardly be said that the great majority of cheques are never presented to be turned into cash; they are paid into banks by those who receive them, and crossed off against one another in the Clearing-house, where representatives of all the banks meet and exchange claims against one another; and cheques thus for the most part merely act as indicators in the transactions which result in the daily transfer of an enormous amount of credit from one hand to another, the whole affair being finally reduced to a matter of book-keeping exchanges between the various bankers and between the various accounts in their books. But the fact that every cheque gives the holder, or his bank, the right to demand legal tender from the bank on which it is drawn is highly important; without it, the cheque could not have won its way to general acceptability, and could not be treated as cash, as it is rather heretically treated here, on the ground that it is, in the vast majority of cases, readily accepted in exchange for goods or services in ordinary transactions. And the immediate

convertibility into Bank of England notes, which is behind every cheque, means that an adequate supply of notes to meet them on presentation is as necessary to bankers who supply their customers with cheque-books as an adequate stock of gold was to those who formerly made advances to them in the shape of notes, or promises to pay. In these days when a banker lends money, he lends the right to draw a cheque and promises to meet it on demand, so that the principle of mutual indebtedness as part of the basis of modern commercial currency is again evident. And since the right to draw a cheque implies the right to call for Bank of England notes, the extent to which credit can be created by bankers will depend, among other things, on the amount of notes that bankers hold against possible demands. A banker who has £10,000 in notes at his command would be running too great a banking risk if he advanced ten millions to the most unexceptionable customers against the most unexceptionable securities; for by doing so he would give them the right to take out ten millions in notes, and if even a thousandth part of the right were exercised, the banker's notes would all be gone. And since, as we have seen, Bank of England notes are bullion certificates, immediately convertible into gold for export purposes, we come back to gold as an element of great importance in the creation of banking credit. All this is perhaps a little premature in a chapter which purports to be dealing with cash transactions.

But the cheque, like the bank-note, is at once cash and credit, and it cannot be too early stated and understood that every credit operation implies a possible cash transaction, and that prudent banking consists in making due allowance for cash demands involved by the creation of credit.

CHAPTER IV

THE BILL OF EXCHANGE

HAVING reviewed the various forms of cash, or money here and now, for which goods and services are habitually exchanged, and for which the money market exchanges money some day or money somewhere else, we proceed to the bill of exchange, a versatile credit instrument which is often all these three forms of money in the course of its career. The complicated relations between the different kinds of money, and their habit of melting into another, are well exemplified when it is stated that the cheque, with which we are supposed to have already dealt, is actually nothing else but a bill of exchange, with which we now propose to deal.

But there is this difference. A cheque is a bill of exchange payable on demand. A bill of exchange, as we shall see, is an order from A to B to pay a sum either to himself, A, or to a third party, C. When it is payable forthwith it is a cheque and bears a twopenny stamp; when it is payable at a future date it is a bill of exchange and bears a stamp *ad valorem*, varying with the amount of the sum named. It is characteristic of monetary nomenclature, which seems to try to confuse matters by applying illogical

and confusing names, that the title "bill of exchange" should be given both to the genus and to one of the species into which it is divided. Another distinction exists in the eye of the law, from the fact that a cheque according to its legal definition, must be drawn on a bank, whereas a bill may be drawn on a bank but is also often drawn on a merchant or accepting house, or any debtor who gives his creditor the right to draw on him. The practice of the market-place, however, does not always follow the legal definition of the cheque, but applies the word to any bill payable on demand. The element of time is thus the real outstanding quality in the bill of exchange, which separates it from the cheque and justifies my reservation of it to a separate chapter apart from the forms of paper cash.

Logically, the reasons which included cheques under the category of cash would perhaps include the bill of exchange. Goods and services are constantly given in exchange for bills; and a good bill, drawn on a bank or firm in England—or any other country where gold is to be had readily—is convertible into gold. But it has to go through two important processes before it can be so converted. It has to be accepted, and it has either to be discounted or to await maturity.

The bill of exchange is of immemorial antiquity. "It is probable," says a great authority on its legal aspects, "that a bill of exchange was in its original nothing more than a letter of credit from a mer-

chant in one country to his debtor, a merchant in another, requiring him to pay the debt to a third person, who carried the letter, and happened to be travelling to the place where the debtor resided. . . . It was found that the original bearer might often with advantage transfer it to another, and the assignee was, perhaps, desirous to know beforehand, whether the party to whom it was addressed would pay it and sometimes showed it to him for that purpose ; his promise to pay was the origin of acceptances.”¹

It is obvious from this theoretical description of the early bill that it, like its modern descendant, was not immediately payable, since otherwise its bearer would most obviously and simply have tested the willingness to pay of the merchant on whom it was drawn, by presenting it for payment. Acceptance is nothing else than the promise of the party on whom the bill is drawn that he will pay it at due date ; and this acceptance he signifies by writing his name across the face of it. A cheque, in its legal sense, drawn on a bank, does not require acceptance, because its payment constitutes and includes its acceptance ; but a cheque, in the sense of a bill payable on demand, drawn on a firm which is not a bank, is often accepted.

It is rather astonishing to find the authority just referred to stating that there is no evidence that bills of exchange were in use among the ancients, though he refers to a passage in Cicero's letters

¹ Byles on Bills of Exchange.

which appears, to a lay mind, to establish the fact beyond doubt. Writing to Atticus,¹ Cicero asks him to consider whether the monetary requirements of his son at Athens can be provided by exchange operations, and it is interesting to see that the Latin phrase is a literal counterpart of the English—*permutari*. But although this passage is not sufficient evidence, from a legal point of view, that such a thing as a bill of exchange was used, it clearly proves the existence of some form of exchange machinery in Rome and Athens; and it is safe to assume that the acute and quick-minded Greeks exchanged credits against the goods that they bought and sold between their busy cities.

The precise age of the bill of exchange, however, is a question of merely antiquarian interest. We are now concerned with its meaning and the function that it performs in the monetary machine. It is legally defined as “an unconditional order in writing addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand, or at a fixed or determinable future time, a certain sum in money to, or to the order of, a specified person, or to bearer.”

Thus says the law. But, as we have already seen, a bill of exchange becomes a cheque, in practice and in the eye of the tax-gatherer, when it is payable on demand; and in the eye of the law likewise when it is payable on demand and drawn on a bank. So

¹ Cic. *ad Att.*, 12, 24.

that the distinctive part of its actual definition consists in its being payable at a future date. Further, though it may be an order drawn by one party on another in the same street, nevertheless, since trade consists largely in the exchange of goods between persons separated by distance, it is usual to find that bills of exchange are drawn by the merchants or financiers of one centre on those of another. In other words, time is a constant element in the composition of a bill of exchange, and space is a very usual one. When Sancho Panza had his ass stolen by a ruffian whom his master's chivalry had set free from the grip of the law, Don Quixote consoled him with a promise of a bill of exchange (*cédula di cambio*) for three asses out of five in his stable. As they were then wandering in the Sierra Morena, the elements of time and space were both present. The bill was duly drawn on Don Quixote's niece, and ran as follows :—

“ Dear niece,—At sight of this, my first bill of ass-colts, give order that three out of the five I left at home in your custody be delivered to Sancho Panza, my squire ; which three colts I order to be delivered and paid for the like number received of him here in tale ; and this, with his acquittance, shall be your discharge. Done in the heart of the Sierra Morena, the twenty-second of August, this present year——”

“ It is mighty well,” said Sancho, “ now you have only to sign it.”

“ It wants no signing,” said Don Quixote ; “ I

need only put my cipher to it, which is the same thing, and is sufficient, not only for three, but for three hundred asses.”

The draft was thus in many respects irregular ; apart from the fact, with which the priest consoled Sancho when he found that he had lost it, that “ one written in a pocket-book would not be accepted.” Nevertheless, this bill drawn in jest by Cervantes on posterity more than three centuries ago, is a very fair parody of its modern counterpart. Its verbiage, of course, has been left out, the bill of to-day being generally drawn with business-like brevity ; but it is a definite order to Don Quixote’s niece, signed by his cipher, to pay a stated number of asscolts, to Sancho, against value received from him at the place where the bill is drawn. The fact that this value received is wholly fictitious is not quite without parallel in modern practice. Modern practice, in its insatiable search for means of credit manufacture, has often found it convenient to create bills of exchange out of nothing, drawing them against aspirations or expectations or speculations. And cases have been known in which an attempt was made to give the “ kites,” or accommodation paper, so produced, an air of demure respectability by some reference to goods passing, as imaginary as the three asses which Don Quixote states that he has received from Sancho.

The original essence of a bill of exchange was that it was a claim for the payment of a debt, based on the moving of saleable produce to the place at

which it is expected to find a market. The custom which made it payable at a date subsequent to its arrival, and the arrival of the goods, was presumably arranged in order to give the merchant who received them, and owed the money for them, time to dispose of them and garner the proceeds. But his acceptance of the bill, or acknowledgment that he has to pay the money at its date of maturity, makes it immediately negotiable, or convertible into cash, by the process of discount, which will be explained later.

Let us take a concrete example, and simplify it by the elimination of many of the processes through which a modern bill actually passes.

Silas P. Watt, farmer, of Dakota, sells his wheat-crop for £2,000 to John Smith, of London, corn-dealer; John Smith sees no reason why he should pay for the wheat before it has been shipped, knowing that a month or two must pass before it has reached him, and been marketed and turned into money in his pocket. Silas P. Watt, on the other hand, sees no reason why, during all this interval, he should have parted with his wheat and should have nothing to show for it; and his banker or trust-manager, who has probably made an advance against it, is even more strongly convinced of the impropriety of such a proceeding. Consequently, thanks to the compromise which commerce has devised to meet this difficulty, Watt in Dakota draws a bill on Smith in London for £2,000 payable at sixty days' sight—that is, sixty days, *plus* three “days of

grace," after the bill has been accepted—and is able to give this bill to his bank or trust company to be realized in payment for the loan on his crop. The bank endorses the bill by signing its name on the back of it, and sends it to its agent in London, together with documents showing that the wheat has been actually shipped and insured against risks on the way, and on its arrival it is accepted by Smith, who writes his signature across the front of it to show that he acknowledges the indebtedness at the due date, and is given possession of the documents. It is thereupon, supposing Smith's name to be good and in sound credit, a negotiable instrument which can be discounted, that is, turned into as much ready cash as a promise to pay at a distant date is worth according to the current rate of interest. For example, if the £2,000 bill has still a month to run and the current rate of interest is 6 per cent. per annum, its present value will be decided by simple arithmetic to be £1,990.

This is a very simple example of the manner in which the bill of exchange facilitates trade by creating a piece of negotiable paper against a genuine trade transaction. Wheat was not wanted in Dakota, and is always wanted in London, and therefore its transfer from Dakota to London gives it value by putting it into the place in which it will fetch a price. The interval is bridged by the bill, which finances the transaction from its beginning to its end. When the bill falls due, if, as we may suppose for the sake of clearness, it has not been

discounted, Watt or his bank (to whom we suppose him to have passed it on) applies through his London agent for the money, and Smith, having in the meantime disposed of the wheat, has the necessary funds ready at his bank to meet his acceptance; the agent places the proceeds to the credit of the bank in London, to be used as it may direct. In actual practice, however, the bank's agent would probably have discounted the bill and so turned it into immediate cash on its arrival, and the bank in Dakota would already have sold drafts on London against it, to customers in America who had payments to make in England.

A bill, such as this one that we have imagined, drawn against the actual shipment of actual produce, and especially of produce of universal demand and immediate consumption, such as wheat, obviously possesses the great advantage of "paying itself," according to the common phrase in Lombard Street. The wheat comes to market and is sold, and cancels the debt created against it.

It thus begins to appear that the bill of exchange is not only a beautifully simple and efficacious device for financing commerce, but is also an ideal form of investment for bankers and others who are obliged by the nature of their business to keep their resources liquid, that is, readily convertible into cash.

For a genuine bill of the kind described pays itself automatically, as we have seen, at maturity, owing to the necessities of the community, which must

have wheat or perish, and a banker who invests his funds by discounting good bills has only to let some of his bills mature without replacing them, in order to replenish his store of cash. Bills drawn against wool, cotton, hides, and other raw materials of the principal industries which are turned into articles of universal consumption are, for practical purposes, equally good ; for the goods behind the bill, being certain of a market, and likely, if anything, to rise in value in time of war or political scare, secure the acceptor against the chance of being "locked up," as it is called, with an asset which he cannot realize.

It is this quality, inherent in a genuine bill, which gave rise to the saying that banking is the easiest possible business to conduct, when once the banker has grasped the difference between a bill of exchange and a mortgage. We have seen that the genuine bill of exchange is easily negotiable before maturity, and on maturity is cash by the sale of the goods on which it is based. A mortgage or loan against real property, houses and land, is by no means readily negotiable, since the two expensive processes of survey and examination of title are involved before it can be transferred, and the security behind it is the most difficult of all to turn into cash, especially at times of political or other disturbance. "You may buy land now as cheap as stinking mackerel," says Falstaff, when he brings news of Hotspur's rebellion.

But, as a matter of practical fact, a number of the

bills drawn are not of this genuine character, and the use of this admirable and efficient instrument of credit has been so extended, that the distinction between it and a mortgage on real property has sometimes been in favour of the latter, which has at any rate something behind it.

We have seen that the original justification of a bill of exchange arose from its being drawn against produce in the course of being marketed or being worked up into a state in which it would be more valuable, and that the bill bridged the intermediate period by providing the buyer and seller with an instrument that could be immediately realized. A very short step in advance of this arrangement led the dealers in exchange (or international money) to create bills at a time of year when no crops were ready to be drawn against, in order to make profits out of the provision of a form of remittance at these periods, and to cover themselves later on when the genuine produce bills began to come forward. Let us once more take a concrete case. In July, Silas Watt may want to make a payment in London for farming machinery; he has no crop to draw against as yet, but his bank will sell him a draft on London, having made arrangements with Smith, who is now grown from a merchant into an "accepting house," to accept bills drawn by it, for a consideration, against securities as well as produce. When Watt's crop is harvested, and a genuine bill on London is created by its sale, it will restore the American bank's credits in London, which were reduced by

the draft that it had provided to pay for Watt's machinery.

When John Smith is described as having grown from a merchant into an accepting house, he is supposed to have passed through a process which has been a fairly common experience. Like many other merchant houses, he has given up the actual handling and selling of merchandise, though retaining the title of merchant, which is highly honoured in the City, and is confining his attention to the profits which he can more easily earn, if his name be good enough, by placing his acceptance at the disposal of borrowers who want to draw on him. The arrangement that he has made with Watt's banker, and with many other dealers in bills of exchange in other parts of the world, enables them to draw on one another at any time, whether there be produce passing or no, and brings into being the instrument known as a finance bill. By this operation he and they create credit instruments which can be discounted and turned into cash, on the security of their names which are on the bills.

This system of creating bills of exchange, as long as they are created in anticipation of crop movements and other genuine processes by which products are given value by treatment and movement into the place where they are wanted, is quite legitimate, and tends, as will be explained in a later chapter, to steady the fluctuations in exchange, and to check unnecessary shipments of gold backwards and forwards across the hemispheres.

But having discovered that profitable business was to be done by creating bills in anticipation of movements of produce or manufactures, the enterprising spirits of the financial community were naturally impelled to go further, and create bills for the mere purpose of discounting them and so providing themselves with cash. As there was no moving produce in question, they were created against property that would be difficult of realization, such as landed estate, or against securities which might or might not be easy to sell, or merely against the credit of the creators, and all the varieties of bills so produced differ more or less essentially from the ideal form of bill of exchange, which, as we saw, paid itself on maturity by being drawn against actual movements of produce of general and rapid consumption. And there is often great difficulty in detecting from the appearance of a bill whether there be real produce behind it, or some other form of security, or nothing but the credit of the parties. Some bills carry on their faces a history of the whole transaction involved. The subjoined specimen, faithfully copied, with names altered, shows that Messrs. Laing, Mackay & Co., of Madras, the drawers of the bill, order John Smith & Co., a London accepting house, to pay to the Credit Bank of India £169 4s. 6d., against hemp shipped to Bremen in the steamship *Napoleon*. Laing, Mackay & Co. have probably sold the bill to the Credit Bank, and so provided themselves with funds for paying for the hemp. The bill is payable "three months

No. 406.

EXCHANGE FOR £ 169.4.6 Stg. *Madras*, 11th June 1908

Three months after sight of this first of Exchange
(second and third of same tenor and date not paid) pay to
the Credit Bank of India _____ or order

Pounds One hundred and sixty nine, shillings four, and pence six

Sterling, value received, and placed the same to account as advised.

Of 50 Bs. Hemp, per s.s. Napoleon to Bremen.

50 Messrs. John Smith & Co., LAING, MACKAY & Co.
London.

after sight ” ; as it is drawn in Madras on June 11, we may suppose that it arrives in London on July 1. It is probably sent to the London office of the Credit Bank of India, by which it is immediately presented to John Smith & Co. for acceptance. •They accept it by marking across it with a stamp—

ACCEPTED JULY 1, 1908.

PAYABLE AT THE CAPITAL & COUNTIES BANK, LTD.

and adding the signature “ John Smith & Co.” The bill is thus payable three months after July 1, with the customary three days of grace added, that is, on October 4. The bill is probably then discounted, that is, sold for cash, and on, or the day before, its due date the holder, whoever he may be, will pay it in, like a cheque, to his account at his own bank, which will collect the amount from the Capital & Counties through the Clearing House, and the Capital & Counties will debit John Smith & Co. The phrase which describes the bill as “ this first of exchange ” and orders its payment “ second and third of same tenor and date not paid,” shows that this is the original bill, and so the first of exchange. The “ second and third ” are the duplicate and triplicate of it ; the second of exchange is sent by another boat, as a precaution against delay, if the first should happen to go to the bottom of the sea, or be lost in the post. The third is generally retained by the drawer.

More often the bill takes a form like this:—

£2,000.

NEW YORK, *Sept. 3rd*, 1908.

At ninety days after sight of this FIRST of Exchange (SECOND Unpaid) pay to the order of Messrs. Jones.

TWO THOUSAND POUNDS STERLING,

Value received, and charge the same to a/c as advised.

To John Smith & Co. }
London.

EVANS & PUGH.

Evans and Pugh.

Experts in credit may be able to hazard a shrewd guess from the appearance of a bill, as to what is behind it. But the phrase “Value received” covers a multitude of mystery, and the difference between a genuine produce bill and a piece of finance paper is often difficult to detect. Finance bills being based on securities which are less readily realizable, especially in times of apprehension and uncertainty, than genuine produce of general demand, are obviously more likely to land their acceptors in difficulty if they have been accepting too many of them. And it is thus easy to understand why, when there was any strain on credit, Lombard Street used in bygone days to talk seriously about the number of finance bills that were passing. Since the war, however, finance bills have been discouraged and diminished.

Another class of bill that becomes unpopular when the market for credit is in a nervous state is the “house bill,” that is, the bill drawn by a firm or company on itself. If, for example, John Smith establishes his brother Robert in Oporto to finance

the port wine trade, and the Oporto Smith draws bills extensively on Smith in London, being merely an oversea branch of the same firm, the bills so drawn will not be as good as if they were drawn by one firm on another which is wholly distinct, and so carried behind them the credit and resources of two establishments. If this paper became too common, the watch-dogs of the credit organization would remark that there was too much Smith on Smith about, and would describe it, in its picturesque phrase, as mere "pig on pork."

The classical example of pig on pork is the order on Mrs. Micawber which Mr. Micawber gave to David Copperfield in the King's Bench prison. "Mr. Micawber," so David tells the tale, "was waiting for me within the gate, and went up to his room (top story but one) and cried very much. He solemnly conjured me, I remember, to take warning by his fate; and to observe that if a man had twenty pounds a year for his income, and spent nineteen pounds nineteen shillings and sixpence, he would be happy, but that if he spent twenty pounds one he would be miserable. After which he borrowed a shilling of me for porter, gave me a written order on Mrs. Micawber for the amount, and put away his pocket-handkerchief and cheered up."

David would have found some difficulty in inducing anybody to discount that bill, though doubtless Mrs. Micawber would have accepted it with a fine flourish, and with perfect confidence that "something would turn up" before it was presented.

Nevertheless its complete worthlessness has been paralleled before now in the world of commercial fact, when foreign firms have established branches, consisting of a clerk and an office boy, in England, and drawn bills on them, which have been accepted, of course, by the clerk, who had authority to sign for the firm by procuration, and have then actually been discounted and turned into cash.

Mr. Micawber has thus taken us a step further than Don Quixote. The Don drew a bill on this niece, whom he knew to be able and ready to meet it, in favour of Sancho, against a fictitious delivery by Sancho to him of three ass-colts. Micawber, in a debtor's prison, drew in favour of David on his wife, who was then in process of being sold up. He doubtless believed, nay was certain, that his paper was as good as gold. So do many others who draw on a branch establishment which possesses nothing but an office table ; and this Micawberish optimism is at the back of a good deal of the exuberant energy which makes trade hum in times of activity. And consequently when trade slackens, and folk begin to consider sceptically concerning the basis of the credit that has been built up during the humming period, there are sometimes some awkward moments of surprise and disillusionment.

The importance of the bill of exchange thus lies in a merit and a danger attached to it. The merit is the fact that in its genuine form it facilitates trade by creating credits and so supplying cash against real produce not yet marketed, and is also an ideal

form of investment for those whose investments must be liquid, or certain of easy realization. The danger is the ease with which it can be created against securities which may not be readily marketable, or by being drawn on firms by themselves, or by correspondents, in order to provide cash for speculative enterprise.

CHAPTER V

THE MANUFACTURE OF MONEY

HAVING reviewed the various forms of cash or money here and now, and the bill of exchange, which, from its ready negotiability and from its becoming cash on maturity, may be described as very nearly cash, we may pause and look back over the ground already traversed.

We saw that gold, with auxiliary tokens of silver and bronze, was, until 1914, the cash of the pocket for retail transactions, but that its use in big commercial and financial transactions was economized first by the use of bank-notes, and then, when the law laid restrictions on the use of bank-notes which prevented any increase in their issue except against an equal amount of gold, by the use of cheques. But we found that the general acceptability of notes and cheques arose from their being convertible into gold, which is the only form of payment that is universally and always acceptable in the economically civilized world.

The restrictions on the bank-note have practically eliminated note issues in England except that of the Bank of England note, which being legal tender and backed by the gold in the Bank's vaults is regarded as a bullion certificate just as good as

gold, and has become itself part of the basis of credit. That is to say, a banker who has Bank of England notes in his till is in a position to make advances to his customers on the strength of them. The money of modern English commerce and finance is the cheque, and the credit dealt in in the London money market is the right to draw a cheque. We have next to find out how this right to draw a cheque is created, and we shall find that it is generally created by an advance made by a banker.

Since the cheque is an order to pay coin or notes, it is sometimes assumed that all these orders which are turned over by the London bankers' Clearing-house, to an extent that sometimes runs up to over 270 millions a day, are orders drawn by folk who have acquired the right to do so by depositing coin and notes with the banks. And it is a common popular mistake, when one is told that the banks of the United Kingdom hold over 2,000 millions of deposits, to open one's eyes in astonishment at the thought of this huge amount of cash that has been saved by the community as a whole, and stored by them in the hands of their bankers, and to regard it as a tremendous evidence of wealth.

But this is not quite the true view of the case. Most of the money that is stored by the community in the banks consists of book-keeping credits lent to it by its bankers. It is usually supposed that bankers take money from one set of customers and

then lend it to other customers ; but in most cases the money taken by one bank has been lent by itself or by another bank.

It will be remembered that when we were tracing the origin of the bank-note, we drew up an imaginary and simplified balance-sheet of a note-issuing bank showing—

Due to depositors	£10,000	Cash in hand . . .	£10,000
Notes outstanding	40,000	Advances to cus- tomers . . .	40,000
	<u>£50,000</u>		<u>£50,000</u>

In order to simplify the matter, we left out the bank's capital reserves, investments, and other items which appear in balance-sheets, but, now that we have come to the point at which the manufacture of the right to draw cheques has to be made as clear as may be, it will be better to come into closer touch with the facts of the case and look at a bank balance-sheet of to-day. In order to get a fair average specimen I have taken the latest available balance-sheets of what are now known as the Big Five banks, and put their figures together. But before we can consider them it will perhaps be safer, in the interests of clearness, to try to arrive at some rough notion of the meaning of a balance-sheet.

A balance-sheet is a statement showing on the left side the balances of the amounts that have been received, or are owing, by the company or

firm that issues it ; and on the right side the amounts that have been paid out by it, or are owing to it, or are held by it. On its left side are the liabilities, on the right the assets. If you are not well versed in these mysteries you will probably be astonished to see the banks' capital among their liabilities ; but reflection will show that the capital was subscribed to the companies by their shareholders, to whom they have to account for it, and was invested in the assets on the other side.

After this introduction to balance-sheets in general, let us examine the aggregated specimen that I have drawn up.

	Millions of £.		Millions of £.
Capital paid up . . .	64	Cash in hand and at the Bank of Eng- land	208
Reserve Fund . . .	52	Cheques in course of collection, etc. . .	66
Current and deposit accounts	1,665	Loans at call and short notice . . .	149
Acceptances and en- dorsements on be- half of customers . .	206	Bills discounted . . .	231
Profit and Loss ac- count	7	Investments	234
		Loans and Advances	869
		Liability of customers on acceptances, etc.	206
		Premises	31
	<hr/> <hr/>		<hr/> <hr/>
	1,994		1,994

The above statement does not include the figures of the Bank of England, but is an agglomeration of

the balance-sheets of the five biggest ordinary joint-stock banks—Barclays, Lloyds, Midland, National Provincial, and Westminster.

The first feature that strikes the casual observer is the smallness of the paid-up capital of the banks when compared with the vastness of the figures that they handle. We see that only 64 millions out of the 1,994 that they have to account for have been actually paid up by shareholders, though 52 millions have been retained out of past profits and accumulated in reserve funds, and 7 millions are due to shareholders, for distribution as dividend or to be carried forward, in the profit and loss account balance. It thus appears that a narrow margin of profit on their total turn-over enables the banks to pay good dividends, and that the business of credit manufacture earns its reward, as might be expected, out of the credit that it makes.

Proceeding in our examination, we see that the item of acceptances and endorsements on behalf of customers on one side is balanced by the liability of customers on acceptances, etc., on the other. This means that the banks have accepted or endorsed bills for their customers (so making them first-class paper and easily negotiable), and are so technically liable to meet them on maturity; but since the customers are expected to meet them, and have presumably given due security, this liability of the customer to the bank is an off-setting asset against the acceptance. The acceptance and endorsement

business done by the banks has grown rapidly in recent years, but a bank's liability under it is not a liability in quite the same sense as its deposits, and since it does not immediately affect the present question of the manufacture of currency, it may be omitted for the present. We can thus simplify the balance-sheet by taking out this contra entry on both sides.

Further analysis of the liabilities shows that the capital, reserves, and profit and loss balance may be regarded as due from the banks to their shareholders, and that the remaining big item, current and deposit accounts, is due to their customers. This is the item which is usually spoken of as the deposits according to the tiresome habit of monetary nomenclature which seems to delight in applying the same name to a genus and one of the species into which it is divided. Just as the bill of exchange is divided into cheques and bills of exchange, so the banks' deposit accounts are divided into current and deposit accounts. But most people who have a banking account know the meaning of this distinction. Your current account is the amount at your credit which you can draw out, or against which you can draw cheques, at any moment; your deposit account is the amount that you have placed on deposit with the bank and can only withdraw on a week's or longer notice (unless you really needed it at once, in which case, you would have to pay something for taking it); it earns a rate of interest, usually 2 per cent. below the Bank of

England's official rate. The essential point to be grasped is the fact that the banks' deposits, as usually spoken of, include both the current and deposit accounts, and are due by the banks to their customers.

Now let us see how this huge debt from the banks to the public has been created. An examination of the assets side of the balance-sheet proves that most of it has been created by money lent to their customers by the banks, and that the cheque currency of to-day is, like the note currency of a former day, based on mutual indebtedness between the banks and their customers. For the assets side shows that the banks hold 274 millions in cash in hand at the Bank of England in course of collection, etc., 234 millions in investments, and 31 millions invested in their premises—the buildings in which they conduct their business—and that 1,249 millions have been lent by them to their customers, either by the discounting of bills or by advances to borrowers, or by loans at call or short notice. This last item is generally described in bank balance-sheets as "money at call and short notice," but it has been lent, in most cases, to bill brokers, whose functions will be described later; and though more readily called in than the advances to ordinary customers, it has nevertheless been lent, and so seems to be hardly money in the ordinary sense of the word. We can now reconstruct our balance-sheet, leaving out the acceptances on both sides, as follows:—

	Millions of £.		Millions of £.
Due to shareholders . . .	123	Cash in hand, etc.. . .	274
Due to customers . . .	1,665	Investments	234
		Premises	31
		Due from customers . . .	1,249
	<hr style="width: 100px; margin: 0 auto;"/> 1,788 <hr style="width: 100px; margin: 0 auto;"/>		<hr style="width: 100px; margin: 0 auto;"/> 1,788 <hr style="width: 100px; margin: 0 auto;"/>

And it thus appears that just three-quarters of the amount due from the banks to their customers are due from their customers to the banks, having been borrowed from them in one form or another. And this proportion would perhaps be exceeded if we could take the figures of English banking as a whole. But that cannot be done at present, because some of the smaller banks do not separate their cash from their loans at call in their published statements. The greater part of the banks' deposits is thus seen to consist, not of cash paid in, but of credits borrowed. For every loan makes a deposit, and since our balance-sheet shows 1,249 millions of loans, 1,249 out of the 1,666 millions of deposits have been created by loans.

To show how a loan makes a deposit, let us suppose that you want to buy a thousand-guinea motor-car and raise the wherewithal from your banker, pledging with him marketable securities, and receiving from him an advance, which is added to your current account. Being a prudent person you make this arrangement several days before you have to pay for the car, and so for this period the bank's deposits are swollen by your £1,050,

and on the other side of its balance-sheet the entry "advances to customers" is also increased by this amount, and the loan has clearly created a deposit.

But you raised your loan for a definite purpose, and not to leave with your bank, and it might be thought that when you use it to pay for your car the deposit would be cancelled. But not so. If the seller of your car banks at your bank, which we will suppose to be Barclays, he will pay your cheque into his own account, and Barclays bank's position with regard to its deposits will be unchanged, still showing the increase due to your loan. But if, as is obviously more probable, he banks elsewhere—perhaps at Lloyds—he will pay your cheque into his account at Lloyds bank, and it will be the creditor of Barclays for the amount of £1,050. In actual fact, of course, so small a transaction would be swallowed up in the vast mass of the cross-entries which each of the banks every day makes against all the others, and would be a mere needle in a bottle of hay. But for the sake of clearness we will suppose that this little cheque is the only transaction between Barclays and Lloyds on the day on which it is presented; the result would be that Barclays would transfer to Lloyds £1,050 of its balance at the Bank of England, where, as we shall see in a later chapter, all the banks keep an account for clearing purposes. And the final outcome of the operation would be that Barclays would have £1,050 more "advances to customers" and £1,050 less cash at the Bank

of England among its assets, while Lloyds would have £1,050 more deposits and £1,050 more cash at the Bank of England. But the £1,050 increase in Lloyds' deposits would have been created by your loan, and though it will be drawn against by the man who sold you the car, it will only be transferred, perhaps in smaller fragments, to the deposits of other banks; and as long as your loan is outstanding there will be a deposit against it in the books of one bank or another, unless, as is most unlikely, it is used for the withdrawal of coin or notes; and even then the coin and notes are probably paid into some other bank, and become a deposit again; and so we come back to our original conclusion that your borrowing of £1,050 has increased the sum of banking deposits, as a whole, by that amount.

The same reasoning applies whenever a bank makes a loan, whatever be the collateral, or pledge deposited by the borrower, whether Stock Exchange securities, as in the case cited, or bales of cotton or tons of copper; or, again, whenever it discounts a bill. In each case it gives the borrower or the seller of the bill a credit in its books—in other words, a deposit; and though this deposit is probably—almost certainly—transferred to another bank, the sum of banking deposits is thereby increased, and remains so, as long as the loans are in existence. And so it appears that the loans of one bank make the deposits of others, and its deposits consist largely of other banks' loans.

Even when a bank invests in Stock Exchange securities, the same result happens—an increase in its own or some other bank's deposits. When a bank invests it will buy the security through a stockbroker, who will have an account with it, and it will pay him for the stock by crediting his account with the amount required, which we will suppose to be £500,000. So far, the effect of the transaction is that the bank's assets have been increased by an addition of half a million to its investments, while its deposits are also half a million higher. But the broker immediately draws a cheque, to pay for the stock, in favour of the dealer—or jobber as he is more usually called—in the Stock Exchange from whom he bought it, and the jobber will pay a cheque to the broker from whom he bought, who will pay a cheque to the client who was the original seller. All these cheques between intermediaries will roughly cancel one another out, apart from small differences in the prices at which the stock changed hands and additions and subtractions for commissions, contract stamps, etc. It is also probable that the half-million bought by the bank, which we will call the Midland, was composed of many rivulets of small sales, and that many accounts would be affected before the bargain was paid and quitted. But in order to simplify the example we will suppose that the whole half-million was sold by an insurance company, and that it pays a cheque, for half a million or thereabouts received for it, into its account

at (let us say) the Westminster Bank. Then the final result will have been that by the payment made by the Midland's broker, drawn on the credit which had been added to his account, the Midland's deposits will be left unchanged on balance, while half a million will have been transferred from the Midland's balance at the Bank of England to that of the Westminster, which will also have had its deposits increased by half a million. The Midland will show half a million more investments and half a million less cash at the Bank of England, and by its purchase it will have increased the deposits of the Westminster, which will show a corresponding increase in its assets through an addition to its cash at the Bank of England, drawn from that of the Midland.

A shrewd and sceptical bank manager, however, with a healthy mistrust for theorizing, objected, when this aspect of the case was put before him, that, as a matter of practical fact, the stock bought would not have come from a genuine holder, but out of the jobber's store carried on money borrowed, which would be paid off as the result of the bargain. If that were so, the credit created by the Midland's purchase would be balanced by the cancellation of the credit created by the jobber's bank, and there would be no addition to deposits. In this case, a loan would have been paid off without the cancellation of a deposit, which would otherwise have happened, so that the Midland's purchase would in fact have prevented the aggregate of

deposits from being reduced, which is very much the same as increasing them. Moreover, it seems probable that the jobber whose stock in trade was thus reduced, would restore it by buying more securities on which he would borrow, and so bring about the actual increase in deposits which was supposed. Since the stocks of securities held by jobbers on borrowed money may be assumed to be fairly constant, it may be taken as a general rule that when banks buy securities they are increasing deposits, and, even when they do not do so, they are preventing their reduction, which would have happened if the securities had come "out of pawn" into the hands of genuine holders.

The manufacture of money is thus more difficult to follow under the system of banking by deposits and cheque-drawing than in the old days of note issue. When notes were the currency of commerce a bank which made an advance or investment or discounted a bill, gave its customer its own notes and created a liability for itself. Now, a bank makes an advance or investment or discounts a bill, and makes a liability for itself in the corresponding credit in its books; but this liability is in most cases almost immediately acted on and drawn against, and so transferred to another bank by being paid in as a deposit in the shape of a cheque on the lending or investing bank. This cheque gives the bank which receives the deposit the right to so much of the lending bank's balance at the Bank of England, and the average result of the

vast mass of credits so created and transferred roughly balances itself.

In order to try to see the process at work, let us take out all the loans, discounts, and investments from the balance-sheet on page 56, and the corresponding deposits, and then build them up again. Their excision would leave the balance-sheet, simplified in other respects, thus—

	Millions of £.		Millions of £.
Capital and reserves .	116	Cash in hand, etc. .	274
Profit and loss . .	7	Premises	31
Current and deposit accounts	182		
	<u>305</u>		<u>305</u>

If, next day, each of the five banks lent ten millions and invested two millions which were drawn against and paid into one or other of the five, the aggregate of cash in hand and at the Bank would be unaltered, and the aggregate deposits would be increased by sixty millions, which would be represented by loans and advances on the other side, thus—

	Millions of £.		Millions of £.
Capital and reserves .	116	Cash in hand, etc. .	274
Profit and loss . .	7	Investments	10
Current and deposit accounts	242	Loans and advances .	50
	<u>365</u>	Premises	31
	<u>365</u>		<u>365</u>

And so the process could be continued till we arrived at the actual figures originally shown. The supposition that the operations would result in transfers between the five banks, and not to any of the others, makes our example look artificial, though if we could get an aggregate balance-sheet for all the banks, this supposition would be fact, though complicated by possible withdrawals of coin and notes, which would, however, be a small fraction of the total transferred, and most of which would ultimately find their way back to the banks.

But perhaps we can make the matter clearer by eliminating the question of other banks, and their action and reaction on one another's position. Let us take the case of a little local bank with a complete monopoly of the banking business of a country town, in which it lends to every one who is in a position to borrow, and takes the deposits of every one who has a banking account. And let us suppose that this community is completely isolated, as far as money matters are concerned, from the rest of the country. We may draw up an imaginary and simplified balance-sheet for the bank as follows :—

	£		£
Capital . . .	100,000	Cash in hand . . .	200,000
Deposits . . .	1,500,000	Investments . . .	400,000
		Discounts and advances . . .	1,000,000
	<u>1,600,000</u>		<u>1,600,000</u>
	<u>1,600,000</u>		<u>1,600,000</u>
M.M.			F

With these small and simple figures before us, and the conception in our minds of the small and compact community whose banking business they represent, it is easy to see the whole thing at work in imagination. The little town could not have deposited £1,500,000 without advances from the bank because there never was such a sum in the place. It has presumably deposited £100,000, since the bank holds £200,000 in cash, of which £100,000 may be taken as having been contributed by the subscribers of its capital. The rest of the deposits have been provided by the bank itself which, on the strength of its £200,000 of cash, has discounted bills for the local paper-mill and chair factory, and made advances against any securities or commodities that its customers had to borrow on and it considered good collateral, and has also given credits in its books for £400,000 against securities bought by it.

The borrowers have generally been the producing, manufacturing, and trading classes, who have discounted bills and taken advances in order to finance themselves over the periods that necessarily elapse between outlay and realization in their various enterprises. This does not mean that their trade is unsound. They are earning regular profits ; but before one profit is garnered they are at work in search of another, and borrowing the wherewithal to seek it ; and by meeting their demands the bank is fulfilling the obvious and most useful business of a bank in financing production and industry. The

land-holding, investing, and professional classes, who live ultimately on the producers and distributors, taking toll from them in the shape of rent, interest, and fees, probably do most of the depositing, paying back to the bank the cheques that they receive, drawn by those who acquired the right to draw by a discount, loan or overdraft. Part of the loans raised by the producers and distributors will be drawn out in coin for the payment of wages, and will work their way round, through the tills of the shopkeepers, back to the bank, when the shopkeepers pay in ; for the retail dealers necessarily, from the nature of their trade, habitually deposit a considerable amount of currency with their bankers, while other people generally deposit cheques. And thus it appears that the banking credits provided by the bank for one set of customers, in the shape of loans and discounts, come back to it from another in the shape of deposits created by the loans and discounts.

In this case we see that a bank in this exceptional and monopolist position can, on a small cash basis, create, by discounting bills and making loans, the right to draw cheques, confident in the expectation that the cheques drawn by one customer will be paid into it by another ; or that, on the rare occasions on which the right to draw is used by withdrawals of actual coin or notes, the coin or notes will find their way back to it, being deposited with it by those who receive them. And when its loans are repaid, or bills that it has discounted

are met on maturity, this can only be done by the customers who have borrowed from it or taken bills to it for discount, paying it with a cheque on itself, and so cancelling a deposit; or perhaps by paying it in coin or notes, which they will get from some one who has cancelled a deposit in order to withdraw them. And so its loans and discounts create deposits when they are entered on, and cancel deposits when they mature, though in actual practice their place would more probably be taken by fresh loans or discounts.

From this parable of a little bank in an imaginary isolated community we can see how an exactly similar process works in English banking as a whole, though in its case the question is complicated by transfers from one bank to another. The historical evolution of the business tells the same tale. Banking in its note-issuing stage lent currency to its customers in the shape of its promissory notes, and had on the assets side its loans, and in the liabilities, its notes outstanding. It manufactured notes which it lent. Now, it manufactures credits in its books, and current and deposit accounts have taken the place of notes outstanding on the debit side of its balance-sheets.

It cannot conduct this manufacture without the assistance of its customers, and it may be contended that these banking credits are manufactured, not by the banks, but by the customers who apply to them, and by the security that the customers bring, and the bankers approve of, as fit collateral. It

is certainly true that the banks cannot make advances unless somebody asks for them, and their capacity for doing so thus depends on the needs of the community, and also on the supply of unpledged property that the community has available as security. Whether the manufacture be conducted by the banks or by their borrowing customers is a question of little moment, as long as the fact is grasped that the greater part of the deposits shown in bank balance-sheets have been brought into being by means of book-keeping credits—whether in the form of discounts, advances, or overdrafts—granted by banks to customers, and passed on by these customers to others.

The broad conclusion arrived at is that banking deposits come into being to a small extent by cash paid into banks across the counter; to a larger but still comparatively small extent by purchases of securities by the banks which create book credits; and chiefly by loans from the banks, which also create book credits.

There is nothing alarming in this conclusion, though people who have been accustomed to regard bank deposits as so much cash paid in are sometimes startled when the other side of the matter is put to them, and feel that banking credit is a kind of questionable conspiracy between banks and their customers. A little reflection shows that it is a beautiful piece of evenly working mechanism, by which coin is economized and a perfect currency is provided with extraordinary ease and cheapness.

Nor need any sense of disillusionment be felt when it is realized that bank deposits, in so far as they are borrowed, are evidences of indebtedness quite as much as of wealth.

Everybody knows that in all long-established, well-ordered and industrious communities vast stores of wealth are accumulated ; and even if they could be heaped up in banks and expressed in figures nothing would be gained by the information. But the contemplation of this mass of indebtedness, and of the cheque currency with which it is passed from hand to hand, is novel, stimulating and unique. It is a wondrous example of human ingenuity applied to the cheapening and furtherance of trade, finance and speculation, and its development has only been rendered possible by the confidence, based on solid experience, of the majority of Englishmen in one another's commercial probity, and readiness to carry out a contract at all costs.

The only defect in the system is its perfection. English banking has been so ably and successfully conducted, and has moved forward so steadily, especially since the foundation of the great joint-stock banks and the publicity which their establishment made necessary, that it sometimes becomes difficult to realize that banking is not merely a matter of quickening the wheels of commerce with a plentiful supply of credit when trade is prosperous, checking the growth of credit when it outgrows its cash basis, writing off a few bad debts occasion-

ally, and, year in and year out, making splendid profits by lending people the right to draw cheques, on the assumption that nearly all the cheques so drawn will be cancelled against one another, and will never involve a demand on the banks for legal tender cash. To the modern generation of bankers, to whom such a thing as a run on an English bank is a matter of tradition, a mere echo of a bad old past which is gone for ever, banking is sometimes a little apt to present itself as the simple process described above. But the thoughtful bankers, that is the great majority of the wary, cool-headed men who carry on this curious and magical business of providing currency and credit on a basis of mutual indebtedness between themselves and their customers, know well enough that there is another side to the question. Just as a man cycling through a crowded street depends, for his life, not only on his own skill but also on the care with which the rest of the traffic is driven, so the English banking system is dependent on the sanity and sense of the public as much as on its own soundness.

This dependence of the banks on the sanity and sense of the public arises out of the fact that bank deposits are payable in cash, either on demand, or in theory at a week's notice; and even the deposits at notice are practically liabilities on demand, because if anyone who had money deposited at notice wanted it suddenly, a banker would find it very difficult to refuse to let him draw it. Hence it follows that if the public, or a

considerable portion of it, became suddenly bereft of sense and sanity to a sufficient extent to make it want to take its money out all at once, the position of the banks would be uncomfortable, if they were not amply provided with legal tender cash, and so able to quell the outbreak by meeting its first demands with a bold front.

It might appear that since bank deposits, as has been demonstrated, are largely created by credits given by way of loan or discount, any bank which happened to be subjected to the inconvenience of a run would only have to call in loans from its debtors to meet the demands of its depositors. But the matter could not really be settled by this simple method, in the first place because banks habitually make loans for fixed periods, but have to meet liabilities, as we have seen, on demand; and, in the second, because in the case of a panic severe enough to cause a run on a bank, a large number of its debtors would almost certainly be obliged to admit their inability to repay their advances. The bank would find itself reduced to the unpleasant predicament of having to try to realize the securities or commodities, or other collateral pledges, against which the loans had been granted, and in the state of panic which our hypothesis postulates would find it extremely difficult to do so, and would probably find it impossible to do so as rapidly as demands were pressed upon it.

Moreover, since we have already seen that the

loans of one bank create the deposits of another, the attempt by one to call in its loans would inevitably cause pressure on the deposits of the others, and so the evil would swell and spread in a vicious circle. There is, however, no need to dwell on the possible horrors of a general banking panic, which is almost inconceivable under modern conditions. So much had to be said in order that the tremendous obligation might be realized which lies behind this business that is conducted so smoothly and easily, and that some appreciation might be gained of the responsibility that is faced by the affable and imperturbable gentlemen who conduct it. And it was also necessary to bring the skeleton out of the banking cupboard in order to emphasize the stern necessity for unceasing vigilance on the part of the banking world in the matter of its first weapon of defence against an outburst of public insanity which might start an importunate demand for cash from its bankers.

For in this matter the public and the banks act and react on one another, and the public is much less likely to be bitten with a mania for hoarding its money instead of leaving it in banks, if it knows that the banks are strong enough to meet a sudden demand without flinching. And hence it follows that, by keeping a strong line of defence in the shape of legal tender cash, the banks can do much to prevent the danger from arising, against which it is intended to protect them. Just as we saw that the note-issuing banks ran serious risks when

they made advances in the form of their own notes without due regard to a store of metallic cash in which to meet their notes when presented, so the modern cheque-making banks have to keep an adequate proportion of legal tender cash against the right to draw cheques that they lend to their customers or become liable to by other means.

If it were not for the fact that the credits which they lend represent the right to draw cheques payable on demand, the extent to which they could lend would be only limited by the demands of their customers, and the amount of security that their customers could provide. But this all-important fact makes the question of an adequate cash reserve against their liabilities an essential factor in the problem.

This reserve of cash consists of the Bank of England notes that they have in their tills and in their vaults, and their balance at the Bank of England ; it is the first line in the assets side of the balance-sheet, " cash in hand and at the Bank of England." On the other side, among the liabilities, we saw the entry " current, deposit and other accounts," and, if you work out the proportion of cash against those liabilities, you will see what is the proportion which the banks, whose position is there displayed, think it right and proper to keep.

There is no hard and fast rule on the point in England, and it would be absurd if there were, for the circumstances of banking business differ so widely, that what is a barely adequate proportion

for one would be wastefully excessive for another. Good banking consists in giving as much assistance as possible to trade in the matter of credit, but ceasing to expand credit as soon as the proportion between cash and liabilities touches the lowest point at which prudence and caution require that it should stand. This is the happy mean that the banker has to find. The exact point at which the mean stands is a matter which he is best able to judge ; and though the desire to earn big dividends and the pressure of competition are strong incentives to him to place his ideal proportion too low, on the other hand the fine traditions of English banking and the wholesome dread of criticism, and of the moods of the multitude, are eloquent arguments in favour of wisdom and caution.

Good banking is produced, not by good laws, but by good bankers. Just as the most carefully planned constitution will inevitably break down if the men at the helm of government are incompetent or dishonest, so no skilfully devised banking system will make banking good, unless the banking is conducted by straight and able managers, or defend banking from suspicion by its customers, if other wheels in the financial machine have been proved to be unsound.

In the United States, before the Federal Reserve system was established, the national banks in the chief cities were compelled by law to keep a cash reserve equal to twenty-five per cent. of their deposits, and were liable to inspection by Govern-

ment officers whose business it was to see that the cash was duly there. And yet, the panic of the autumn of 1907 saw the banks of the United States obliged to suspend payment because of mistrust on the part of the American public, which would have withdrawn most of its cash if the banks had not adopted the simple expedient of refusing to pay it. This mistrust was no doubt exaggerated, and in the case of most of the American banks was wholly unwarranted. But Americans, in discussing the matter, generally admitted that it had a certain amount of basis. The mere fact of legal regulation of the amount of cash probably made the banks in America less careful with regard to the nature of the rest of their assets.

But the American monetary system, as will be shown in a later chapter, has been so radically altered by the establishment of the Federal Reserve banks, that the events of 1907 are now interesting only *from an historical point of view, as showing that a legally imposed proportion of cash to deposits is, under certain conditions, no protection against panic.

In England, where the law imposes no rules on bankers in this matter, the public feels assured that its money is protected by the integrity and ability of those to whom it is entrusted. As long as this confidence lasts, all is well ; but anyone who trades on public confidence has not only to merit it, but also to provide for any accident that might arise if, in spite of his meriting it, the public were to with-

draw it owing to some mistake on its part. Hence bankers have to be constantly alive to the necessity of keeping their position strong.

And though, owing to the consolidation of the banking position that has taken place in late years, the question of the cash holding is less important than it was; an adequate proportion of legal tender cash to liabilities is still a very necessary jewel in a banker's crown. And legal tender cash means gold or Bank of England notes. Gold no longer circulates, but as Bank of England notes, above a certain number, can only be issued against gold, we come back once more to gold as an important part of the basis of credit.

Bankers' credit, as we have seen, consists of advances given to customers against goods or securities, and to that extent the goods and securities may be said to be the basis of credit. But since prudent banking demands that the extent of credits given must depend on the amount of the bank's legal tender cash, and that is gold, or, more probably, Bank of England notes, the amount of gold that is available in the hands of the banks, or of their bank, the Bank of England, is an important influence on the supply of credit.

Nevertheless, this dependence of the money market, and of the City as a whole, and of the supply of money for all of us on the amount of gold available, has lately been a subject of much criticism, and will have to be discussed later. For the moment it is enough to say that the money market

wants gold because gold is the only universally acceptable form of international payment. By linking our money to gold we also link it to the money of all the other gold-using countries. And this statement leads us to the door of the international money market.

CHAPTER VI

THE WORLD'S MONEY MARKET

SO far money has been dealt with chiefly as a matter of internal experience, and from the point of view of the relations between the Englishman and his banker. In the account given of the origin and development of the bill of exchange the horizon was expanded for a time, but otherwise our attention has been concentrated on the forms of cash with which we English buy and sell commodities and services, and the process by which these forms of cash and the right to draw and use them, are created by our bankers and their customers, through loans against goods and securities.

But the money market is a very much bigger and more interesting affair than it appears to be from this merely insular examination. It is, in fact, the most interesting of all markets, because it is world-wide to a greater extent than the market in anything else, with the possible exception of wheat. And in the international money market an immense revolution, the effects of which we are only just beginning to see, has been wrought by the war, and the great westward shifting of wealth that it caused.

The use of money in cash transactions is obviously

world-wide ; wherever men buy and sell they must use some medium of exchange which is commonly accepted in their country, even though it be only an inconvertible paper dollar printed at the caprice of a Central American Republic. But money in its wider sense, in the sense of bankers' credits, is also a matter of world-wide use, or at any rate demand, and international monetary affairs have been profoundly modified by the rising in the western sky of a brilliant if somewhat erratic constellation, the American money market. When I wrote this book in 1908, the following passages, now dead as Queen Anne, were as true as I could get them :—

It is only in London that money of this kind is to be had freely, and in the fullest meaning of its real definition, which implies, as we have seen, the right to demand, and the certainty of receiving payment in gold.

It is clear that in order to be of any use in international finance, money must be immediately and unquestionably convertible into gold, the only form of payment which is universally and always acceptable in economically civilized countries. And money of this kind is only to be had in London.

In a pleasant American comedy produced very many years ago, one of the characters, holding out a bundle of papers to her husband, exclaims, "What's this? You said you'd give me some money!" "That's so," says the husband, "and so it is. Why, it's Wabash!" Wabash was the name of a railroad stock of somewhat problematical value, and quite useless as a medium of exchange for the purposes of household shopping. And anyone who has a credit in any other centre but London, is liable to find himself, when he

tries to realize it and turn it into cash, met by an offer of Wabash, or something equally inconvenient for his purposes.

The French are clever and versatile financiers, and the unflinching thrift which distinguishes the inhabitants of their country gives it a great and almost insatiable power of absorbing investments, so that Paris is a very important factor in the international loan market. But the French temperament is essentially cautious, and the Bank of France does not attempt to do the business that we regard as banking, which includes readiness to meet all demands in gold. Its notes are convertible, but convertible at its option into either gold or silver; and it frequently takes advantage of this option when it considers it undesirable to part with its gold. So that anyone who has a credit in Paris has a credit which is of no international value, except in so far as he can make use of it, by means of the machinery of exchange, to buy a credit in London which is convertible as a matter of course.

In theory Berlin has a gold standard, and the notes of the Imperial Bank are theoretically payable on demand in gold. But Germany is young as a financial nation, and its banks have been so busily and deeply engaged in promoting the industrial activities of the country that their resources and energies have been hitherto absorbed by this task, which they have performed with great success. Consequently they have not yet addressed themselves to this question of international banking and of being prepared to meet all demands on them in gold; and anyone who wants to draw on the Imperial Bank's store to any large extent is likely to find obstacles and difficulties in his way, and is moreover likely to be met with a most discouraging countenance when next he requires accommodation. With the store of sagacity and scientific method that it has available, it is probable enough that Berlin may one day rise to the full responsibilities of a monetary centre, ready to face the real tasks of the international banker. At present, it is chiefly engaged with the solution of internal problems.

In New York the right to gold is less ostensible, but in

ordinary circumstances more practicable. A credit in the United States carries with it the right to legal tender currency, and the general probability of securing what is called a gold certificate and turning it into the metal. But in the autumn of 1907, the whole American system broke down, and an interesting form of emergency currency, created to fill the gap caused by an outbreak of hoarding on the part of both the public and the banks, became the only available medium of exchange. It took the form of "clearing-house certificates" issued by the American banks, but whatever else they certified, it was not a certainty, or even a chance, of obtaining gold.

It is a cherished ambition among Americans to see New York some day established as the monetary centre of the universe, and with their vast natural resources and population there is no doubt that the United States can achieve any material tasks that they choose, if they can learn the necessary lessons and develop the necessary character. At present the characteristics of the typical American business man seem to fit him to do most things better than banking. His haste to grow rich, his eager enthusiasm and buoyant optimism followed by plunges into apprehension and depression, his quickness and versatility, his keen sensibilities, his craving for speculative excitement, and his genius in exaggeration—all these qualities make him an excellent producer, a first-rate distributor, a miraculous advertiser, an unapproachable gambler, and a somewhat questionable banker. There are hundreds of good bankers in the United States, who take a scientific interest in the problems of their business such as is comparatively rare among their English brethren. But they are developed in spite of their environment, and of the atmosphere of eager enterprise which makes it difficult to observe the humdrum laws and limitations of banking.

In 1907, the American banks were so strongly suspected by their own public of having made indiscreet use of their opportunities and capacities, that the public preferred to take care of its own money. And American banking met the

situation by refusing to meet demands on it. Banks that can be so suspected by their own public, and can meet the suspicion in such a manner, have much to do and undo before they can constitute themselves into an international banking centre. . . . When it has lived down this lapse, and provided the confidence that is now lacking, and the necessary machinery of a discount and money market, American banking may set about making New York the monetary centre of the world. And an American can learn anything, if he thinks it worth while.

Some of the smaller centres meet drafts on them in gold, but their limited resources limit their powers. Practical financiers of all nationalities will admit that a draft on another centre is only valuable from the international point of view from the readiness with which it can be turned, through the machinery of exchange, into a draft on London, which is the real cash of international commerce and finance, because money in the real sense of the word, gold or its equivalent, is only to be had, always and without question, and to any amount, in London.

“ These things,” to vary Hamlet slightly, “ were sometime a truism,” but the effects of the war have wiped out their veracity, as an elephant wipes out an ant on which it treads. New York has arisen, an international money power with immense resources behind it, equipped with brand-new machinery, devised after years of research, in the light of the experience and mistakes through which other countries have fumbled their way. Berlin is still under the shadow of a currency collapse which divided the value of the mark by millions, and of a Reparations problem which an international committee is now believed to have solved. France, having seen the value of the franc divided

roughly by ten, has now stabilized it at about one-fifth of its pre-war value as measured in pounds and dollars and is pulling herself together to resume her place as a great—probably greater than ever—financial centre. London's dominion in the international money market is already shared by New York, and seems likely soon to be shared by Paris and possibly also by Berlin.

And so this market, once largely controlled by London's beneficent dominion—beneficent because it knew that beneficence paid—bids fair to be in the hands of several masters. Will they be able to work together and give the world what it needs for steady and expanding production and trade, that is, money reasonably stable in price and buying power? It is an immensely important question, and all the more interesting because, as we shall see later on, there are now many people—some of high authority, some merely vociferous—who challenge the gold standard as an obsolete convention, and want to give us a new monetary heaven and earth. If the new oligarchy cannot pull together and give us the good money that we want, there will be worse than wigs on the green, while the reformers are fighting out the question of a substitute. In the meantime, let us look a little more closely at the powers and aptitudes of the new stars.

America comes first, for she has been shoved into the middle of the picture by the four years which were spent by the European Powers, with centuries of statesmanship and political wisdom behind them,

in mutual destruction. The people of the United States, first as neutrals and afterwards as belligerents, lent money and supplied goods to the combatants, and to other nations which had formerly gone to the combatants for money and goods, with such profitable effect that they leapt at one bound the whole length of a road that they would otherwise have taken years, perhaps generations, to traverse, and America became a world's creditor, instead of a debtor country. Since the war she has given away immense sums in charity to devastated Europe and has also lent enormously, as a matter of business, all over the world.

With regard to her war-time lending, especially that which was done by the United States Government when it was fighting or preparing to fight on the anti-German side, some of her European debtors have criticized her as a greedy and unconscionable creditor, because she has not been willing to wipe out these debts, contracted by brothers-in-arms, fighting for a common cause. These criticisms have little or no real foundation, because her interest in the result of the war was so much more remote than ours on this side, that she had no pressing reason to throw all that she had into the common pool. Moreover, though she did not wipe the debts out she made compositions which let the debtors off a good deal. But we are on surer ground when we criticize her trade policy, by which she aims apparently at selling everybody goods, lending everybody money and taking as

little as possible from them in goods and services. She not only maintains a tariff, stiff to the point of prohibition, against manufactured articles, but by subsidizing shipping lines at the expense of the American taxpayer makes it difficult for those of her debtors who try to work marine transport on business lines, to meet their debt charge by earning freights. This policy looks short-sighted, for a nation that drives her debtors out of business cannot expect them to pay ; and the solution that America has so far applied to the problem, namely lending her debtors more money to pay with, leads finally to the finance of Alice in Wonderland. But for the time, it increases her already strong hold on the international money market, for she only has to cease or reduce her foreign lending, her foreign travelling and the charity that she dispenses to poor relations abroad, in order to turn the exchanges in her favour and suck in gold.

At the same time, while this shower of wealth was pouring into the lap of this modern Danae, she has exchanged a monetary system which seemed to have been devised to show all the blots and drawbacks that a monetary system can contain for one that has been described by Sir Edward Holden, an experienced English banker, as surpassing "in strength and in excellence any other banking system in the world."¹ It has, without doubt, very effectively cured the evils that marred

¹ See his speech to the London Joint City and Midland Bank shareholders on January 29, 1918.

the old one. The ordinary American banks are still, it is true, compelled by law to keep certain proportions (varying according to the place where the bank works) of cash to the deposits for which they are liable ; but instead of coming to the end of their tether when the legal limit is reached, those that are members of the Federal Reserve system—the “ member banks ” as they are called—can now reinforce their reserves by borrowing from the Federal Reserve banks, which are the keepers of their reserves just as the Bank of England keeps the surplus cash of our Clearing banks. There are twelve of these Federal Reserve banks, scattered at strategical points over the broad area of the United States, and linked together by a Federal Reserve Board, sitting at Washington, and also by a very complete system of communication between them, by which the needs of one district can be met from the plenty of another, so that the whole country is united into one great money market, instead of being spotted over by thousands of unconnected banks with no common interest except to protect themselves by pulling at one another’s monetary entrails. By this ingenious device of twelve central banks designed to work as one united whole, under the control of the Federal Reserve Board, the founders of the new American system avoided the charge of copying the methods of the Old World and blunted the edge of the evil associations left in the public memory by former experiments in central banking.

On paper the new system seems to be as near perfection as can be expected from any human effort, if perfection in a banking system means infinite powers of credit expansion. The member banks can borrow from the Reserve banks as long as the former have "eligible paper" to offer to the latter for discount, and the Federal Reserve banks can issue notes as long as they have 40 per cent. gold reserve against them, and can exceed this limit on payment of a tax. If and when the system can pull itself together and work as a harmonious whole, it will be a splendid instrument for the wealthiest people in the world to play monetary melodies upon. But lately, though it did excellent work during and after the war, its behaviour has reminded one of Kipling's story of *The Ship That Found Herself*. You remember how when the ship left Liverpool for her maiden voyage, her capstan and deckbeams and stringers and thrust block and pistons and screw and all the parts of her rattled and argued in different voices until at last, when they had all been buffeted into unity by the Atlantic billows, the ship spoke with her own single voice as she steamed into New York harbour. In the same way the listening world has heard different voices from different Reserve banks, from member banks which begged to differ, from the Federal Reserve Board, the Federal Reserve Advisory Council, Wall Street operators and critical Congressmen and Senators; it hopes that this is only a passing phase and that soon we shall hear the single voice of the

American money market, working as one united whole for the true interests of America and of America's debtors and customers.

On this side of the Atlantic we see the old countries still licking their war wounds and trying, without any startling degree of success, to work together in financial affairs. France, having recovered confidence in her franc, thanks to M. Poincaré's bold leadership, has developed immense financial strength, which she used in the spring of 1927 with clumsy rough-handedness, pulling away gold in shiploads from London and New York, so as to put rates up there and so prevent francs that had run away from France in the bad days of depreciation from coming back too fast to be convenient. And during 1929 her performances in the bullion market have been still more inexplicable, short-sighted and disturbing.

Germany is a very dark horse, but if we can believe the unprejudiced testimony of an American, Mr. Parker Gilbert, as given in his reports as Agent-General for Reparation Payments, she is a good deal swifter and more steadfast than her statesmen, naturally talking for the benefit of war creditors, have described her. She also has distinguished herself by a Reichsbank rate policy that inflicted grave inconvenience on the international money market, causing what seemed to be unnecessary additions to her gold stock, when what she chiefly needed was a stock of foreign currencies, for meeting Reparation obligations.

And as if this international monetary position were not already full to bursting of new and incalculable features, the 1929 Reparations Committee went out of its way to produce a Bank for International Settlements which has terrifying possibilities for good and evil. Some day, if and when the world is really civilized, it may provide us with an international bank-note, or an international ledger, which will take the place of gold in settlement of trade and financial balances. In the meantime, there is serious danger that it may spoil a good idea by putting it into practice before the world was ripe for it, may make discord more discordant and send a fresh and burly forward into the scrum of central bankers that is scrambling for gold.

Such are some of the conditions under which London, with its wealth of experience and tradition, its impregnable rock of common sense that refuses to be shaken by logic, its horde of critics—domestic and foreign, amateur and scientific—and its politicians and literary humorists who think that money is such a simple business that any Civil Servant could manage a bank, has been trying to work a restored gold standard.

CHAPTER VII

THE CHEQUE-PAYING BANKS

WE have now considered the various forms of cash money, and the process of the manufacture of the money, or right to draw a cheque, which is dealt in by lenders and borrowers in the money market. And we have seen that the right to draw a cheque in England carries with it the immediate and invariable right to demand gold, and so links London with the other gold-using centres and raises the question of our gold stock, and of foreign demands for gold, to an importance which some people find inconvenient or even absurd. Before we can discuss this problem, we have to examine the various wheels of the great machine by means of which the London market carries on business.

In our chapter on the manufacture of money we formed a distant acquaintance with the greatest of these wheels, when we saw that the cheque currency of England is manufactured by the banks, largely through the loans and discounts by means of which they create deposits which represent mutual indebtedness between them and their customers.

The provision of currency for large transactions has

thus passed into the hands of the other banks. The Bank of England's note issue has taken the place of the sovereigns that we used as pocket money before the war and is also used as a basis of the cheque currency which the other banks provide, that is, is held in reserve by them to meet cheques that may be presented for payment in legal tender cash. Before we go further, however, we must make sure of what we mean when we talk or write about the banks. I have headed this chapter "Cheque-paying Banks," manufacturing a very ugly phrase in the hope that it may be clear. For it may be said that the essential function of English banking, which differentiates it from other institutions which are very nearly but not quite banks, is this fact that it gives its customers the right to draw cheques against credits arising sometimes from the deposit of cash, more often from advances against security or the discounting of bills, and is prepared to meet these cheques on presentation by paying notes across the counter. The phrase cannot claim the watertight completeness of a logical definition, but it is roughly descriptive. It includes the country banks, which in their turn bank with the London banks. The cheque-paying banks, in short, for the purposes of this inquiry must be taken to include the native banks of this country, with the exception of the Bank of England, which may be regarded either as the foundation of the banking edifice or as a pinnacle on its summit, but in any case stands by itself. But they do not include the merchant

firms and accepting houses, who do a business which is often described as banking, but do not meet cheques drawn on them with legal tender cash, but with a cheque drawn on one of the banks which we classify as cheque-paying.

It need not be said that banking groped its way to its present perfection through many difficulties and mistakes. A Royal Commission which inquired into the subject in the early part of the nineteenth century laid bare the fact that in 1793 more than a hundred English country banks failed, and that in 1810 to 1817 six hundred closed their doors. Novelists of earlier generations made effective use of bad banking in the plots of their novels, and actual fact was even more romantic than fiction in the days when the speed of a post-chaise full of bullion might save a bank which was troubled by a run, and difficulties of transport were increased by the highwaymen who infested the roads. In 1793 "a general panic was raging in London ; many bankers failed, some of whom acted for their northern brethren. Fresh London agents had to be appointed and duly advertised in the local papers. This helped to spread alarm. Every holder of a note was anxious to convert it into gold. Scores of country bankers were in London, trying, by any means, to gather the precious metal, with which, when obtained, they immediately posted home, disregarding the perils of robbery on the road. The very bank that had reported ' all quiet and undisturbed ' on the 20th had before the close

of the month (March) first a clerk and then two partners in London seeking gold, a supply of which they obtained and carried north with all speed. Mr. Rowland Burdon, partner in the Exchange Bank, Newcastle, was in the metropolis upon the same mission. On the return journey his post-chaise was stopped by footpads, who pinioned the banker and rifled his pockets. The bullion fortunately escaped their notice.”¹

It is recorded in the interesting work just quoted that the great banking family of Backhouse of Darlington were wont, when they found it necessary to replenish their gold store and were anxious to avoid the suspicions that would be aroused if they were known to be doing so, to drive quietly off in a gig as if about to visit a local meeting and to change into a post-chaise and four at Scotch Corner, a noted place on the North Road. The practice throws an interesting light on the extreme care which had to be exercised by bankers in early days in order to do nothing which could possibly excite suspicion. And having mentioned the Backhouse family I cannot avoid the well-known story of the attempt made, according to legend, by Lord Darlington early in the nineteenth century deliberately to break their bank. It is stated that he actually instructed his tenants to pay him their rents in Backhouse notes, meaning when he acquired a sufficient number of them to present them all at once, demand gold, and so make the bank put up

¹ Maberly Phillips, *History of Banks, Bankers and Banking*.

its shutters. Jonathan Backhouse was apprised of this intention, and went off to London post-haste for the necessary supply of gold. On his way back one of the fore-wheels came off the chaise, and rather than wait to have the wheel replaced the banker piled the gold at the back part of the chaise so "balancing the cash" and driving into Darlington upon three wheels. "By this sudden *coup* the bank was so well provided with specie that when Lord Darlington's agent presented a very large parcel of notes they were all promptly cashed, the Quaker quietly remarking, 'Now tell thy master that if he will sell Raby, I will pay for it with the same metal.'"¹

Finally, I must risk still further the charge of irrelevant anecdotage by telling the story of the man who came down the steps of his bank, the door of which had been closed against him, stumbled under the shock of his ruin into the arms of a friend, and apologized by saying, "The fact is, I had lost my balance."

It would be pleasant to linger over the romance and humours of the primitive days of banking, but it is perhaps still pleasanter, and certainly more profitable, to record that both the comic and tragic side of bank failures, as a common experience, are to the present generation only a matter of tradition. And yet they are not really a matter of very ancient history, and I have talked with a grey-haired manager of a country bank, now absorbed into a

¹ *Ibid.*

great joint-stock concern, who was behind his counter during a run and asked a customer who came in to draw his balance how he would take it, and was astonished by being asked for the bank's own notes.

The improvement in English banking has been coincident with the development of joint-stock banking, a fact which is the more interesting because it was noted by keen-eyed Adam Smith that the joint-stock system is particularly well suited to banking. His reasons are worth quoting. "Though," he says, "the principles of the banking trade may appear somewhat abstruse, the practice is capable of being reduced to strict rules. To depart upon any occasion from these rules, in consequence of some flattering speculation of extraordinary gain, is almost always extremely dangerous, and frequently fatal to the banking company which attempts it. But the constitution of joint-stock companies renders them in general more tenacious of established rules than any private co-partnery. Such companies, therefore, seem extremely well fitted for this trade."¹

Apart from this regular working by rule and tradition, joint-stock companies have for some time been subjected to greater publicity than private firms. When there is a large body of shareholders, it is impossible to maintain the same dignified secrecy and reserve concerning the position of a business, which is generally observed by private

¹ *Wealth of Nations*, book v., chapter 1.

enterprises : and any bank which has to issue a statement of its position is bound to issue a strong one, or it would at once be the subject of cavil and suspicion, which might have unfortunate results. Hence it is that publicity has compelled the banks to keep themselves strong, in wholesome fear of the criticism of their rivals and of other members of the monetary body. A good balance-sheet was soon seen to pay those who produced and published it, and the banks found that by giving publicity to their position they gained and maintained public confidence : so much so that nearly all the private banks, though not bound to do so by law, had taken to publishing annual or half-yearly balance-sheets, before they were gathered into the advancing ranks of their joint-stock competitors.

Publicity has thus done much for banking, though it won its way in the teeth of much opposition on the part of old-fashioned folk who thought it undignified. The regular publication of half-yearly balance-sheets was a great step forward. But much may happen between January 1 and June 30, and again between July 1 and New Year's Eve, and the freedom and facility with which the English system of banking works was a temptation to bankers to employ too freely the admirable machinery with which they supply credit and currency to the commercial and financial community, and to build up too big a basis of credit on too small a foundation of cash. The fact that their doing so facilitates trade and finance and quickens

the wheels of commerce all the more efficiently, as long as no untoward result follows, made it difficult to advocate reform without affecting the interests of a large and powerful multitude, and twenty-one years ago, when this book was first written, a good deal had to be said about the great difference in the practice of the various banks, in this matter of the information that they gave to their shareholders and their depositors concerning their liabilities and assets.

It was contended that the system then prevalent by which publicity was applied to banking, once a year in some cases, once a half-year in others, and once a month in others, was unfair and illogical, and that "the fact that obstinate resistance is offered to publicity, especially by certain of the country banks, only shows how necessary is its application." These criticisms were an echo of those voiced by the banks which had led the way in the fullness and frequency of their statements, and naturally tried to prod their lagging competitors into coming into line with them. In their eyes it was most unfair—to say nothing of the dangers of bad banking involved—that some of their competitors should be allowed to over-trade, as they were suspected of doing, by only being called on to show their proportion of cash to liabilities at much longer intervals than the most enlightened leaders of the banking world. "It has," I recorded in 1908, "been insisted over and over again by practical and distinguished bankers that the proportion

of cash to liabilities, in the case especially of some of the country banks, is inadequate, and that periodical publication of their position is an important step towards a remedy for this evil. All that is asked of the banks is that they should show what they are doing, and the reluctance of some of them to do so is not a good sign."

Since then, this question has become much less important, owing to the rapid march of the process of consolidation and amalgamation which has wiped out many of the weaker brethren of the banking fold, absorbing them in the ranks of the big battalions that now dominate the field. In 1908 there were sixty banks (apart from the Bank of England) in England and Wales. In 1928 there were twenty. Of these only nine published monthly statements, but these nine controlled about 90 per cent. of the banking resources of the country outside of the Bank of England.

Owing to this process of weeding out small weak banks, the question of inadequate cash reserves has ceased to be a hardy annual in the speeches of bank chairmen. People with a craving for full and symmetrical statistics occasionally suggest that it would be more satisfactory if all the banks were obliged to publish figures as full and as frequent as those produced by any. But in these days this claim is put forward less owing to suspicions of too much creation of credit by those which do not issue monthly statements or go into much detail in their balance-sheets, than owing to a desire for more

of such light on the state of industry and trade as is given by banking figures.

But one hardy annual of banking criticism, which bloomed in this chapter as originally written, still flourishes. "A periodical 'tightness of money,' as Lombard Street calls it, towards the end of every month, when the monthly statements of the publishing banks are being prepared," was then described as leading "irresistibly to the conclusion that some of them call in loans or diminish discounts, and so increase their cash holding in order to make their position stronger on the day of its publication." This practice, pleasantly dubbed "window-dressing" by one of those wags who do so much to brighten life in the City, still survives, though in a slightly altered form. Since the war the banks which publish monthly statements show, therein, not the position at the end of the month, but the weekly average figures of the various items. It was hoped that this system would abolish periodical withdrawals of cash from the market by the banks, to make their statements look pretty; but in fact, though it may have made them less extensive, it has made them more frequent, being now a weekly absurdity instead of a monthly nuisance. In the inaugural address delivered by him as President of the Institute of Bankers on November 12, 1928, Mr. Frederick Hyde referred to window-dressing as "an operation which causes considerable disturbance in the money market at the end of each half-year and to a small extent each

week. Although," he said, "it is of old standing and has been generally indulged in, I do not think that anyone would seriously defend it. Apart from all other considerations it fails of its purpose, for it misleads nobody. Window-dressing, which is a subject of weekly comment in the Press, loses all taint of deception, but equally loses all value as an advertisement." Very nicely put, but why, this being so, does it continue?

It has already been stated that the great improvement in English banking, which has changed the picturesquely exciting system illustrated at the beginning of this chapter for one of monotonous solidity, has coincided with the development of banking by joint-stock companies. And it is interesting to note that the law of the land, as far as it could, presented an insuperable obstacle to this development. It gave a monopoly of joint-stock banking in London to the Bank of England, but it defined banking, as banking was when this monopoly was given, as the right to issue notes. But when the nature of banking changed, and it became the business of a banker not to give a customer a credit and let him take out notes, but to give a customer a credit and let him draw cheques, it was perceived that the Bank of England's monopoly did not prevent the establishment of joint-stock banks in London; and so the law, in spite of its manifest intention, was practically annulled by a change in banking practice which its framers could not possibly have been expected to foresee.

It was in 1834 that this discovery bore fruit in the foundation of the London and Westminster Bank, and since then it may be said that English banking has passed into the hands of the joint-stock banks by their rapid development, by the readiness with which they absorbed the old private banking firms, and finally by the action of a large number of the latter, which were amalgamated in 1896 into a great joint-stock bank, named Barclay and Company, after the principal firm among its components.

The distinguishing feature of the new banking which has thus grown up is the system of banking by branches. In former days each bank stood by itself with its customers all in one neighbourhood, and if it had branches they were quite few and confined within a comparatively small area. The new banking opens branches all over the country, or buys the interests of other banks, and seems to seek to diffuse its business as widely as possible. The consequence is that English banking, instead of consisting of a large number of small firms or companies providing monetary facilities each for its little band of customers, has been systematized into a compact army, composed of a few well-regulated and strongly equipped regiments, each of which has its companies and outposts scattered up and down a big area, but worked from a common centre, and with excellently organized arrangements by which the needs of each district can be watched over and provided for.

This development has great advantages, the most obvious of which is the imposing magnitude of the gigantic modern banks as compared with the pygmy firms of the old system of separate entities. Since the banker trades on public confidence, and size is the most impressive quality for striking the public imagination, the process of amalgamation and branch building has certainly strengthened banking in a most important respect. And it need hardly be said that it has also done a great work in regulating the ebb and flow of monetary facilities and providing a number of channels, all connected with the central reservoir, by which the process of financial irrigation can be most easily and cheaply conducted, and the supply can most readily be applied to any part that may happen to be suffering from drought. As long as all goes well in the world of banking, the present system will readily be acknowledged to be a great improvement on its predecessor.

At the same time, it must not be forgotten that this multiplication of bank branches has also multiplied the number of points at which the banking body is vulnerable, and that, if it should so happen that all did not go quite well in the banking world, and every branch open became a sucker instead of a feeder, the magnitude of the defenders' task would be greatly increased by the diversity of the outlets for the bank's life-blood. A cash reserve which would be adequate enough for an institution which keeps all its liabilities under

one roof may easily be meagre for one which has smaller liabilities scattered over different points in a score of counties.

From this point of view the size of a bank, which is so striking an indication of solidity in the eyes of the uninstructed, presents a different aspect on closer examination. For it is usual to measure the size of a bank by its deposits, in other words by its liabilities, and by the number of its branches. And when the liabilities are not only great but widespread, they become still more misleading as a test of greatness. In estimating the wealth of an individual we should hardly begin by enumerating the number of millions that he owed, and the number of places in which he owed them. We should admire the magnitude of his credit operations, but in assessing his solidity we should most of all want to know how liquid were the assets which he held against this mass of debt. And so with banks. The bigger they are, and the more widely scattered their places of business, the greater is their need for prudence and foresight. It need not be said that these platitudes are fully recognized by those in charge of the many-branched banks.

It must also be remembered that the recent consolidation of banking in England, and the ease and quickness of modern transport, have greatly reduced the dangers involved by branch banking. And the experience of the United States seems to show that greater risks are run by a system of many small single banks. There, though some of the

banks are as big as the biggest of the English,¹ the total number runs up to nearly 26,000, of which 662, with deposits of 193 million dollars, suspended in 1927, and 491 with deposits of 138 million dollars in 1928,² though in neither of these years was there any suspicion of banking crisis.

We have seen that the banks, by creating the cheque currency with which English commerce and finance is now conducted, play a supremely important and responsible part in the domestic economy of the London money market; and the loans and advances which we saw (in our balance-sheet on page 56) to be by far the biggest item among their assets, are chiefly supplied to British industry and trade, which they feed and fertilize.

In international affairs their power has been clipped by the closer control over the market now exercised by the Bank of England, though it has been expanded by the extension of their activities in acceptance and foreign exchange. Formerly in normal times, that is, at times in which it was not necessary for the Bank of England to intervene and control the position, they regulated the price of money in London as indicated by the rate for day-to-day loans and short fixtures, and the discount rates for bills of all dates. To a certain very limited extent, it is true, they were controlled or affected at

¹ See an article on the Amalgamation Movement in American Banking in the *Economist Banking Supplement*, May 11, 1929, page 6.

² *Federal Reserve Bulletin*, April, 1929, page 261.

all times—or at nearly all times—by the Bank of England's official rate, because the allowance that they made to depositors for the use of their money was generally—in pre-war days— $1\frac{1}{2}$ per cent. below Bank rate. But, besides the funds which they held on deposit, they also had very large sums left with them on current account, on which they in most cases paid no interest at all, so that it often happened that they could and did lend in the money market at a lower rate than they paid to depositors. And the price at which they lent in the money market made the market rate for loans, except on quite rare occasions.

It seems to be impossible to go straight forward in this inquiry, and now we must pause and explain the meaning of this phrase, the market rate for loans. If I may be allowed to express it with a view to clearness and simplicity rather than fullness and precision, it means the rate at which the banks are prepared to lend money—or the right to draw a cheque—to the bill-brokers. The bill-brokers ought to be explained too, but they must wait for the next chapter, and in the meantime can be described roughly as specialists who devote themselves to discounting bills, or acting as intermediaries in the discounting of bills. If you look at the aggregate bank balance-sheet drawn up to illustrate our chapter on the manufacture of money, you will see on the right-hand side among the assets first the cash in hand and at the Bank of England, the bank's first line of defence, and

then "loans at call or short notice."¹ These loans are made day by day by the banks to the bill-brokers, money lent to whom is regarded by bankers as a second line of defence, since it is habitually placed either "at call" from day to day or for periods which do not usually exceed a week; and can thus, in theory at least, be called in readily. The phrase also, in some cases, covers loans from banks to stockbrokers; but when the rate for money is quoted in the City, it usually means the rate between banks and bill-brokers. And anyone who reads the opening paragraph of a newspaper money article and is puzzled to find that there was very little demand for money, and day-to-day loans were easily to be had for some apparently absurdly unremunerative rate, need not therefore infer—as sometimes happens—that a great revolution has been effected in human nature, and that money is no longer an object of man's ambition. The phrase generally misleads those who are not used to City jargon, and I once heard an indignant gentleman in a railway carriage vehemently asserting that the newspapers talked infernal nonsense, because he had apparently strayed by some mistake into the money article of the one that he had been reading, and had learnt from it that money was "unuseable," and that balances had been offered in vain at 1 per cent. It appeared that he had spent the previous day in a fruitless endeavour to induce his bank

¹ Page 56.

to allow him an overdraft on the security of certain pictures, apparently his own works, and of quite problematical value; he had offered to give up to 10 per cent. for the accommodation, and was so deeply stirred by the statement that there was no demand for money at 1 per cent. that he roundly dismissed all City journalists as unfit even to be art critics, which appeared to be the extreme limit of condemnation in his opinion.

It is very important that the meaning of the word "money" as used in the City should be clearly grasped, for we shall find that the rate for this money and the facilities for getting it are most important wheels in the machine, and it is essential to keep a tight hold of the correct significance of the phrase.

Money, then, has a special sense when spoken of by the chief dealers in it, thus presenting yet another example of the confusing inconsistencies of economic nomenclature. In this sense it is usually a loan granted by a banker to a bill-broker for a day or for a period not exceeding a week. The rate for this class of accommodation thus represents the price of the right to draw a cheque given to a borrower of the highest possible credit against securities of the highest possible class, and for the shortest possible period. And it is thus quite misleading to draw any inference from it concerning the rate that ought to be paid under different conditions.

This rate is, in normal times, practically decided

by the cheque-paying banks. Other lenders, such as the Indian Government's representatives, or the colonial and foreign banks, or the finance houses or merchants, sometimes have large balances employed among the bill-brokers, but the deciding voice concerning the value of the rate for short loans is ultimately that of the English banks. And the extreme elasticity of this rate was formerly one of the difficulties that had to be coped with by those who controlled the London money market. In those days many of the difficulties of London's position arose from the fact that many members of the money market did not adequately recognize that it has to be controlled, and that even those who did wavered constantly between the horns of a dilemma which was ever present, one being their own immediate interest, and the other that of the market as a whole and in the future.

For example, any given banker at any given moment might most reasonably consider that the rate at which he lent money to the bill-brokers was a question which merely concerned himself and his duty to his shareholders. He had so much cash, so much invested in securities, so much advanced to customers, and a further proportion which he could, according to the rules by which he regulated his business, lend to the bill-brokers at call or short notice. Any rate for this was better than none, and, if the bill-brokers only bid him $1\frac{1}{2}$ per cent. for it, why should he not take

it rather than lose the profit to be made by the creation of so much credit? If he did not, he would very probably cause the bill-brokers to go across the street and bid a rival bank $1\frac{3}{4}$ per cent., and the only result of his abstinence would be to swell the profits of a competitor. From the point of view of the individual banker these arguments were irrefutable, but from that of the market the results of their practical application were sometimes unhappy. "It is much to be desired," I wrote in 1908, "that some system could be devised of more harmonious agreement among bankers as a whole, by which the rate for money, in the City sense of the word, could be made less mercurial, and especially could be prevented from falling to a merely nominal level, and so unduly depressing discount rates, encouraging all kinds of kite-flying and the production of finance paper, turning the foreign exchanges against London, and increasing the difficulties of those responsible for the maintenance of the gold reserve."

When this book first appeared I was reproved by my bill-broker friends for this and other passages in which I had urged the establishment of a link, elastic but effective, between Bank rate and the market rate for money. To bill-brokers, as we shall see when we come to look at their functions in the next chapter, plenty of cheap money is part of the definition of the monetary Paradise, and I was accused of advocating the establishment by the banks of a permanent corner in money.

But violent fluctuations in loan rates are not good for Lombard Street, and since the war the banks have adopted the habit of only lending to bill-brokers at a rate which is usually 1 per cent. below the Bank of England's official rate, commonly called Bank rate.

By this system they have given the Bank of England closer control of the price of money in London, and this control has also been strengthened by the effect of banking consolidation and the consequent check to over-trading by small banks. We have got back to the state of things described by Walter Bagehot in *Lombard Street*, when there was never enough money to go round, unless the Bank of England was lending. For a long spell before the war this was no longer true, and the market often drifted with the steering gear not working, unless the Bank of England tightened it up by borrowing some of the surplus money. Now, unless the Bank of England is lending either to the Government or to the market, stringency nearly always sets in. To this extent the control that was formerly exercised by the cheque-paying banks over the rate for money has gone back to the Bank of England.

The cheque-paying banks were also, in former days, chiefly responsible for regulating the discount rate in London, that is, the rate at which bills of exchange drawn, as described in a previous chapter, for payment at a future date, can be turned into immediate cash. This market rate

of discount is an even more momentous matter than the market rate for money, because it has a very important bearing on the foreign exchanges, another of the complicated questions which have to be dealt with later on. The importance, in fact, of the market rate for money arises largely out of its effect on the market rate of discount; if the bill-brokers are supplied freely with money at low rates, and think that they see a probability of the continuance of this free and cheap supply of credit, they are naturally encouraged to discount bills at low rates, so that the power which regulates the money rate thus exercises a strong and direct influence on the discount rate.

Though the banks have to a great extent surrendered this power, they still exercise a strong influence by being themselves large discounters of bills, so much so that many bill-brokers contend that it is the bankers who directly determine the market rate of discount. And this is probably true, for most of the bill-brokers are chiefly intermediaries, and only discount bills with the object and intention of promptly rediscounting the greater number of them; and the bankers are the chief buyers with whom they can most regularly count on placing the bills that they take; consequently, when it is known that two or three of the chief banks are not taking bills below, for example, 3 per cent., this fact has a marked effect on the market rate of discount, that is, the rate quoted by the bill-brokers. And as the market rate of discount is an important

factor in influencing the foreign exchanges, which in turn are an important factor in influencing the inward and outward movements of gold, we come round once more to the great importance of the policy pursued by the banks with regard to discounting bills.

Still more important and delicate do their duties become when there arises any question of discriminating between the classes of bills that will be taken, whether the objection be to bills of a certain kind, or to bills drawn on a certain house. By merely intimating to the bill-brokers that he does not want many¹ "house bills," or many bills drawn on a certain name, or that he is not taking paper which is too obviously of the kite-flying order, a bank manager can at any time profoundly affect the inner working of the financial machine. The exercise of such a power has to be handled with the nicest discretion, for any such intimation, especially when the paper of any particular accepting house is objected to, generally produces a good deal of gossip and conjecture, and is certain to have some effect on the credit of the firm that is indicated as having been accepting more heavily than its resources are considered to warrant.

And this part of the bankers' duty in watching over the volume of acceptances, and seeing that the accepting houses do not overstep the bounds of prudence, is complicated by the fact that the banks have themselves lately taken up the business of

¹ Page 49.

acceptance to a greatly increased extent. But this feature in their business will be more fitly discussed when we come to consider the position and function of the accepting houses as such.

Further, the bankers fulfil a highly important function by providing credit facilities for Stock Exchange speculation. This they do both directly and indirectly. Directly by making loans to their customers on the security of stocks and shares which the latter buy, not as investments, but because they think they will rise in price, or will return a higher rate of interest than the rate which the banker will charge for the loan ; and indirectly by making loans to members of the Stock Exchange which the latter employ in financing the speculative commitments of the public. The rates earned by bankers for this kind of accommodation are generally profitable, and the most strait-laced moralist would hardly question their right to provide credit for this purpose. In fact, in the case of direct loans to his ordinary customers, the banker need not necessarily know that the transaction is intended for speculation. Let us suppose that you arrange with your banker for an advance against a line of Greek bonds, which you want to buy because you think you see a chance of reselling them at a profit, or because you can buy them to pay you 7 per cent., and you can get a loan from your banker at 5 per cent., and pocket the difference of 2 per cent. In such a case, as far as your banker knows, you may want the credit in order to buy a

house, or to engage in some productive commercial operation. Nevertheless, in most cases he is probably in a position to make a fairly accurate guess, and when he is lending directly to members of the Stock Exchange, he knows well that in nine cases out of ten he is financing the purchase of securities by those who for one reason or another are not in a position to pay for them, and so is facilitating the speculative holding of stocks as opposed to the real possession of them by investors who have paid for them out of savings.

By performing this function, within due limits, the banker is carrying out a perfectly legitimate side of his business, and assisting operations which are beneficial to the community as a whole. The majority of speculators probably lose more money than they make, but if they choose to indulge in this expensive form of amusement, it is not their banker's business to interfere with it, and during the course of the process they are unconsciously rendering a financial service by promoting the freedom of markets and facilitating dealings in securities, and so indirectly promoting enterprise and trade.

Nevertheless, the readiness with which bankers can place credit at the disposal of speculators sometimes has bad effects, which have to be watched for carefully by those who regulate the supply of it.

For example, there can be no doubt that it was an important cause, among others, of the abnor-

mally high level to which the prices of well-secured stocks were forced in the period of exceptionally cheap money in 1896-97, when Consols touched 114, and "gilt-edged" securities could with difficulty be found to yield the buyer $2\frac{1}{2}$ per cent. This state of things was a great hardship to the real investor, and was undoubtedly brought about to some extent by the number of enterprising folk who borrowed from their banks at 1 per cent. or so against gilt-edged securities yielding $2\frac{1}{2}$ per cent., and pocketed the difference accruing from the yield on the stock and the profit arising from the advance in its price, which continued merrily up to a point. The demoralization of the gilt-edged market, dating from that golden period, and quickened by subsequent wars and other causes, was still being painfully lived down, when the Great War came and showed it what demoralization really could mean. But this is a point which perhaps does not directly concern the banker, as such, though as a large holder of securities he is affected by any tendencies which warp the true course of markets. Still, he is quite justified in arguing that he is not to blame if his customers, by the use that they make of the credit that he gives them, produce abnormal effects on prices.

More to the purpose is the fact that Stock Exchange securities are only to a limited extent liquid, that is to say, realizable at a moment's notice, and that the more a banker wanted to call

in credit granted against them the less liquid they would be. It was once gravely contended by a gentleman who was opposed in principle to the existence of Government debts, that if every holder of Consols wanted to sell at once, and there were no buyers, the price would be *nil*. Which is one of those absurd truisms which contain their own refutation in their very truthfulness, but nevertheless are only caricatures, so grotesque as to be unrecognizable, of a very real fact. In this case the fact is the less exciting platitude that the more people there are who want to sell stock, and the fewer who want to buy it, the lower its price will be, and the less easy it will be to sell it at all. It used to be boasted that the market in Consols—then the premier British security—was so free that they could be sold on Sunday. And there are securities enjoying the advantage of an international market, that is, of being freely dealt in in Paris and on the other Continental Bourses, which can really be disposed of at any time, at a price. But they are not many, and in times of difficulty or crisis, the possibility of which can never be wholly absent from the mind of a prudent banker, it is quite conceivable that securities, quoted officially at substantial prices, could not be turned into cash on any terms, and that the lending banker might find the credit that he had granted used to draw away his cash, without being able either to compel his customer to repay him or to convert the collateral and so replenish his resources.

From this it must not be inferred that bankers commit any indiscretion in conducting this class of business to the moderate extent that is customary here. In America, as we have seen, the relations between banks and Stock Exchange have been a serious bone of contention, but the conditions on the other side of the Atlantic are quite different. All these matters are questions of degree, and if due attention be given to the class of security advanced against, and the extent to which these transactions are entertained, nothing can be said against them by a reasonably minded critic. The finest class of security for a banker to hold or to finance is the bill of exchange drawn against real produce of universal consumption which is moving into the hands of those who will consume it, and so will pay for itself in due course. In all other securities the existence of a buyer to meet the views of the seller is more or less problematical. However intense the panic, the human race must be fed and clothed, but the extent to which it will take securities from those who want to sell them will vary in an inverse ratio to the severity of the panic. And though it would be absurd to argue from this ground that bankers ought to hold nothing but produce bills, it is quite relevant that the limits to the negotiability of some other securities should be constantly kept in view.

This chapter has grown to a portentous length, which must be excused owing to the great importance of its subject. "I am always willing to run

some hazard of being tedious in order to be sure that I am perspicuous," said Adam Smith, and was fortunate in being able to write so confidently. I have to face the certainty of being tedious, and can only hope that I run some hazard of being perspicuous. What I have tried to make clear is the enormously important function of the cheque-paying banks in the English money market. Recapitulated in tabular form it may be expressed thus:—

By providing their customers with cheque-books they create the currency which settles the great majority of commercial and financial transactions and much of the retail traffic of daily life.

By lending money to industry and trade, discounting bills and making advances to bill-brokers and other customers they create the credits by which enterprise is fed and commerce and finance are carried on; and these credits become in turn their liabilities on current and deposit account.

They exert an influence, second only to that of the Bank of England, on the current rates for money in London, and on the discount rates current in London, which have an important effect on the foreign exchanges, and so on the maintenance of London's gold reserve.

They are large acceptors of bills, and so, again, facilitate commerce and create instruments which are readily convertible into cash or credit.

Since the war they have developed a large business in foreign exchange, so furthering international trade, finance, travel and intercourse.

By advancing to customers or stockbrokers against Stock Exchange securities they facilitate speculation, and thus to some extent affect the prices of stocks and shares.

It is a tremendous function, and it follows obviously that the cheque-paying banks are in the aggregate the most important members of the financial body. We shall find that, with one exception, the other members are more or less dependent on them, and can only work with the assistance of the credit created by them. The one exception is the Bank of England, which exercises special functions which will be more fully described hereafter, and leads and regulates the whole course of the money market. But even it derives much of its power from the fact that it acts as banker to the cheque-paying banks.

As originally written, this chapter, which had already, like King Charles, apologized for taking an unconscionable time over dying, died at the end of the last sentence. But nowadays Iago sets the fashion and we are all "nothing if not critical." Having seen what the banks do, we have to consider whether they might not do it better. They are charged with having grown so big that they are unwieldy, and the *laudator temporis acti* is fond of telling us that now that all the small country banks have been gobbled up by the octopuses with heads in the City and tentacles sprawling all over the place, the bright lads in the villages and the country towns do not get the backing, in the shape of

credit, that was to be had in the good old days, when the partners in the private banks managed their own businesses, and knew all their customers and all their families and circumstances and could appraise their solvency to a hair's-breadth.

On the other hand the octopuses have plenty to say for themselves. In defence of the policy of amalgamation and absorption, they can urge, with obvious truth, that it has been forced upon them by the similar process in industry, which has made the industrial units so vast, that the little banks of a past generation could not possibly have met their legitimate demands for credit. But they can go further, and say that while opening magnums and Jeroboams for the heavy drinkers, they are still ready with half-bottles and "nips" for the humbler thirsts. And they produce figures to prove it.

Mr. McKenna, chairman of the biggest of them, gave an analysis, in his speech at the annual meeting on January 22, 1929, of the advances of the Midland Bank, outstanding on June 30, 1928. After making full allowance for bad and doubtful debts, they amounted to the impressive total of £214 millions odd, and they were extended to more than 180,000 borrowers, the average amount outstanding being about £1200. Among the groups in the classification, one of the largest was composed of the wholesale and retail traders, who took 11½ per cent. of the whole. More than two-fifths was

lent to retailers with a single place of business: the bank had 31,000 loans of this particular character, the average amount being £330. Loans to agriculture, for financing current agricultural requirements, numbered nearly 15,000, the average amount being less than £500.

These figures do not look as if the small user of credit is being starved, and one does not see why the banks should be such fools as to starve him. From the nature of the business, bankers and their customers must always differ as to the amount of credit that the latter ought to have. Most enterprising and energetic business men want, and ought to want but ought not to get, more credit than they are good for. But if they got it, both they and their bankers would probably be sorry some day. When, as usually happens, they do not get it, they cry out against bankers as a set of stingy curmudgeons who starve enterprise. If there were no such criticism and all borrowers got what they wanted, it would be time to sell a bear of bank shares.

At the same time, the existence, often asserted, of a real gap in our banking machinery is confirmed by the final report, published in March, 1929, of the Committee on Industry and Trade. While finding that on the whole the existing machinery for supplying British industry with financial facilities for meeting its legitimate needs is adequate and suitable, it calls attention to the "suggested absence of any adequate means of financing long-

term credits (say over a two- to five-years' period) in respect of the export of certain classes of capital goods, and the consequent difficulty in which manufacturers of such goods may find themselves, in comparison with their competitors in countries where it has been the practice for the banks to ally themselves closely with industrial enterprise and to give long-period credits."

This Committee, which was presided over by Sir Arthur Balfour, a practical and distinguished industrialist, and has published in the seven volumes of its report an immense mass of information concerning the outlook and conditions of British trade, considers that these inadequate facilities for financing long-term credits are not a reflection on our joint-stock banks, which do not and in its opinion ought not to lock up their depositors' money for long periods; but thinks that they point to "a gap in the machinery available for the financing of industry."

In the present state of keen international competition in industry, such a gap ought not to be allowed to exist. The banks are certainly right in refusing to lock up their depositors' money, for which they may be asked at any time; but there is no reason why they should not increase their capital, by the issue of more shares or of terminable debentures, and so have funds available, which would not be repayable on demand, for the long-term requirements of industry. Or it ought to be very easy, if the right people took the matter

up, to form an institution for this special purpose, so that our financial system which boasts that it has taught all the world what modern banking means, may no longer be open to the charge of failing in one of its most important duties.

Our banks are also sometimes criticized for the inadequacy of the profit and loss figures that they publish and the veil that they draw across the amount of their expenses and the provision that they have to make for bad debts. But when claims are made that shareholders ought to be told all about losses and bad debts, we have to remember that the banks have very special reasons for reticence, because they live on the confidence of the public and the public is so likely to draw mistaken conclusions. Shareholders and depositors know all that they want to know, having complete confidence in those who direct and manage the banks, and knowing that owing to the long-established custom of accumulating hidden reserves—made possible by the reticence of which the critics complain—the position of the banks is generally much stronger than the figures show it to be. The real objection to the veil behind which banking does its business and the obscurity in which bad debts are wrapped, is that their effect is to mislead many stupid people—and some very clever ones like Mr. Bernard Shaw¹—into a delusion that banking is quite an easy job, which

¹ See the *Intelligent Woman's Guide to Socialism and Capitalism*, page 268.

any Government official could tackle. Lending money with reasonable despatch and with a reasonable chance of getting it back again is, in fact, a business that requires a lifetime of training and experience. Nobody doubts that our Government officials, if they were caught young enough and were freed from red-tape fetters, could be taught to do anything, for they are very clever hardworking folk. But if banking were handed over to Government officials who have lived for years in the Whitehall atmosphere, referring everything to somebody else, the pace of enterprise and development would be likely to slacken.

If bank figures can throw any light on the state of trade, the more of such light that we can get the better, for our industrial leaders certainly want all the light that they can find. But on this point again bare figures may easily mislead. It is easy to ask why all the banks should not always, as a matter of course, give us an analysis of their advances such as Mr. McKenna furnished in the speech already cited. It would be very interesting, but would it enable us to draw safe inferences about the state of industry? A trade may need more credit if it is active, and likewise if it is depressed. On one point, however, Mr. McKenna did show us that useful light can be thrown by bank figures and that is by the separation of current from deposit accounts. He was able to demonstrate from the shifting of the Midland Bank's current accounts to deposit and *vice versa*,

that the state of trade is clearly reflected by these movements and that the proportion of "demand deposits," more usually called current accounts in this country, rises and falls with the activity of trade. Since this is so, and since some of the banks used to separate these figures, why should not they all do it regularly in all their statements, monthly and half-yearly?

CHAPTER VIII

THE BILL-BROKERS AND DISCOUNT HOUSES

WE have seen that the main functions in the manufacture of credit and currency are performed by the cheque-paying banks, and we have now to examine the operations of several minor but important subsidiaries, which the specializing tendency of civilization has called into being.

The banks manufacture money by making advances, that is, giving the right to draw cheques, against all kinds of security, by making investments and by buying or, according to the technical phrase, discounting bills, that is, giving the immediate right to draw a cheque or cash in return for an instrument which conveys the right to cash at a later date. The bill-brokers appear to have originally performed the function of intermediaries between the banks who were buyers of bills and the merchants who had bills to dispose of. This function they still carry on to a great extent, and, in so far as they remain bill-brokers, this is the chief part of their business. But several distinctions have arisen through the natural tendency to diversification of function, and it may now be said that there are roughly three

classes of firms to be included under the titles which head this chapter.

(1) There is the bill-broker pure and simple, who devotes himself entirely to taking a parcel of bills from the merchants, accepting houses, foreign and colonial banks, and other chief agents, who receive them in batches by every mail, and selling them there and then on the best terms that he can obtain, receiving a commission for his pains, and for his knowledge of the market. This variety, which is the real survivor of the original bill-broker, is now comparatively rare. It is commonly described by the term "running broker."

(2) There is the retail dealer in bills, who is still generally called a bill-broker, but does not work on commission but buys bills outright, either from the running broker, or from the merchants and accepting houses, or from foreign correspondents, but nevertheless does not, as a rule, hold them himself until they mature, but sells them to the banks and other buyers, selecting the dates and classes of paper that the several buyers may happen to require. From the nature of his business, the retail dealer requires more capital and credit than the bill-broker pure and simple, because it may sometimes happen that his goods may remain on his counter for more or less time, until they happen to suit the fancy of a purchaser. His capital, however, is, as a rule, small when compared with the volume of his turnover, and he depends on credit, most of which is advanced by the banks, for the financing of the bills of which

he daily remains the holder. It will be remembered that the banks habitually have considerable sums lent to bill-brokers "at call and short notice," and that these loans were described as their second line of defence, as being most easily called in. Their first line of defence, as need hardly be repeated, is their holding of "cash in hand and at the Bank of England."

(3) Out of the retail dealer in bills has grown the discount house, an institution which still does a certain amount of retail business, but is at the same time in a position, owing to larger capital and more extended credit, to "run a much bigger book," as the jargon of the craft would phrase it; that is, the discount house is to a greater extent a permanent holder of bills and depends in a minor degree on the momentary fluctuations in the price of credit. Nevertheless, the discount houses are very large users of borrowed money, and regularly announce rates which they allow to depositors, these being generally slightly above the rates offered by the banks. Owing to this fact, of the slightly better rate allowed by them, they generally have the control of a considerable amount, placed on deposit with them by merchants and financiers, but at the same time, though their dependence on credit supplied by the banks is not as great as in the case of the retail dealer in bills, it is still sufficient to make a serious difference to their operations, whenever the banks have occasion to reduce their loans, or to charge more for them.

Having thus, for the sake of being perspicuous, classified and distinguished the three kinds of dealers in bills, we may proceed to eliminate the real bill-broker, the almost obsolete dealer on commission, and to apply the term bill-broker to the two classes who have grown out of him and are still called by his name, in accordance with the consistently illogical manner in which the City applies titles and descriptions.

As we have seen, the distinction between the other two classes is solely one of degree, the degree being the extent to which they hold bills permanently, and depend for financing their operations on credit obtained from the banks. At the head of the body stand some few private firms of old standing, great wealth and first-rate credit, side by side with two big companies which have applied the joint-stock system with considerable success to the business of dealing in bills, and an old firm which has now been joint-stocked. Under this leadership the market is compact and well organized. The business is one which requires exceptional abilities and alertness, and the market rate of discount in London is perhaps the most sensitive and trustworthy barometer of international monetary conditions.

It was stated in the last chapter that the market rate is regulated by the Bank of England and the banks; and we have now seen more clearly why this should be so, having found that the bill-brokers depend to a great extent on the banks both to supply them with credit and to buy bills from them.

Nevertheless, though the average level of the rate is thus regulated, the action of the bill-brokers themselves has an important influence on its daily fluctuations and so may make a considerable difference to the movements of the foreign exchanges.

In order to realize the complicated nature of the problem that has to be solved by a bill-broker whenever he buys or sells a bill, let us endeavour to enumerate some of the chief considerations which determine his judgment on the points that have to be borne in mind. We will suppose he is offered a line of first-class paper due in three months' time, the present date being the last week in June.

But first it will be necessary to try to get a clear understanding of the meaning of the terms in which the discount market expresses the conduct of its business.

We will suppose then that the bill is offered to the broker at 4 per cent., that is to say, that 4 per cent. per annum is the rate of interest which is deducted from the face value of the bill, which it will realize in three months' time, in order to induce him to give cash for it. In other words, he is asked to give £99 to-day for each £100 in the amount that he will receive on presentation of the bill on maturity. As the calculation of discounts is very puzzling to the uninstructed inquirer, perhaps it is better to be still more arithmetically elementary, and point out that as three months is a quarter of a year, the 4 per cent. per annum is divided by four to arrive at the

discount for three months, and hence it is that since the current discount rate is 4 per cent., we must knock £1 off each £100 of the bill's face value on maturity in order to arrive at its cash value on this basis. This rough calculation is only an illustration, of course, and the bill-broker, or his clerks, will work the problem out much more finely on the actual number of days in the bill. What has to be made clear is the fact that a bill is a security with a price, just like the stocks dealt in and quoted on the Stock Exchange, but that, instead of quoting the cash price for it, the market quotes the discount or the difference between its cash price and its face value on maturity. It is quite reasonable and simple when one thinks it out, that an instrument that will realize £100 in three months' time should only be worth £99 at the present moment, if 4 per cent. per annum be the current rate arrived at by the higgling of the money market. But the number of people who have never taken the trouble to work out this elementary but tiresome problem, and consequently flounder when they think or talk about the discount market, is a continual astonishment, and must be my excuse for giving so much space to a statement which is about as informing as $1 + 1 = 2$.

Another frequent cause of confusion in this connection, though it also is dissolved by a moment's thought, arises out of the fact that the market is described as firm when discount rates go up, that is, when the price of the bill goes down. A firm dis-

count market would result, we will suppose, in a rise in the discount rate from 4 to $4\frac{1}{4}$ per cent., and the result of this would be that the cash value of a bill with a year to run (for the sake of simplicity) would fall from 96 to $95\frac{3}{4}$. It is quite clear and reasonable that if money is more valuable the present price of a bill that will not mature for a year becomes less, because the buyer is giving immediate cash in return for the promise of cash a year hence. But to people who are accustomed to the expressions current on the Stock Exchange the notion of a firm market resulting in a fall in the price of the securities handled in it is often very confusing, for on the Stock Exchange, when they talk of a firm market, they mean one in which there is a strong demand for the securities handled by it and a consequent rise in prices. When the Consols market is firm Consols go up, when the discount market is firm bills go down, which is only another way of saying that discount, which is the commodity in which the market really deals, goes up.

All this is very platitudinous, but I have known an occasion on which a financial journalist was taken to task, by a man of high standing in the City, for stating in his money article that the discount market was weak, with easier rates, owing to the scarcity of bills. In this case a practical banker of many years' experience had fallen into this trap, so that I must be excused for giving a considerable amount of space to the endeavour to warn less well-informed inquirers against it. A moment's thought shows that when

bills are scarce and in demand, buyers who want them will have to take them at lower rates, that is, at higher prices, so that the newspaper statement objected to was perfectly correct.

Having done our best to put a fence round this tiresome pitfall, let us return to our bill-broker, who is still wondering whether to buy a parcel of three-months' bills at 4 per cent. in the last week of June, and let us examine a few of the principal factors that will determine his decision.

In the first place he has to consider the immediate circumstances of the market and the prospect of his being able to resell the bills forthwith at a profit, or to finance them comfortably if he be obliged to retain them.

The last week of June is a most unencouraging period from this point of view. The close of the two halves of the year are habitually marked by two processes, both of which severely restrict the supply of credit and of cash. In the last week of June and the last week of December an enormous volume of actual payments is made throughout the country, increasing materially the demands on all the banks for cash, and, at the same time, a large number of firms and companies, including some of the banks themselves, are making preparations for their half-yearly balance-sheets, that is to say, reducing credits granted to customers, and so increasing the proportion of their holdings of cash. As there is not enough cash to meet these two demands, it is nearly always necessary for the Bank of England to fill the gap ;

and in the period immediately preceding the turn of the two half-years it is usual for borrowers to go to the Bank of England and obtain credits with it for sums which sometimes amount to twenty or thirty millions or more.¹ Part of these credits is used for the withdrawal of actual currency, for the cash payments that have to be made all over the country ; the rest is left to the credit of the borrower—or some one to whom he transfers it—in the books of the Bank of England, and the financial community is thus enabled to show a fine round sum of “ cash in hand and at the Bank of England,” a credit in the Bank of England’s books being universally regarded as quite as good as, and much safer than, so many notes in the pocket. *

Our bill-broker, of course, has no need to think of all this ; it is all so well known to him that it is part of his being. But it is a very important factor in the problem that he is debating. For the first consequence that arises is the probability, or certainty, that he will be unable to resell the bills to the banks, or to other regular buyers. At such a season, the banks are most unlikely to increase the number of their bills, and will probably not even replace those that fall due and are paid off. They will have a considerable stock of bills in their portfolios bought with a view to the cash demands at the end of the half-year and maturing within this very week ; and

¹ At the end of June, 1929, when there was unusual pressure owing to heavy gold exports, estimates of the amount borrowed from the Bank ranged up to £60 millions.

the maturity of this paper will be one of their weapons in providing the cash that they will require for their customers and themselves.

Since, then, the bills under consideration by the bill-broker will not be easily convertible into immediate cash, he is faced by the problem of having to finance them himself. And from what has been said above it is clear that during the next few days this is likely to be an expensive matter.

As we have already seen, the bill-brokers depend largely on a supply of credit from the banks for financing their business, and our friend has, in all probability, been already apprised by his bankers and other providers of credit that they have, at the present moment, other uses for their funds. For the advances to bill-brokers have been described as the banks' second line of defence, and when they wish to increase their first line, which is their cash in hand and at the Bank of England, or to maintain it when it is diminished by their customers' demand for currency, they at once do so by calling in these loans to bill-brokers. So that far from expecting to be able to obtain the wherewithal, from ordinary sources, for financing the parcel that is offered, the bill-broker in question is probably already severely pinched in the matter of credit, and knows that if he takes these bills he will have to borrow from the Bank of England in order to pay for them. And borrowing from the Bank of England is an expensive operation, since it usually charges, for advances, $\frac{1}{2}$ per cent. above its official discount rate, which,

again, is almost always well above the loan rates current in the outside market.

So much for the adverse aspect of the immediate conditions. Against them we have to set the keenness of the seller, which induces him to offer an exceptionally fine parcel of bills at a rate which is tempting to the buyer, a high rate, that is to say, which means a low price for the bills ; also the fact that as most buyers of bills are cramped in the matter of credit by the seasonal demands already alluded to, and so are not in a position to compete eagerly for them, the present moment is a time in which the bold bargain-hunter, prepared to face the inconveniences of the moment, can often reap fine profits by the exercise of a capacity for disregarding immediate loss.

The forbidding appearance of the immediate conditions thus works both ways. In order to take the bills the broker knows that he will have to borrow from the Bank of England for at least a week, and that the higher rate paid for this temporary accommodation will make a hole in the profit that he hopes to make on the bill during the course of its currency ; but if future prospects are inviting he will be willing enough to do this, and it is the future prospect that will sway his decision.

And now the vastness of the problem really begins to open itself out, and our broker, if of an imaginative turn of mind, may well fancy himself like a doubtful partisan, standing on a hill-top and vainly trying to peer through thick mists, with the aid of a

somewhat inefficient spy-glass, into a great plain in which a battle is being waged by a number of forces of shifting and incalculable strength, and knowing that his life depends on throwing in his lot with the winning side.

In the immediate future there lies the probability of a spell of cheap money, when the usual reaction takes place after the satisfaction of the temporary demands at the end of the half-year, and after the distribution of the dividends on Government stocks early in July, which results in transferring to the hands of the ordinary banks some millions previously held by the Bank of England on behalf of the Government. These millions then become available at the market rate for loans, instead of at Bank rate, or $\frac{1}{2}$ per cent. above it. After that, according to the normal tendency of the year's monetary history, the demands of holiday-makers and harvesters at home ought to begin to tell ; while the great demand for currency all over the world, which generally shows itself during the autumn, when the crops of the chief agricultural countries are being gathered and garnered and shipped to the consumers' markets, ought just to be showing its force during the latter period of the currency of the bills offered, so that their date of maturity should be happy, enabling the holder to replace them on favourable terms.

According to the normal behaviour of monetary events, the buyer of a bill at a good price at the end of June ought thus to be able to reckon on a short spell of ease during which he would be able to finance

his purchase on very favourable terms—perhaps getting his money at 2 per cent. against the bill which we suppose him to have bought at 4 per cent.—and a gradually hardening tendency, which should not, however, reduce him to the necessity of giving more for his money than he was earning on his bill, or being obliged to sell his bill at a loss, owing to inability to provide the wherewithal to carry it.

But it need not be said that monetary events do not habitually move along the lines of normal behaviour, and even along these lines a little swerve in one direction or another may suffice to upset calculations that have to be reduced to the fine terms required by the keen competition of the discount market in London. The slackening of general trade may greatly reduce the demands of commercial customers on the banks and so throw a mass of credit back on them which they will pour out among the bill-brokers ; a quickening of trade may have an equally marked effect in the other direction and upset all expectations of the spell of easy money which was to have made the holding of the bills a profitable transaction. A cold, wet summer will check holiday travel and expenditure, while a brilliant season will send a shower of currency through tourists' pockets into the hands of hotel-keepers and others who provide for their wants ; and the extent of this outward tide will be among the innumerable items that will affect the volume of what is called money in Lombard Street. The quality and date of the harvest is another matter that affects the

monetary position, and in calculating its probabilities the weather has once more to be allowed for ; for if at the harvest season something like an ideal English summer is reigning, and farmers think that they can rely on the continuance of favourable skies, they will proceed leisurely and gradually, and the supply of currency that they will require will be so much the less ; but if the season is capricious, and a burst of harvesting weather arrives, everybody will want to save his crop at once, and each farmer will be pouring all the labour that he can get on to his fields and wanting money for wages, and for all the other expenditure that moving a crop entails.

And when he has balanced, as well as he can, the chances of trade, travel, and harvest requirements, the bill-broker must not forget the possible effects of an equally elusive factor, namely, the demands of Government finance ; these used not, as a rule, to count heavily at the period during which the parcel of bills offered is supposed to be current ; it was in the January to March quarter, when the income-tax is being gathered, that the money market was habitually pinched by the transfer of cash to the Government's balance at the Bank of England ; but throughout the year it was always possible that the Treasury would intervene with some unexpected demand in the shape of an issue of Treasury bills, or, on the other hand, might make money unexpectedly plentiful by allowing its balances to run below their normal level. For owing to the fact that the Bank of England is the Government's banker, the

Government's money is in its hands, and consequently when the Government holds an unusually large sum, there is so much locked up, and not available in the outside market. Since the war the existence of a huge floating debt, handled by the Treasury and the Bank of England, has given, as we shall see, these Olympian powers an immensely strong hold on the money market, though it has also obliged them to ride the market with a very gentle hand on the curb, and continually to pet it and pat it.

And as if weather, trade, and Government finance were not sufficiently incalculable factors in the problem, there arises the purely psychological question of the possible extent of speculation on the Stock Exchange. We have seen that the banks, which supply the bill-broker with money, employ a considerable amount of the credit that they make and handle, in financing the requirements of those who buy stocks and shares and pay for them with borrowed money. Consequently, if an unusually large number of people come to the conclusion that a purchase of securities with borrowed money is likely to be profitable, the supply of money available for the bill-broker may be curtailed. And the reasons which suddenly impel the public to indulge in one of its periodical outbursts of speculation are, perhaps, as complicated a psychological problem as anybody could ever be asked to solve.

And yet we are still only on the threshold of the bill-broker's difficulty.

For all these things happen, or do not happen, at

home and more or less under his own eye, and when he proceeds, as he must, to consider the possibility of foreign demands, he is face to face with questions which are much more difficult to answer and much more important in their effects. The movement of currency into the country for harvesting and holiday purposes, or the piling up of the Government's balance at the Bank, or the demands, arising out of an unexpected outburst of speculation, may cause inconvenience, and perhaps, if their effects are particularly unanimous and untoward, make a serious difference to the profit on a bill: but a sudden foreign demand and a considerable export of gold might easily be followed by a complete alteration in the whole aspect of the market—a rise in Bank rate and a readjustment, for the time being, of the value of credit at home and abroad.

Having devoted so much space to the consideration of the bill-broker's problem and having discovered that we have only touched the surface of it, it seems wiser on the whole to leave him with his problem and our sympathy. For any attempt to enter in detail into the innumerable causes which affect the demand for money abroad would lead us into a discourse of most formidable area.

But it may be mentioned incidentally that the risks of foreign politics and of international friction, the mere hint of which is often sufficient to affect the sentiment of the money market, are among the items in the enigma which has to be solved, or guessed at, by our bill-broker before he arrives at

his decision. And it need not be said that any serious shock to credit occurring in any part of the commercially civilized world might easily upset all his calculations.

It is not, of course, implied that all these matters are actually revolved by a bill-broker before he makes up his mind about any of the numerous transactions which make up his day's business. If this were so, the work of the discount market would never get itself done. But they, and many more, are the data on which he has to work, and a rough-and-ready view of the balance of all these possibilities and hypotheses has to be at the back of his head somewhere in his subconscious intelligence.

The essential difference between him and the banker lies in the fact that the banker makes credit, while the broker sells credit, relying on being able to buy it cheaper. The conditions most favourable to the broker are a high discount rate, which is the price of the credit that he sells, and a low rate for money, or short loans, which are the credit that he buys. The broker has need of keen and sensitive alertness as opposed to the level-headed sagacity, which is the most necessary asset of the banker. But the most important feature in the position of the bill-broker is that he constitutes the second line of the banker's defence, and consequently first feels the effect of any monetary pinch. If money is wanted suddenly by other customers whom bankers think fit to oblige, or if it is thought necessary to restrict the supply of money, the advances from

bankers to bill-brokers are likely to be straightway curtailed. And this is an additional reason which makes a large supply of alert and open-eyed intelligence so necessary for his success.

CHAPTER IX

THE ACCEPTING HOUSES AND FOREIGN BANKS

IT ought by this time to be clear, unless the proportion of the perspicuity of this work to its tediousness has been most lamentably inadequate, that what we call money generally means credits with a bank, and that most of these are created either out of loans or investments made by the bank or by some other bank, or by the discounting of a bill, which is only a special form of loan.

Further, the bill has been shown to have advantages over any other form of security, because the shortness of its currency ensures a speedy return of his cash to the holder, and because it is drawn, or ought to be, against actual produce moving into consumption, so that, as is claimed by those who deal in it, a good bill of exchange pays itself.

It will also be remembered that the original bill of exchange was an order drawn on the purchaser of the produce by the seller, instructing him to pay its price to himself or some other party at the end of a period during which the purchaser might be expected to have disposed of the produce, either in its original form or worked up for con-

sumption by some process of manufacture. And the purchaser of the goods accepted the bill by signing his name across it—that is, acknowledged that he would be liable for the sum named at the due date, and so became the acceptor of the bill. After which the bill, drawn by a good name and accepted by a good name, and with the necessary documents in order showing that goods had been duly shipped and insured, was as sound and attractive a security as the most sceptical money-lender could require, and could readily be discounted and advanced against.

It is necessary to pick up these threads which we left flying loose when we turned from the consideration of the forms of money to that of the principal wheels in the machine which produces money. Of these we have found that the banks are the chief, since they provide the right to draw cheques, which are the currency of English commerce, and give credits against indebtedness, which is called into being by the fact that trade habitually lives on the profits which it is in process of realizing, and could not proceed with its present unceasing velocity if it had to wait for their realization before it went on to its next task. Next we examined the operations and responsibilities of the bill-brokers, the retail dealers in bills, who are, as it were, an offshoot of the banks specializing on the selection of bills to suit the requirements of the bankers as to date, etc., and keeping them in stock with the assistance of credits chiefly furnished by

the banks. It is now necessary to consider the functions of those who manufacture the bills, against which the banks and discount houses jointly or severally provide credits.

In describing the bill of exchange in Chapter IV we took the simplest possible case in order to keep the ground as clear as might be of confusing obstructions, and imagined an American farmer, Mr. Silas P. Watt, selling wheat to a London merchant, Mr. John Smith, and drawing a bill on him for the value of the produce. By so doing we not only attained a measure of clearness which would otherwise have been impossible, but also got down to the ultimate facts of the case. For the real manufacturers of real produce bills are still the grower of the produce and the merchant who handles it in its ultimate market. Without them the produce could not come into existence, and without produce there could be no bills, except of the kite-flying order, as drawn by Mr. Micawber on Mrs. Micawber.

Nevertheless, modern processes of specialization have introduced certain intermediaries between the producer and the merchant in the ultimate market. As matters are arranged now Mr. Watt would sell his wheat to a merchant in his own country, and it would probably pass through many hands on paper before it was finally shipped. It would be financed in the meantime by advances from American banks, and the bill drawn against it, when finally shipped, would be drawn by an American bank or finance house on its correspondents in London, who would

be a firm devoting much if not most of its time and attention to this specialized industry of acceptance.

Since this inquiry is confined to the machinery of money in London, we can leave out the producer and the American merchant and their bankers and confine ourselves to the London end of the bill, that is, the London name which is written across it, and so marks it as accepted.

It is easy to understand how a distinct class of accepting houses grew up out of the merchant importers who originally accepted bills in the course of their importing business, that is, accepted orders on themselves to pay for goods which were in process of being forwarded to them. The readiness with which the acceptances of the different merchants would be discounted and turned into cash would vary considerably with the difference in their reputation and standing, and the caution with which they were credited in the matter of conducting their business. And the varying readiness with which certain acceptances were discounted would inevitably express itself in varying rates at which their bills could be placed. It would thus naturally follow that it would profit merchants of second-rate standing to give a commission to those whose reputation was more exalted in order to secure a more attractive signature than their own, and so get back the commission and a little more by being able to finance their operations more cheaply than by means of their own acceptance.

The merchants of first-class credit would thus find that they could let out the use of their reputations on profitable terms, and proceed to specialize in this branch of business, which consisted in examining the bills put before them for acceptance, keeping themselves well acquainted with the means and standing of the drawers of them, and giving their acceptance, for a commission, to such paper as fulfilled the requirements of their discrimination.

The foreign connections arising out of the original trading operations, with which they laid the first foundations of their mercantile position, naturally led these houses into providing monetary accommodation for the governments of the countries with which they traded, and there thus grew up out of the ranks of successful City merchants a class of merchant bankers, financiers and accepting houses, which, along with the old private banking houses, constituted a sort of aristocracy in the City, which still survives to some extent. They are often described as merchant bankers, but it is important to remember that they are not bankers in the strict sense of the term—that is, they do not pay cash across the counter against cheques drawn on them—because it is from their ranks that the directors of the Bank of England are chiefly recruited, and as we shall see in a later chapter, it used to be a rule that a director of the Bank of England must not be a banker.

The importance of the function of the accepting

house need not be emphasized. If the producer of the produce is the original creator of the bill, it is the acceptor who, by his signature, gives it currency and hall-marks it for the purposes of the London market. A banker or broker who discounts a bill and parts with cash or credit in exchange for it, cannot be expected always to know the position and trustworthiness of the drawer, and must often rely on the name of the acceptor as his sole guide in appraising its merit. So that it is by the judicious and properly regulated use of their names that the accepting houses put into circulation an enormous mass of credit instruments, the supreme merits of which as liquid investments have already been insisted on with "damnable iteration."

Nevertheless, the office of the accepting houses is still dependent on that of the banks, because the bills that they accept, though thereby greatly furthered in their progress towards becoming cash, do not actually become cash until they have been discounted. And this is done either by a banker or by a bill-broker who works with credit, generally furnished to him by a banker. A bill that cannot be discounted is of no use to the holder until its day of maturity, and is not until then a credit instrument in any sense. And we thus come back once more to the supreme importance of the banks in London's monetary polity.

For the power of the accepting houses to give currency, by their acceptance, to paper concerning the merits of which they are best in a position to

discriminate, is one that is obviously liable to dangerous abuse, and in their case the check of publicity is absent, since the private nature of their business keeps it free even from the ceremony of a half-yearly published balance-sheet. A very little carelessness, a very little error on the side of optimism, and a very little neglect of the principle that the basis of a real bill should be real produce moving into consumption, and there are all the materials for a dangerous inflation of credit. And the banks, which ultimately provide the means by which acceptances are turned into cash or credit, have thus an important responsibility thrown upon them, and one which is not apparent to the general public, to which the whole machinery of acceptance is more or less a mystery.

The question is complicated by the fact that, as has already been mentioned, the banks have themselves undertaken the business of acceptance to an extent that has increased rapidly in recent years. The excellent sanity with which the banks conduct their business makes this complication more apparent than real; and the dependence of the accepting houses on the good opinion of the cheque-paying banks concerning their paper is modified by the fact that they can ultimately have recourse to the Bank of England, through a bill-broker. The Bank of England requires two British names, of which one must be the acceptor's, on bills that it discounts, and a bill accepted by a British firm and endorsed by a London bill-broker fulfils its

requirements. And the Bank of England has before now intervened with effect when the paper of an accepting house has been unreasonably considered too plentiful by the other banks.

Nevertheless, the opinion of the banks concerning the paper of an accepting house is very important to it ; and the position is curious which makes the banks at once the watch-dogs over the volume of acceptance, and large, increasingly large, acceptors themselves. It is possible that, in order to attract customers and increase other kinds of business, the banks sometimes give their acceptance too cheaply, and it is natural that the accepting houses should regard their expansive intrusion with an unfavourable eye. It is also very essential that the banks should remember that the least irregularity or carelessness on their part in the selection of the paper that they hall-mark with their acceptance might have very far-reaching effects, if it came to light and were the subject of City comment, because the general body of their customers and depositors would be extremely likely to misunderstand it ; and that what would be a mere indiscretion in an accepting house, which does not depend for its existence on the confidence of the uninstructed multitude, might mean disaster to a bank, which does.

At the same time, if watched over with due care, the growing interest of the banks in acceptance business seems to be a perfectly natural process arising out of the increasing requirements of the

expanding trade of the world. It is difficult for the ranks of the old private accepting houses to be recruited ; it had lately been done with success, when this book was first written ; but a firm that enters on the business has to have capital and credit at its command, such as are rarely to be found in the hands of folk who are prepared to risk them in a new enterprise, the technicalities of which have to be acquired with patience, and perhaps through costly experience. The extent to which the old houses can accept is restricted by the obvious limits which are imposed on the amount of business, especially of business in credit, that can be done by any one firm. And the reputation and position of the banks seem to qualify them naturally to fill the gap.

An important part of the machinery of acceptance is also furnished by the Indian and Colonial banks, which, naturally again, give a large part of their attention to providing exchange between London and the country with which they are connected, and to handling the paper which its trade calls into being. The high reputation of the Indian banks, and the skill with which the bills endorsed by them are marketed, makes the prices fetched by their bills often a leading factor in the quotations of the discount market.

Finally, in considering the main springs which feed the flood of acceptance, we come to the London agencies of the chief Continental banks, which in pre-war days played a very important part both as

sellers and buyers of bills. Since the closing of the German banks' London agencies owing to the war, bills drawn on foreign bank agencies are much more rarely seen. But this only means that credits which used to be raised in London on foreign account by drawing a bill on a German bank's London agency are now raised by drawing on a London bank or accepting house. The volume of credit provided for foreign borrowers is probably greater than ever.

Foreign financiers were quick to detect the advantages of the English credit system, and to turn them to their own profit and to the furtherance of the trade of the countries that they represent. It is often contended that the rapid expansion of German trade, which pushed itself largely by its elasticity and adaptability to the wishes of its customers, could never have been achieved if it had not been assisted by cheap credit furnished in London, by means of which German merchants ousted English manufactures with offers of long credit facilities to their foreign customers.

An instructive example of this system of pushing business on credit, and of its disastrous results to all parties when carried too far, was furnished, twenty-one years ago, by the embarrassments of German traders with Japan. A letter from the Tokio correspondent of the *Economist*, dated May 8, and published on May 30, 1908, dealt with the financial and commercial strain and depression then ruling in Japan, and its adverse effect on

foreign (non-Japanese) merchants, and proceeded, in the following passage :—

“ Almost all the foreign firms thus far affected are German, and the reason is not far to seek. Years ago, the Japanese import trade was chiefly carried on upon a cash basis. A Japanese merchant gave an order for goods, against which he deposited bargain money, and when the merchandise arrived he took delivery only after paying the balance. The German merchants, however, gradually introduced a credit system. First the goods were permitted to be taken away, and payment deferred until they reached the go-downs of the Japanese purchaser, this concession being made on the quite reasonable plea that, as soon as the latter had the goods in his possession, he would be able to get advances on them from the native banks, and liquidate his account. But the time limit was gradually extended . . . until delivery was permitted to be taken against promissory notes for as long as from three to six months. Though the British merchants stood out against the practice as long as possible, they were compelled to follow suit to some extent ; but, holding that such an extension of credit was dangerous in Japan, they never went so far as their German competitors. So long as things went well in this country the credit system worked satisfactorily, and during the boom after the war, there can be no doubt that the business handled by the Germans went ahead more rapidly than that in the hands of British merchants, who preferred to work on the old conservative lines. As soon, however, as a period of stringency in money and contraction in trade took place, difficulties began to arise . . . Very heavy losses have been suffered. It is not too much to say that in the last six months the German merchants have lost far more than they gained during the two years of the boom by the extension of the credit system. Once more it has been shown that unsound methods of doing business, whatever advantage they may bring for the moment, are disastrous in the long run.”

This instructive message is an example of much that had been happening in many other countries besides Japan, Morocco having been another field in which seed of this sort is believed to have been plentifully sown. No one can quarrel with the Germans for making use of the credit weapon in extending their trade, though their over-extension of credit facilities had results which fell on others besides themselves; still less can they be blamed for their cleverness in taking full advantage of London's monetary machinery, and providing themselves in London with the credit with which they wheedled away England's customers in countries where credit facilities were an attractive novelty, over-indulgence in which has since proved unwholesome both for the giver and the taker.

It is very probable that the extent to which they did so is much exaggerated, since in a case of this kind, in which figures are necessarily not available, an active imagination roams at large. But it is at least interesting to note that England, having done so much to establish the foundations of German military and political greatness at the time of Frederick the Great, when it subsidized the young kingdom of Prussia at a critical period in its Titanic struggle,¹ has also given a helping hand to German trade with the facilities so cheaply offered by the London discount market.

Let us hope that our German friends are duly grateful, and let us avoid the mistake of imagining

¹ Carlyle, *Frederick the Great*, book xviii. chapter ii.

that we have done ourselves any permanent harm by this assistance. It is to the economic interest of humanity at large that production should be stimulated, and the economic interest of humanity at large is the interest of England with its mighty world-wide trade. Germany has quickened production with the help of English credit, and so, it may be remarked, has every economically civilized country in the world. The fact that all or most of them, including our own colonies, develop their resources with the help of English capital and credit, and then do their utmost to keep out our products by means of tariffs, makes it appear to superficial observers that England provides capital for the destruction of its own business. But, in practice, the system works quite otherwise. For all these countries that develop their resources with our money, aim at developing an export trade and selling goods to us, and as they have not yet reached the point of economic altruism at which they are prepared to sell goods for nothing, the increase in their production means an increasing demand for our commodities and services. And in the meantime the interest on our capital and credit, and the profits on working the machinery of exchange, are a comfortable addition to our national income.

This digression is not quite as irrelevant as it seems, for there is a strong feeling among the manufacturing classes that the facilities given by the London money market to foreign borrowers are

detrimental to English trade. This contention cannot be set aside as lightly as it sometimes is by the defenders of our banking system. The obvious answer to it is that England makes profits out of its credit factory which very much more than compensate it for any handicap imposed on its manufactures of other commodities. But it must be admitted that this is only a partial answer, and that if the handicap were real and persistent, its working would tend to make England a banking, discounting and exchange-dealing nation rather than a manufacturing nation ; in other words, it would tend to turn out energies into financing, calculating, and book-keeping, rather than producing and working on commodities. This process would not necessarily be an evil, but is a matter which might have important economic and social results, and ought not to be ignored if it were really at work. The organization of foreign banking which places credit facilities, borrowed in London, at the disposal of foreign manufacturers, is a matter which calls for respectful imitation in England. There ought to be no possible ground for the assertion, which is sometimes heard, that English traders cannot borrow in their own market as cheaply as foreigners. Reference has already been made to the gap in our financial machinery observed by the Balfour Committee and the need for plugging it.¹

This excursion into complicated questions of international trade was necessitated by the appear-

¹ See *ante*, page 125.

ance of the agencies of foreign banks as an important item among the institutions whose acceptances give currency to bills of exchange and enable them to be discounted or sold for cash. They also at times have an important influence on discount rates by dealing on the other side of the market and buying English bills. And both these operations, whether they raise credits on this side by selling their own bills, or obtain a credit due at a later date by buying and holding English bills, give them a hold on London's gold. In fact, their holding of English bills is arranged with this direct object. Some Continental institutions—and this system has been greatly expanded since the war—always keep a portfolio stocked with bills on London, constantly replaced as they mature, either as part of the legal basis of their note issues, or so that in time of need they may take gold from London. And this fact is one that obviously has to be continually remembered and allowed for by the directors of the Bank of England, which has London's store of gold in its keeping. And moreover, the dealings of foreign houses in bills of exchange have an important effect on the foreign exchanges, and bring us face to face with the necessity for an explanation of that formidable subject.

CHAPTER X

THE FOREIGN EXCHANGES

THE foreign exchanges are really a fairly simple matter if we keep them free, as far as possible, from the technicalities which are the delight of experts in the subject, who generally expound it. They were exemplified in Chapter I by the purchase of a postal order, and they may be described as the mechanism by which money here is exchanged for money somewhere else. In the example there given the business was simplified by the existence of the machinery of the Post Office, which is prepared to undertake exchange transactions at fixed rates.

In the exchanges of the large amounts which international commerce makes payable in one place or another, the bill of exchange plays an important part. But the essential point to be grasped is the fact that fluctuations in rates of exchange are caused by variations in the relative value in the currencies of the two centres between which the exchange is quoted. If Londoners have big payments to make in Paris, or want to send large sums to Paris, they will want to exchange many pounds for francs, and the value of the pound will be depreciated when expressed in francs, and the Paris exchange will move "against London." The most obvious

reasons which will cause this variation, or stimulate this demand in London for remittances to Paris, will be the balance of trade in its widest sense—the exchange of commodities and all kinds of services between England and France—and the rate of interest ruling in the two centres. If Paris sells more goods and services to London, people in London will have larger payments to make in Paris; and if the rate of interest be 3 per cent. in Paris and 2 per cent. in London, money will tend to flow from London to Paris to earn the higher rate, and the demand for remittances to Paris will thus be further stimulated.

Since bills of exchange play an important part in this business of the exchanges, it is perhaps safer to repeat here that a bill of exchange is an order by A directing B to pay a sum of money to himself, A, or to a third party; that the cheque with which you tell your bank to pay £2 to your butcher is, in fact, a bill of exchange; but that the term, in its more usual meaning, implies an order on a person at some distance in space to pay a sum at some distance in time. As, for example, when a dairy farmer in New South Wales sells butter to a produce merchant in London, and draws a bill on him at sixty days' sight. When the bill is "accepted"—that is, when the merchant acknowledges his liability to pay by writing his signature across the bill—it becomes a negotiable instrument and can be discounted and turned into cash.

It can also, evidently, be used wherewith to pay

any debts that the farmer may have to meet in London. If he owes a similar sum to his harness dealer, he can hand the bill over to him and let him collect the money from the merchant; and the one bill will thus have paid two debts. It has paid the farmer on behalf of the produce merchant, and the harness dealer on behalf of the farmer. Or if the farmer owes money in other parts of the world, a bill on London is always acceptable; if he has bought hay-making machinery in America, the draft on his merchant could be used equally well to pay for it, for there would be plenty of people in the United States who have payments to make in London and will give a certain number of American dollars to the manufacturer of mechanical hay-makers for his order on the London merchant.

And here comes in the difficulty which makes the foreign exchanges apparently so obscure. When it was a matter of a payment between London and Sydney, there was no question of a difference of currency, for in both these places the pound is the unit in which payments are expressed. But when a draft on London has to be sold in America, the relative value of the pound and the dollar comes into the calculation. And the unfamiliar observer is puzzled by the fact that these relative values continually fluctuate, with the result that the table of exchange quotations constantly varies, and the exchanges are said to move in favour of or against a particular country in a manner which is

very extraordinary to him, since the intrinsic value of the currencies that they represent is unaltered.

We shall arrive at a clearer understanding of the matter if we leave out for the present this question of exchange of different currencies and return to that of the exchange between London and Sydney. These two towns use notes of the same gold value as legal tender and as money of account, and therefore it might be supposed that anyone who has to make a payment of £20 in Sydney would have to put down in London exactly £20 plus a payment to the colonial banker who sells him the draft for his trouble and expense in sending the money.

But this is not so. Owing to the fact that Australia constantly has to remit to England in order to meet interest on debt, etc., the Australian exchange tends to be in favour of England ; that is to say, a credit on London is more sought after in Sydney than a credit on Sydney is sought after in London, because the drain of money is habitually from Sydney to London.

Hence, if you go to an Australian bank's London office and buy a draft on Sydney with your cheque on the Westminster Bank, you are giving it money in London in exchange for money in Sydney, and we have seen that money in London is relatively more valuable than money in Sydney owing to the exchange being normally in favour of London.

Consequently, the Australian bank is prepared not indeed to give you an order for £20 and some-

thing over in Sydney in return for your London cheque for £20, but to do what comes to the same thing, namely, manage your remittance for you for nothing, making no charge for its trouble.

But if the movement were reversed, and some one in Sydney were buying a draft on London, he would have to pay £20 plus a premium, because the exchange is in favour of London ; that is, a pound in London normally commands more than a pound when compared with a pound in Sydney.

Here, then, we have an example of the working of the laws of exchange between two countries in which the coins into which drafts are convertible are identical, and if once we can grasp the logic of this, we have gone a long way towards simplifying the more complicated question of the exchanges between countries with different currencies.

For the broad principle is the same everywhere. Whenever, for any reason, one place, A, has to send more money to another place, B, than B has to send to it, B's currency will be relatively more valuable, and the exchange will be in favour of B.

Let us consider the matter again in the case of Sydney and London and suppose that instead of going to one bank to arrange your remittance you went into a regular market wherein were assembled representatives of many Australian banks and exchange dealers, and waving your cheque on the Westminster before them asked them how much money in Sydney they would give for it. If the pressure to remit money from Sydney to London

were keen, they would all be eager to have your London cheque, because by buying it in exchange for a draft on their Sydney balance they would be increasing their London credit at the expense of their Sydney credit without incurring the cost and risk of sending coin or bullion from Australia.

Consequently competition would impel them to give you something more than £20 in Sydney, but that something more would be limited by the expense of sending coin and bullion. If we suppose, for the sake of simplicity, that expense to be covered by 6*d.* per pound, it would pay them if the demand were eager enough to give £20 10*s.* for your London cheque. Beyond that it would not pay them to go. If you tried to insist on £20 10*s.* 1*d.* it would be cheaper for them to send gold from Australia. So that in this case £20 10*s.* (or £1 0*s.* 6*d.* per pound) would represent what is called gold point, and if your London cheque really fetched that price, the exchange between London and Sydney would be said to have gone in favour of London up to gold point, and the movement of gold from Sydney to London might be expected to begin.

In the case of large amounts, and of places far distant, the element of time becomes important. If exchange between London and Sydney were at par, it might still pay an Australian banker to give more than a pound in Sydney for a pound in London because he would receive the pound in London at once, and his balance in Sydney

would only be drawn on five weeks hence when the draft arrived. So that he would have the use of your money for five weeks, and in times when the rate of interest is high this is an important consideration.

In the example just considered, where the exchange between London and Sydney was strongly in favour of London, it was supposed that a pound or a pound's worth of credit, in London might fetch £1 0s. 6*d.* in Sydney. If the tendency of the balance of indebtedness were flowing in the other direction, and there were a great demand for drafts payable in Sydney, London's currency would be depreciated as compared with Sydney's, and a pound here might only fetch 19s. 6*d.* on the other side. But this depreciation could only work up to the point at which it would pay those who have debts to pay in Sydney to pack gold and send it rather than make use of the machinery of exchange. If you were offered only 19s. in Sydney in exchange for your pound here you would obviously inform the dealers in exchange that you preferred to dispense with their services, and would ship gold to your Australian creditor.

Restating the matter yet again in the effort to be clear, we may express it by saying when the sums that people want to send from Sydney to London are greater than the sums which have to be sent from London to Sydney, the Londoners will be in an advantageous position, and able to buy drafts on favourable terms : but that the amount

in Sydney that their pounds or cheques representing pounds in London will fetch cannot rise above the exact equivalent plus the cost of remitting gold from one centre to the other. When that point is reached the exchange is at gold point.

What is called the mint par between the two places is in this case the pound, and if the cost of remittance, insurance, etc., be 6*d.*, as we have supposed for the sake of simplicity, the outside fluctuation of the exchange will be 1*s.*; for if it cost Sydney over 20*s.* 6*d.* to buy a pound in London, Sydney will ship gold to London rather than buy drafts; and if a pound in London fetch less than 19*s.* 6*d.* in Sydney, Sydney will import gold from London.

We can now proceed to consider the question as it appears when the balance of indebtedness is being settled between two countries which use a different currency.

In France the unit is the franc, so that when a Frenchman wants to send money to London he wants to exchange francs into pounds; conversely, an Englishman who wants to send money to Paris has to exchange pounds for francs.

The value of the new franc, established by M. Poincaré in June 1928, was "fixed at the weight of 65½ milligrammes of coined gold at 900 fine, which places it on a par with sterling at 124·21."¹

The cost of sending gold from one centre to another varies from time to time according to the

¹ *Economist*, June 30, 1928, page 1335.

rate of interest current (because money on the way is not earning its keep), changes in freight charges, packing charges, etc. There is no such thing as a fixed "gold point" at which it pays better to send gold than to buy a bill. At present,¹ however, if you ship gold to Paris, your pounds, by the time they made the journey, will realize about 123*f.* 85*c.* Consequently, if you can buy a bill on Paris at any higher rate it will pay you to do so rather than send gold.

Whether you will be able to do so will depend on the value of money in Paris as compared with London, and on the balance of indebtedness between London and Paris. If the rate of interest is higher in Paris than in London, London will want to send money to Paris to earn the higher rate, and if Paris has been selling us more valuable goods and securities and services than we have been selling to her, Paris will have more bills on London arising out of those sales than London has on Paris; consequently, the demand in London for bills on Paris will be keener than the demand in Paris for bills on London, because London has more remittances to make.

Hence it will follow that the seller of a bill on Paris will be able to get more favourable terms, and the exchange will be, as it is called, in his favour; in other words, his francs will be relatively more valuable than the pound, and the pound will fetch less when expressed in francs. And if the balance

¹ November 1929.

of indebtedness be heavy enough, and the competition of those who want to buy drafts on Paris—that is, to exchange pounds for francs—be keen enough, the value of pounds expressed in francs will go below 124*f.*, and then those who have remittances to make will begin to think about shipping gold instead of buying drafts, the Paris exchange having gone down towards gold point.

When the balance is the other way, and London has been selling more valuable goods and securities and services to Paris than Paris has been selling to London, bills on Paris will be more plentiful than bills on London, and the French importers of goods, etc., will have to compete for drafts on London in which to make their payments. That is, they will have to pay more in francs, which will be relatively depreciated, for the pounds that they need for the payment of their debts, and their competition will force the exchange up towards the other gold point, when shipments of the metal may be expected.) But it must not be forgotten that the relative value of money in the two centres is a constant influence which may increase or modify the movement of exchange due to the influence of indebtedness for goods and services. If London has sold large amounts of goods to Paris, but money is dear in Paris, the two influences will tend to counteract one another; London will leave the proceeds of its sales in Paris to earn the higher rate of interest, and as long as it does so those sales will not affect the exchange.

It may have been noted that the French exchange is against London when it is low and in London's favour when it is high. And this is natural and inevitable when we consider that the quotation expresses the value in francs which a pound will fetch. When this value is low the holder of a pound receives less in francs, and so the exchange is very literally against him. When you want to buy francs with your pound, the more francs you get for it the better it is for you. When the rates of exchange are quoted in English money, it is otherwise. The Argentine dollar is quoted in pence. When it rises from $48\frac{1}{4}d.$ to $48\frac{3}{8}d.$ it moves against England, because it fetches more pence, and anyone who wants to exchange pounds for dollars will receive less of them. This is one of the small complications which make the question of the exchanges so difficult to the inexperienced. But it can always be met by considering that the ultimate fact expressed by rates of exchange is the relative value between a pound and a foreign currency. When the pound buys more of the foreign currency the exchange has moved in our favour; when it buys less the exchange has moved against us.

It thus becomes evident that the foreign ex-
changes are a mechanism by which international indebtedness is settled between one country and another, and that rates of exchange are the prices at which the currencies of the various countries are expressed relatively to one another. When the

balance of claims between two places does not roughly agree gold has to be shipped to settle the difference, unless it can be met by what is called arbitrage, which consists of dealings in bills on other centres. For instance, London may not have enough claims on Paris to set off the claims of Paris on it, but may be able to fill the gap with bills on Berlin, or some other centre, which Paris may happen to want.

The system on which the exchanges work is thus similar to that of the bankers' Clearing house in London. In it the claims of the clearing banks are crossed off against one another, and any balance that is due, for example, from the Westminster Bank to the Midland, is settled by the deduction of part of the Westminster's credit at the Bank of England and its addition to the Midland's. But in the case of international indebtedness, the balances have to be settled by shipments of gold. Such, at least, is the theory of the matter, though the restrictions that most of the chief Continental centres used to place on withdrawals of gold often prevented, or at least postponed, the working of the machinery of exchange in accordance with theory. The restoration of the gold standard has been too recent for us to be sure how the gold balancing system will work in future. So far it seems to work more freely than of yore.

The broad principle which has been thus set forth and exemplified is the ultimate basis of the movements in the rates of exchange between all

countries, even those which have currencies based on different metals, or in the case of those in which the currency is based on nothing but the printing-press. But it need hardly be said that there can be no gold point in the case of countries with a currency which consists of silver or of inconvertible paper notes.) Nevertheless, even in their case, though the fluctuation of exchange is complicated by variations in the price of silver or by new issues of paper currency, yet the balance of relative indebtedness between them and other countries is still an important factor, ready to assert its complete predominance at any moment when other complicating influences cease from troubling.

Since, then, it is largely on the mutual indebtedness of various countries that rates of exchange are based—though we must not forget the influence of the rate of interest in the various centres—let us see how this mutual indebtedness arises.

The most obvious cause of it is the mutual exchange of natural produce and manufactured articles—the balance of trade, as it is generally called. This we see chronicled in the monthly returns issued by the Board of Trade of British imports and exports. These always show that England has imported goods of much greater value than those which she has exported, and because there is no published record of her other exports—her invisible exports, as they are sometimes called—superficial observers are often very much frightened about the state of English trade and draw

astonishing inferences, the most notable of which was propounded by a colonial premier who told an English audience that England had to export annually so many millions of golden sovereigns to pay for the balance of the cost of her imports over that of her exports.

In fact, an "unfavourable" balance of trade, which is the misleading description given to this condition of the purely commercial relations between one country and another, is one that may be shown either by countries of the highest economic development which are in a position to supply other countries with credit and other services, which the other countries have to pay for with their goods ; or by countries at an early stage of development, which are borrowing abroad and supplying themselves with goods and equipment, in exchange for promises to pay.

At the same time, those who are alarmed by the extent of the difference between the value of our visible exports and imports are justified to this extent, if they consider that it is better for England to be a manufacturing country than a creditor and banking country. A large part of our invisible exports consists of services rendered by the clerking and financing classes, and those critics of our trade position who do not ignore them, but maintain that they would prefer to see them replaced by goods worked up by the producing and manufacturing classes, take up an attitude which is perfectly logical. The more common course, however, is to

ignore these invisible exports altogether, as was done by Mr. Seddon in the speech referred to above, and to deduce the alarming conclusion that we are living on our capital, and otherwise in a terribly decadent and deplorable condition, from the commercial point of view.

This being so, though it is an oft-told tale, it is perhaps worth while to enumerate some of the invisible exports by means of which we fill the big gap between the values of our imports and exports of visible goods.

During 1928 we had an excess of imports of merchandise and bullion amounting to £359 millions. On the other hand, we exported the following "invisible" items:—

(1) Shipping freights. Our ships were estimated to have carried £130 millions by carrying goods for oversea customers.

(2) Interest coupons. Our estimated net income from overseas investments was given by the Board of Trade as £285 millions, and was suggested by the *Economist* to be £300 millions.¹

(3) Insurance facilities. The English insurance companies and firms do a large business all over the world, and draw thence a regular income in premiums.

(4) Banking facilities. The large sums spent annually by Americans in Continental travel are, to a great extent, financed by drafts on London, on which London takes toll. Still greater, probably,

¹ *Economist*, March 2, 1929.

is the profit that England regularly makes by discounting bills for other countries, financing their speculations by carrying over shares for them in the London market, and making advances in other forms.

(5) Pleasure, social amenities, titles, and art treasures. Americans in times of prosperity spend a constantly increasing amount in travel and enjoyment in England. Many of them, it is said, are anxious to cut a figure in what is called Society, and the lavish expenditure in which they indulge is believed to be of some assistance to this ambition. All this expenditure here on their part has the same effect on the balance of Anglo-American indebtedness as an English export. (It is also well known that the scions of ancient English families frequently find wives among the attractive daughters of America, and the big dowries that the latter bring with them amount to a considerable annual charge on the United States.) The habit of purchasing art treasures, lately rife among rich Americans, is another item in the balance. The fact that owing to American tariff regulations many of these art treasures are left here does not, of course, interfere with the effect on international indebtedness produced by their purchase.

(6) Family affection. Many of the English, and especially Irish, settlers in America and elsewhere, regularly remit sums to their parents and families at home, taking nothing in return but affection and gratitude. Every one who has read *Some*

Experiences of an Irish R.M. remembers the picture of McCarthy, the horse-dealing farmer who charged Mr. Bernard Shute £45 for a mare, saying, "She's too grand entirely for a poor farmer like me, and if it wasn't for the long weak family I have, I wouldn't part with her for twice the money." The long weak family was explained by Mr. Flurry Knox to be "three fine lumps of daughters in America paying his rent for him."

The above list might be continued, but sufficient examples have been given to show that there are many more exports in heaven and earth than are dreamt of by the philosophy of the monthly Board of Trade returns. It must not be supposed that the movement of these items is all in one direction. Foreign ships carry English goods, foreign insurance offices do business in England, and Englishmen spend money on travel and sport abroad. But it is estimated—and all these matters must be to some extent a matter of guesswork—that our total income in 1928 from these invisible items was £508 millions—leaving us with a balance after paying for our excess of visible imports of £149 millions to be added to our investments abroad.

It need not, of course, be supposed that the final balance, after allowing for all exports and imports, visible and invisible, must be exactly equal between any two countries. (It is perfectly possible for one country to be normally indebted to another year in, year out, on this balance of trade in its widest sense, and yet to be in a perfectly wholesome economic

condition, being kept so by being in a contrary relation with some other country.) It will thus be able to meet the bills drawn on it by its creditor with those that it draws on its debtor, and thus the sum of mutual indebtedness is crossed off and cancelled all over the world, or met, when at any time the supply of bills is inadequate, by movements of bullion to settle the balances.

This case arises, for example, when the chief agricultural countries are reaping and moving their crops. They hold, for the time being, the manufacturing countries in fee, and they need gold for the actual circulation of currency or as the metallic basis of paper currency. And, consequently, when gold movements were normal, gold used to move normally to the United States, Egypt, and Argentina in their harvesting seasons.

It is in these cases that the utility arises of the practice, referred to in earlier chapters, of drawing bills in anticipation of crop movements. Without this arrangement, countries whose staple export is harvested at a certain season would take payment in gold for it at that season, and would, during the rest of the year, have to remit in gold for the goods and services that it buys from other countries. But the dealers in exchange, and the more legitimate class of finance bill, provide the means by which, at times when such a country has nothing to export, the exchange dealers will make good profits by creating bills against nothing, but in anticipation of the crop that is in the ground, with the result

that the country exports less gold in its off seasons, and imports less when its crop is ready. Its imports of machinery in July are paid for by semi-fictitious remittances, created by exchange dealers who draw finance bills and so raise credits, and these bills are met later by the shipment of the country's crops in September, and by the bills genuinely drawn against them. And so the clumsy necessity for sending gold backwards and forwards across the oceans is reduced, though not extinguished.

It need not be said that it is quite impossible to gauge exactly the amount and value of the invisible commodities, which, as above enumerated, have so important an effect on the balance of international indebtedness, and so on the foreign exchanges. And one of the most elusive of the influences which thus complicate the question is that of the purchase and sale of securities between one country and another. But it has to be considered now because it is closely connected with the main question dealt with in this inquiry.

When one country raises a public loan in another, everybody is well aware of the transaction, and there is no difficulty about the matter. For example, Brazil borrows three millions in the London market by an issue of 5 per cent. bonds. The issue is advertised and subscribed, there is an open market in the bonds, and it is all clear and above-board. Brazil has exported to England three millions' worth of its promises to pay; England has returned to

Brazil three millions' worth of money or credit, or the right to draw on London, either by taking gold or by using its credits here to cancel debt elsewhere, or to make any purchases required. The immediate effect of the transaction will be to turn the exchange in favour of Brazil, though it must always be remembered that the overt working of this effect may be veiled by other influences. During the currency of the loan the effect of its existence will be to turn the exchange in favour of London, because Brazil will be obliged to remit periodically to meet the quarterly or half-yearly interest payments and the service of the sinking fund established to extinguish the loan gradually by purchase or drawings of the bonds.

Hence it is that no debtor country—that is no country which has borrowed extensively from the investors and money-lenders of other countries—can afford the luxury of what is called an unfavourable trade balance. In order to meet its interest payments and its sinking fund arrangements, it must (unless it does so by borrowing a bit more) habitually ship more goods than it receives, since the lenders are continually sending it interest coupons and drawn bonds, the payment of which it has to provide for either with goods or with fresh borrowing.

In other words, what is usually called a favourable trade balance may generally be taken as a sign of the economic dependence of the country which possesses it.

The same effect on the exchanges is produced when the borrowing is done, not by the Government of the borrowing country, but by companies ; as, for example, when the Pennsylvania Railroad sold £4,000,000 bonds here, the operation for the moment turned the exchange in favour of the United States, but during the currency of the bonds produced a periodical claim by London on New York for interest payments. Nowadays, however, the Pennsylvania raises any money it wants at home.

These public issues of loans are potent and obvious influences on the exchange. But an equally important effect, which is difficult to trace, is produced by the purchases of securities made by the investors of one country in the Bourses of another.

It is the natural tendency for a debtor country, as it makes economic progress, to buy up gradually the securities on which it has borrowed from others, and so to reduce or extinguish the amount that it has to provide abroad for interest payments. For example, Italian Rentes, the public debt of Italy, were formerly largely in the hands of foreign holders in France, Germany, and England. Italy's economic progress has been remarkable ever since her ambitions in the direction of colonial expansion and world-politics received a timely check on the Red Sea. Since then she has developed her internal resources with great success, and she has been assisted by the possession of an inexhaustible asset

which she exports continually, or rather lets other people come and enjoy. For Italy holds the world in fee as an exporter of Beauty—beauty in scenery, beauty in atmosphere, beauty in buildings, sunshine, association, and a hundred other things, besides her art treasures, which it would be absurd to call priceless, because to think of price in connection with them would be a vulgar irrelevance. Every year an increasing number of travellers from all lands pours into Italy to see these things, bringing circular notes and other forms of drafts wherewith to pay their way ; and, in order to meet these drafts and to feed the balances with their Italian agents on which they are drawn, the other countries have to send Italy goods, or services, or securities. Thus Italy has been enabled to buy up a large proportion of her own securities which were formerly held by foreign investors. Consequently, she has largely relieved herself of the drain against coupons, and her exchange has moved rapidly in her favour. So much so that pre-war travellers in Italy who had not been there for some years used to be astonished to find how much less valuable the English sovereign had become when measured by its exchange price in Italian currency.

These purchases of securities by the investors of one nation in the Stock Exchanges of others are a constantly fluctuating element, which has a marked effect on the balance of national indebtedness, and is extremely difficult to trace or gauge. Equally so is the perhaps still more important element pro-

vided by the shifting from one centre to another of the more highly specialized forms of securities, chief among which is the bill of exchange. And when we arrive at the ebb and flow of this restless ocean we come to the point at which the foreign exchanges most obviously affect the main subject of our inquiry, and it begins to be clear that this attempt to explain them was by no means an irrelevant infliction. For the movements of bills of exchange from one centre to another depend to a great extent on the rates of discount respectively current in them.

If the rate of discount be relatively low in London, bills will be poured in from abroad to be discounted and turned into cash here, and foreigners will use their credits here, and draw bills on London and discount them; and so our imports of securities will be increased, and the exchanges will be turned against us. And if the exchanges are against us, and gold is being taken from London, this state of affairs is remedied by a rise in the rate of discount here, which checks this import of bills and impels foreigners to remit funds to London to be employed in the purchase of bills; and if the process is continued, we begin to export securities, and thus turn the exchanges in our favour. And so we begin to see the great importance of the market rate of discount, owing to its effect on the foreign exchanges and through them on the ease or difficulty with which our supply of gold is maintained.

We have thus arrived, through the thorny labyrinth penetrated in this chapter, at a result which may be summarized thus:—

The foreign exchanges are the expression of international indebtedness.

International indebtedness is the balance arising from the exchange between countries of goods, services, and securities. The movement of securities, especially of bills of exchange, depends largely on the discount rates current in the chief financial centres.

The discount rate has thus an important bearing on the foreign exchanges.

It has also been shown that when the foreign exchanges go to a certain point, gold will be taken from London, because, for example, it will pay better to send gold to Paris than to take only 123*f.* 85*c.* (or whatever the gold point of the moment may be) for one's pound on 'change.

So that we are now beginning to see more clearly the importance of the market rate of discount, and the need for its sagacious regulation.

The market rate of discount depends, on the one hand, on the supply of money, and, on the other, on the supply of bills of exchange which come forward to be turned into money. We have already examined the chief parts of the machinery which creates and handles money and bills of exchange—the banks, bill-brokers, and accepting houses—and we found that in normal times the supply of money

and the level of discount rates are regulated by the banks, and especially by the Bank of England. We are now in a position to try to understand the functions of this institution.

CHAPTER XI

THE BANK OF ENGLAND

EVERY schoolboy knows, and most grown-up people have consequently forgotten, that the Bank of England was founded in 1694 to finance William III.'s Government. Since its foundation it has been the keeper of the national balance and the channel through which the nation has conducted its financial operations.

Its notes are the only form of paper currency that is legal tender in England, that is to say, that has to be accepted in payment of a debt, and it is the only joint-stock bank which is allowed to issue notes in London. As we have seen, the advantages possessed by the cheque have enabled it to supplant the note as circulating currency, but the Bank's privileges in the matter of note issue undoubtedly were of great service to it in its earlier history, and were an important cause of the prestige which now makes its name a household word for stability and soundness throughout the civilized world. It may also be presumed that they were an indirect cause of the fact that now gives the Bank its source of greatest strength and importance, namely, its position as the bankers' bank.

It has already been shown that the Bank of

England's privilege in the matter of note issue in London was intended to give it the monopoly of joint-stock banking in London, and that the flank of this monopoly was only turned when it was discovered that note issuing was not an essential part of banking. The result of this discovery, instead of weakening the Bank of England by the creation of a host of nimble competitors, strengthened it by providing it with a number of enterprising and wealthy customers, who developed banking facilities all over the country in a manner which would have been impossible to it without a radical alteration in its machinery and constitution, left with it the cash balances that were not required for their till money and country reserves, and so not only increased its dignity and visible strength, but made its task of financing the Government simpler and cheaper, reducing it to a great extent to a matter of entries in its own books.

For see what happens when the Government has to pay its dividends on War Loan and other Government stocks, and finds itself in need of ten millions or so for this purpose. It borrows ten millions from the Bank of England, and the Bank of England gives it a credit for this amount in its books, against which the Government draws its dividend warrants. But only a small fraction of this amount is actually withdrawn. For the most part the warrants are paid into the other banks to the credit of their customers who hold War Loan, and are paid in by them to the Bank of England to the credit of their bal-

ances with it. So that instead of making a great provision of cash the Bank only has to set its clerks to work with their pens rather faster than usual, and the thing is done. Thus two of the principal duties of the Bank of England, its management of the Government's money matters and its custody of the other banks' balances, fit into and assist one another very aptly.

Equally simple is the Bank's still more important task of providing emergency currency, and again for the same reason, the fact of its being banker to the collective banking community. In all economically developed communities there are periods when the normal supply of cash is insufficient, as, for example, at harvest time in agricultural countries and at the ends of the quarters, when everybody has to pay his rent and meet other periodical demands, and especially in this country at the end of the two half-years, when a large number of firms and companies all over the kingdom draw up their balance-sheets and strive to show a fine proportion of cash in their assets. And at the end of the December half-year these demands coincide with a big movement of actual currency into circulation to provide for Christmas travelling and money paid over tradesmen's counters for Christmas presents and the material ingredients of Christmas jollity. Consequently, at these periods there comes a seasonal demand for what is called money, and the Bank of England, by reason of being the bankers' bank, is able to provide it with extraordinary ease and expedition.

For money in England, as we have long ago recognized, chiefly means a credit with a bank, carrying the right to draw a cheque. In so far as it means pocket-money in the form of notes, the problem here is the same as elsewhere, and the periodical withdrawals of these for the cash payments alluded to periodically affect the Bank's reserve. But the great proportion of the seasonal demands are met by cheques, and a large part of them, those arising out of the desire to show large cash holdings in balance-sheets, are for ornamental purposes, and are only wanted to impress shareholders and customers.

Hence it follows that a large proportion of the emergency currency required at the end of the quarters is created for show and not for use, and is borrowed from the Bank not to be withdrawn or passed on, but so as to figure in balance-sheets included among "cash in hand and at the Bank of England."

We thus arrive at an important distinction between the credits given by the Bank of England and those of the other credit-making banks. When the latter make an advance against any kind of security or buy stock for investment, they create a deposit and give a right to draw a cheque, which is probably exercised; the cheque drawn transfers the customer's credit to the customer of some other bank, and, as we saw in Chapter V, the loans of one bank create the deposits of another, except when the loans are raised with one bank for repaying another. But in the case of the Bank of England, its position as

the bankers' bank results in any credits that it makes for its customers being left with itself, having been transferred from one bank to another in its books ; and, what is still more important, the credits that it makes rank as cash for the rest of the banking world, so that the demand for cash for ornamental purposes in balance-sheets can be satisfied with remarkable ease by book entries. And thus banking development has outwitted and eluded the well-meant effort of the Legislature to guide and regulate it.

The Bank of England's monopoly of note issue, which was intended to give it the monopoly of joint-stock banking in the metropolitan area, was nullified by the discovery that note issuing was not the most important part of banking, and yet some years after this discovery had been marked by the foundation of the joint-stock banks, which are now, collectively, the Bank of England's biggest and most important customer, the Legislature passed an Act which elaborately regulated the note issue of the Bank of England as if its note issue were still the central feature of its business and the only thing which merited the consideration of parliamentary wisdom.

It will be remembered that the Bank Charter Act of 1844, or Peel's Act, as it is sometimes called, laid down the principle that the amount of notes issued by the Bank against securities should not exceed the sum of £14,000,000 unless by the surrender of the note-issuing privilege by other banks, which exercised it, of course, outside the circle of the Bank of

England's monopoly. Any more notes issued were to be based on metal held in the Bank's vaults.

The Bank Charter Act thus proposed to revolutionize banking by taking away from the Bank of England the right of allowing it to judge for itself of the proportion between cash and securities that it held on the assets side of its balance-sheet against the notes issued on the other. "Your securities," it said in effect, "are to remain as they are, and for every extra £5 note that you issue in future you shall hold £5 in coin or bullion."

As to what might have happened if the Act had worked in the manner intended by its promoters, is a matter of interesting but idle speculation. Banking evolution has evaded or avoided the question by the development of a habit of regarding a credit in the books of the Bank of England as just as good as so many bank-notes or sovereigns or bars of bullion. Borrowers do not, as a rule, ask it for notes, but for a credit in its books, which it can create to an extent that is limited only by its own discretion.

By means of this system emergency currency and credit are provided with extraordinary ease. It has grown automatically, commands complete confidence, and works with a perfection that no theoretically planned scheme can excel. If the supply of money runs short, borrowers come to the Bank of England with securities of the kind that it approves, and in the course of a few minutes' conversation with the principal of the discount office add a million

or two to the basis of credit as expeditiously and easily as the ordinary citizen can buy a pair of gloves. The machine is a miracle of ease and efficiency.

The result, as it appears in the published statements of the Bank's position, is merely that the Bank of England shows an increase in securities on one side of the balance-sheet—these being the securities against which it has made advances—and an increase in deposits on the other; and the popular habit of gauging the position of a bank by the amount of its deposits would lead hasty observers to the gratifying conclusion that some fresh mass of accumulated wealth had been stored up and deposited at the Bank, and that it and its customers were richer than ever. Really all that has happened is that the Bank of England has lent "money" to some more borrowers, and, being banker to the other banks, has been able to do so by making a book entry, instead of seeing the "money" taken away from it in the shape of notes or coin.

Actually, of course, the Bank of England's position has been, when strictly considered, weakened by the operation, because the increase in deposits is an increase in liabilities, and the increase in liabilities without an increase in cash necessarily means that the proportion between cash and liabilities has been lowered, and the proportion between cash and liabilities is the most obvious touchstone that is first applied to the position of a bank in considering its apparent strength. And this question of the cash

brings us to the Bank of England's other most important function—that of acting as keeper of the gold reserve for the rest of the banking community.

This function, it is interesting to observe, also arises out of the fact that the Bank of England is banker to the other banks. They, by keeping their balances with it, have, as we have seen, greatly facilitated the readiness and despatch with which the Bank finances the Government and creates emergency currency; but, at the same time, they have imposed on it this heavy burden and responsibility of maintaining the ultimate reserve, and the Bank of England is never able to forget that its liabilities are not as the liabilities of other banks, since they contain that big block of bankers' balances, which the other banks regard and treat as cash, and use as part of the basis for the soaring structure of credit that they build up.

The obligation and responsibility are all the more onerous, because they have arisen, as it were, as an unsuspected irrelevance, and were long unrecognized and unacknowledged. It might have been thought that when the Bank Charter Act of 1844 had definitely laid down the duty of the Bank of England with regard to its note issue, all that it had to do was to carry out its legal responsibility with due punctuality and, for the rest, to carry on banking business on ordinary banking lines.

This, in fact, was the view long entertained by an influential section of the Bank's Court of Directors,

and its fallacy was exposed in that most brilliant of all essays in practical economics, Walter Bagehot's great work on *Lombard Street*. Bagehot not only exposed the fallacy, but killed it, buried it, and damned it. To do the Bank Court justice, it should be mentioned that even those of the directors who maintained it in theory did not advocate its practice, but spoke of a 33 per cent. cash reserve as adequate, though the ordinary banks would regard such a proportion as extravagant. In these days, even the theory has been abandoned, and the Bank of England has so effectually recognized the gulf that separates it from other bankers that it normally shows a proportion of cash to liabilities that is more than twice as large as that shown by those of the other banks which are strongest in that respect. In other words, the Bank might, if it reverted to the theory that it was only one bank among many working on the same principles, double the amount of its liabilities with a corresponding increase in its investments and dividends without altering the amount of its cash.

It is true that the greater part of the Bank of England's cash reserve in the banking department consists of its own notes issued by its issue department. But these notes are secured according to the provisions of the Currency and Bank Notes Act, and the other banks, with the practice of which we are now comparing the Bank of England's, include in their cash not only Bank of England notes but credits in its books.

But Bagehot's brilliant criticism of the manner in which the Bank recognized its responsibilities was chiefly concerned with its handling of the demands brought upon it by internal crises, and in days when an internal crisis meant a demand all over the country for Bank of England notes. Since its publication the position has been modified in two important respects. In the first place, the development of the use of cheques and of book-entry credits has been so great that it may fairly be inferred that at least the early stages of an internal crisis need not have much effect in the shape of a demand for notes. It is, of course, possible, that a panic might arise in England so severe that members of the mercantile community might refuse to accept one another's cheques in payment of debts and that we should take a temporary step backwards to the exclusive use of Bank of England notes. In that case the situation would have to be met by a suspension of the Bank Act in the old-fashioned style, the temporary abrogation of the limits imposed by it on the Bank's freedom of action, and the unlimited creation of notes to meet the demand. But apart from actual general cataclysm it seems reasonable to expect that any gap in credit might probably be filled by a mere enlargement of the Bank's advances, and a consequent increase in the credits which it gives to other credit-makers to serve as a basis for their operations. In other words, instead of the Bank's reserve being depleted by internal panic, it might have the effect of merely increasing its holding of securities and its

liability under deposits, as normally happens at the end of the half-years.

In the second place, the problem that the Bank of England has to face is much more external than it seems to have been when Bagehot wrote. Except during a few days in August 1914, when the shock of war upset all the money markets of the world and drove most of them to the printing press for shelter, our machinery of internal credit has worked so well and smoothly, that the possibility of real internal panic is almost forgotten. On the other hand, the general adoption of the gold standard by the economically developed countries of the world, accompanied by the fact that London was for a long time the only market in which every draft and every credit were immediately convertible into gold as a matter of course, greatly intensified the responsibility of the Bank of England as custodian of a gold reserve, which is liable to be drawn on at any time from all quarters of the habitable globe from which a draft on London may be presented.

For a long time before the war the difficulty of this task that it had to perform was increased, if not created, by the fact that it had in normal times, little control over the extent to which these credits in London were granted. For here again we find that the other banks are once more ultimately responsible, just as we have seen that they are now chiefly responsible for the creation of a mass of internal credit and currency, which they build on the foundation of the Bank of England's reserve, but

expand at their own discretion and at rates which, in pre-war times had no connection or sympathy with the official rate that was named by the Bank. By the bills that they accept, discount and lend against, by financing the bill-brokers, and by advancing against Stock Exchange securities, the other banks give foreign financiers a pull on the Bank of England's reserve, and the Bank of England is expected to maintain it. This responsibility is shared by the accepting houses, which by accepting for a foreigner, create a bill which he can discount at the Bank of England through a bill-broker, and so give him credit which he can convert into gold.

Owing to the extent to which banking facilities have been developed outside it, the Bank of England's official rate was often a quite empty formula, and the business of the London market was carried on without any relation to it ; and herein is another point in which the pre-war money market differed from that described in Bagehot's *Lombard Street*, for we find Bagehot constantly assuming that any change made by the Bank of England in its rate would at once affect, and be followed by, those current in the open market. "At all ordinary moments," he writes, "there is not money enough in Lombard Street to discount all the bills in Lombard Street without taking some money from the Bank of England." In pre-war times this was no longer true. The Bank, in order to make its rate effective, often had to take special measures—considerably

developed since then—of a kind which will be described later.

At present let us recapitulate the work that the Bank of England has to do, and then briefly consider the organization by means of which it faces its responsibilities.

It keeps the balance of the British Government and manages its finance.

It keeps the balances of the other banks, which treat their credits in its books as equivalent to cash.

It provides emergency currency at seasons of stringency, by expanding its book-entry credits and so increasing the amount of this so-called cash.

It keeps a cash reserve which is more than twice as big as those of the other banks which are strongest in this respect.

It keeps the central gold reserve of the one of the few money markets in which any form of credit instrument is immediately convertible into gold, and so has to be ready for any emergency that may arise anywhere, making somebody with a credit in London determined to take away its proceeds in the shape of metal.

Its advantages and responsibilities are thus very evenly divided. Its acting as banker to the Government gives it prestige which is invaluable, conveys the impression that it always has the Government behind it, and in fact often produces the mistaken notion that it is a State institution, instead of a company with stock-holders. And its holding of the balances of the other banks enables it to lend

money to Government and to create emergency currency by a mere transfer in its books. On the other hand, since the bankers use their balances with it as cash and as the basis of the credit that they make, the Bank of England has therefore to see to it that the reserve against these balances is not exposed to the demands of too many other customers; and hence the relatively high proportion between its cash and liabilities, which tells heavily on its power to earn dividends. This obligation of maintaining a relatively big cash reserve is increased in intensity, and made more difficult in execution, by the fact that the Bank of England holds the central gold stock of one of the few free markets in gold in the world, and has to be prepared to meet at any moment demands on it that may come forward from abroad, and have been rendered possible by credits given by its credit-making customers, or created by accepting houses in the shape of bills discounted with it through a bill-broker.

Having thus reviewed the Bank of England's responsibilities and privileges, difficulties and advantages, let us see what kind of machinery and organization it brings to bear on its problems.

Momentous changes in these matters have been carried out in the last twenty years. In 1908 I wrote that the Bank

is like no other bank in the world, and its eccentricities begin before you have crossed its threshold. Its external appearance, which its inhabitants and frequenters take as a matter of course, makes the country visitor gape with wide-mouthed

wonder ; one of them, on learning to his surprise that it was not Newgate Gaol, accounted for his error by saying that he thought it must be a prison because it had not any windows. Except where pierced by windows over the main entrance, the Bank's external walls are all solid, but of course it is part of its business to be among other things a fortress, capable of resisting physical attack by needy gentlemen too eager in the interests of the better distribution of wealth. It has done so before now, as every one knows, because the story of the Gordon Riots is told not only in history books but in *Barnaby Rudge*. Even more obvious and impressive is the low level of its roof, and the fact that this big block of space in a spot where ground is worth so much a foot is covered by a building most of which consists of vaults and two stories. An enterprising American, viewing sadly this waste of an invaluable site, remarked that if that old bank had a live President, he would run up twenty floors on the top of it, make ten times its dividends as a real estate company, and not bother any more about the mouldy old banking business.

Internally it boasts spacious courtyards and a garden full of brilliant bloom and green leaves, in seasons when such things are possible, making a most effective and restful contrast with the grim grey walls, the roar of traffic outside, and the jingle of gold that can be heard occasionally from the big hall in which notes are being cashed. It also contains a certain amount of consecrated ground, part of its site being an old churchyard. Hence it was that an unfortunate giant, who was also a clerk in the Bank, fearing that his seven feet of skeleton would be too valuable a prey for the body-snatchers to miss, got himself buried within the Bank's walls in the vain hope that his bones might there rest in peace. Not many years ago some workmen making alterations in the vaults came on a gigantic human jaw-bone ; it was sold to a dentist, who proudly exhibits it to patients, and so the giant's fears have been partially realized.¹

¹ F. Straker, *The Money Market*, ch. ii.

When we come to consider the Bank's organization, its most striking features are the constitution of its Court of Directors, and its system of government by rotation, and these are points on which the Bank's critics have fastened with the keenest energy and determination.

The Bank Court is a committee recruited chiefly from the ranks of the accepting houses and merchant firms, and its members are nominated by itself, subject to the purely formal confirmation of the shareholders; and it is an unwritten law that no banker in the ordinary sense of the word, that is, no one connected with what we call the cheque-paying banks, can be a member of it.

At first sight this is one of those anomalous absurdities so common in England, and so puzzling to the intelligent foreigner, who cannot understand why we suffer them. A Court of Directors ruling the Bank of England, and so performing most important banking functions, and yet disqualifying for membership anyone with an expert knowledge of banking, is a tempting subject for an epigrammatically minded satirist. But in fact this anomaly, like many of our others, not only works excellently well in practice, but is, when calmly considered, clearly based on sound common-sense. For in the first place it would obviously be undesirable that a member of one of the outer ring of banks should have the insight into the position of his rivals which membership of the Bank of England Court would give him, unless all the others were similarly privileged. But if all the outer banks were represented on the Bank Court, it would become a committee of unwieldy dimensions, perhaps reproducing or reflecting in the Bank parlour the rivalries and jealousies that stimulate the outer banks to work against one another, but are not conducive to their working together. And the question of proportionate representation would be difficult to settle. As it is, the Bank Court, being free from connection with the outer banks except by keeping their balances, is able to watch their proceedings with a wholly impartial eye, and, on occasion, to make suggestions with salutary effect.

Moreover, the functions, already described, that are performed by the Bank of England, are obviously different in many important respects from those fulfilled by the outer banks. Its chief customers, the Government and the other banks, are so special in kind that the custody of their funds has to be approached from a special point of view, and the Bank's duty of maintaining the gold reserve by regulating the ebb and flow of the international bullion stream is a problem for which the ordinary banker's training would be of little assistance, and for which the Bank's directors are obviously better qualified, owing to the closer touch with business affairs abroad, which arises from their connection with the accepting houses and merchant firms.

Nevertheless the narrowness of choice that limits the Bank Court in selecting its new members is certainly one of the drawbacks of its organization, and its difficulty in finding fit recruits tends to increase owing to the changing conditions of modern business. Some widening in the sweep of its net seems to be desirable, and will doubtless be brought about by the alertness that the Bank has shown in recent years in adapting itself to alterations in its environment. As an example of this alertness it may be mentioned that the Bank was one of the first institutions in the City to adopt female clerical labour on a considerable scale.

More genuine are the objections to the rotatory system by which the Governor of the Bank holds office for two years, having previously served for two years as Deputy Governor, and then—so say the critics of the system,—just at the time when he has mastered his duties, retires into the obscurity of the Committee of Treasury, which is composed of members of the Court who have "passed the chair." Apart from the objection already noted, one result of this system is that a Bank director is not likely to become Governor until he has been many years a member of the Court. Consequently the new members of the Court have to be chosen when young, in the hope that in twenty years or so they may be capable Governors, and this is sometimes a matter of perilous hazard.

It cannot be denied that the system by which the Governor is put into the chair is somewhat fortuitous. Nevertheless, it has its advantages. The Committee of Treasury represents a body of experience which is always at the Governor's service, and the periodic tenure of office makes the Governor more inclined to lean on the experience and suggestions of his colleagues on the Court, and of the heads of the various departments, and to be less a self-sufficing autocrat than he would probably become if he held office permanently, as is often proposed. And it is very important that the ruler of the Bank of England should be amenable to, and express, the broad common-sense of the commercial community as a whole, and not the prejudices and convictions of any individual, however gifted. But it is not the purpose of this work to enumerate and examine the many proposals that have been made for improving the constitution of the Bank of England. Subjected to the test of results, it shows a record that is not only unrivalled, but unapproached. For no other institution in the world attempts even to face the problem of being always ready to carry out the immediate conversion of any draft on the centre of which it is the head, which is cheerfully and composedly undertaken by the Bank of England. The elasticity of the English system, which works with the Bank as its centre, is the envy of the world, and any alteration, however slight, in so delicate a machine as a credit system, might have effects which were not at all intended.

Since 1908 the alertness of the Bank in adapting itself to alterations in its environment, then noted, has had plenty of opportunities of expressing itself and has worked hard. Its outward appearance is in process of alteration by the building of a lofty edifice which will largely replace the old two-storied fabric, though the original outside walls are to be religiously preserved, in spite of the claims of a

street-widening project. The old garden is still there (in July, 1929), but will have vanished when the rebuilding is finished. Gone already is the old front courtyard across which, according to tradition, lines used to be drawn to guide the footsteps of Directors, in the jovial days of old, after audit dinners.

The Court of Directors has been strengthened by the addition of an Eastern banker, an ex-official of the Treasury, coming *via* the Indian Finance Ministry, and that mighty worker Sir Josiah Stamp, railway chairman, economist, statistician, Reparationist, and moralist, who began life as an Inland Revenue official, and—perhaps the most striking departure of all—by the appointment as Deputy-Governor of Sir E. M. Harvey, who was formerly Chief Cashier. Another of the Bank's own officials, Sir Gordon Nairne, who had held the position of Chief Cashier and then the lately created post of Comptroller, has been elevated to the Court. At the same time the staff has been diversified by the addition of two ex-officials of the Treasury and (temporarily) of Dr. Stewart, formerly statistician to the Federal Reserve Board at Washington. "In short," as the *Economist* said in its issue of January 26, 1929, the Bank "has shown, and is showing itself eager to take every possible opportunity of enlisting in its service wide and modern experience." It will be noted that the ordinary London banks—the Clearing banks as they are usually called—are still without representation on the Bank Court. Most of

the reasons against their being so, as enumerated above, are evidently still valid. Critics of the Bank and its methods are perhaps, however, right in saying that the great productive industries of the country ought to have more voice in the deliberations of its chief monetary authority. It was noted with a growl that Sir Josiah Stamp, soon after becoming a member of the Bank Court, resigned his seat on the Board of Imperial Chemicals.

But it is in the position of the Governor that the most notable change, at least in the eye of the general public, has happened. That Lord Cunliffe, as he afterwards became, who held office when the war began, should go on holding it until 1918, the last year of the war, was evidently fitting; but it was generally supposed that this breach in the system of Governors with a two years' life was just a war-time event. And when his successor, Sir Brian Cokayne, now Lord Cullen of Ashbourne, resigned in 1920, it seemed that the two years' rotation had been restored. But since then, Mr. Montagu Norman has held unbroken sway. He is periodically re-elected, and we do not yet know whether his continued rule marks a new system which has come to stay. Each time that he is re-elected those who know best, or ought to, about the inner workings of the money market, express hearty approval of his maintenance in office, while old-fashioned critics wonder what will happen some day. In the meantime every one admits that Mr. Norman has set the whole financial world a fine example of disinterested and tireless

energy; and that he, working in double harness with the late Mr. Benjamin Strong of the Federal Reserve Bank of New York, carried out a task of quite incalculable benefit of the world at large in the difficult after-war years. When the politicians were still talking strife and making ugly faces and ugly gestures, these two men got the financial world to see that reconstruction and co-operation were the needs of the moment, and worked like Trojans to put Europe on its legs again. Their success would have been still greater than it was had it not been that while they were helping the shattered nations to stabilize currencies and issue reconstruction loans, and getting them to work together, the politicians were putting up and raising trade barriers, and shouting to their deluded publics that it is bad for one's country to buy foreign goods.

CHAPTER XII

BANK RATE AND MARKET RATE

BANK rate is the official *minimum* rate at which the Bank of England will discount bills. It differs from the market rate of discount in that it is normally higher, and in that it is not a constantly fluctuating rate, shifting with the supply of and demand for bills, but is fixed and announced every Thursday morning at a special meeting of the Bank Court, and except under most unusual circumstances is not changed on any other day. But the fact that it is only the *minimum* is occasionally enforced in practice, if the Bank finds that too many bills are being brought to it for discount; on such occasions it sometimes refuses to take bills except at a higher rate, which usually becomes the official rate on the following Thursday. For loans and advances the Bank usually charges $\frac{1}{2}$ per cent. more than for discounting bills. When the Bank is discounting bills at the official rate, or making advances at or above it, Bank rate is said to be effective.

It should be noted that the official rate only rules at its head office, and there only partially. The Bank of England discounts at the market rate

for private customers at its head office and also at its branches ; in fact, according to the frequent complaints of the other banks, it used to compete with them in the country by under-cutting in the matter of rates in a manner which annoyed them seriously, and with some reason. Here again the Bank had been elbowed into a very difficult position by the force of circumstances. Its branches were never a spontaneous creation, but were founded by it largely in answer to a demand for them in the country which arose out of special and temporary conditions ; when the industrial and agricultural centres had been enmeshed in a network of banking facilities, the branches of the Bank of England remained, and necessarily made some exertion to justify their existence. Hence very natural grumbling on the part of the other banks, which said that the Bank of England took their money and used it to underbid them in their own territories.

Since this old grievance has been abolished or forgotten, a new one has been found in the support alleged to have been given by the Bank of England to certain foreign and semi-foreign institutions, which it has been accused of spoon-feeding in a manner that was unfair to their English competitors in exchange and acceptance business. These charges arose from after-war rescue work done by the Bank on the Continent ; and it has now been laid down by the new Deputy-Governor that " a central bank should not ordinarily com-

pete with the trading banks for general banking business.”¹

In the days of the old grievance, however, Bank rate was so seldom effective that if the Bank wanted discount business, it had to take bills at a lower rate. If it had taken bills in the country only at its official rate its customers, the other banks, would have had no genuine cause of complaint, and the Bank would have got few bills, if any; but when it stepped off its pedestal and entered into the chaffering circle of the market, and chaffered against the market with the market's money, the market had reason to feel that it had a grievance.

This want of connection between the official rate and the market rate also had the effect of leaving the market rate wholly without regulation. The market rate, in those ante-diluvian days was at most times practically arrived at by competition among the other banks and higgling between them, the bill-brokers and the sellers of the bills; and hence it was ruled by mere haphazard cross-currents of individual conceptions on the subject of any particular business proposition that might come forward, and was not directed by the guidance of any consideration for the welfare of the market and of the monetary world as a whole. An individual banker or bill-broker who wanted to add to his holding of bills or renew his maturities naturally discounted at the best rate he could get, and could not be expected to stop and wonder whether his

¹ *Central Banks*, by Sir Ernest Harvey, K.B.E., page 20.

purchase at a lower rate of discount would have an adverse effect on the foreign exchanges, or give some foreign financier too close a hold on London's store of gold. Hence it often happened that we read in the money articles of the newspapers remarks expressing regret concerning the rapidity with which rates were being allowed to decline, as if the bankers and bill-brokers were carrying out some questionable and immoral transaction, when all that they were doing was to buy the bills that they wanted at the only rate at which the conditions allowed them to do so: and it used to seem strange that City editors should shake their heads so sadly about the behaviour of the discount market, while they accepted a rise or fall in Consols as due to the inevitable action and reaction of supply and demand in the stock market.

The justification for this attitude towards the movements of the discount market arose out of the very close connection which we have already seen to exist between the market rate of discount and the foreign exchanges. When the market rate of discount is allowed to fall relatively low in London, bills of exchange are naturally sent here in increasing numbers from foreign countries to be discounted; that is to say, our imports of securities are stimulated, and so the balance of international indebtedness is affected, we have more payments to make abroad, and the rates of exchange tend to move towards the point at which it pays better to ship gold than to buy drafts. The London rate

was normally low when compared with those of other centres ; but the extent of its relative lowness was a question of degree ; and when this degree became exaggerated in a manner which the general monetary outlook did not seem to justify, a situation arose which occasionally called for deprecating comment by the Press, which endeavours to reflect the judicious opinion of the City. The individual bankers and brokers, however, whose competition depresses discount rates, are little deterred by these considerations ; in the first place, because each one would think it absurd to suppose that his individual action would have any appreciable effect ; in the second, because even if it had, he would consider that he could not be expected to refuse a fine parcel of bills in order that by holding out for a higher rate he might prevent an adverse movement in the exchanges. Adverse exchanges make them cautious in their purchases of bills in their own interests, because adverse exchanges generally hold out a promise of higher rates, and so encourage buyers to wait. But individual buyers cannot be expected to be deterred by consideration for the interests of the market as a whole.

So once again we arrive at the fact that the store of gold which the Bank of England is expected to keep is constantly threatened by a mass of credit created by the other banks, which work without any immediate reference to the Bank of England's position, but to suit the requirements of their own

business. And thus the beautiful elasticity of our monetary system led to a certain lack of cohesion, which required, occasionally, drastic measures by the Bank of England to correct it.

This lack of cohesion was a comparatively modern development, and had arisen out of the great growth of the credit-making machinery which is outside of the Bank of England, but is loosely founded on its reserve, and renders its reserve liable to attack by every credit given to a foreigner, by means of a discount or an advance. In Bagehot's time the power of the Bank of England was evidently much more easily exercised, and we find him stating, in the passage quoted on page 198, that in normal times Lombard Street could not discount its bills without the help of money provided by the Bank. In other words, when he wrote, Bank rate was always effective, save on exceptional occasions.

So far was this from being so in pre-war that in order to make its rate effective, the Bank of England often had to borrow money that it did not want, because, the market supply of money being abundant, it knew that the bankers and brokers would continue to discount bills at rates which would keep the foreign exchanges against us, unless a curtailment of the supply of money was carried out. In other words, the credit-making machinery had worked so efficiently in the output of its product that the Bank of England which had to be ready to meet the liabilities so

created, had to take some of the output away from its holders, and pay them a rate for restricting their temptations to take bills at too low rates.

This it did by going into the money market and borrowing. Any money that it borrows can only be got back from it by being borrowed again, and it, of course, only lends, at its head office, at the official rate, or $\frac{1}{2}$ per cent. above it.

It has already been observed that when the Bank of England lends money the result of the operation is generally expressed in a book entry, by which it shows more securities (which it has received as collateral) among its assets, and more deposits among its liabilities. When it borrows, the book entry of course works similarly, but contrariwise; its holding of securities is reduced by the fact that part of them is pledged to the lenders, and the amount that it borrows cancels so much of its liability under deposits, in other words, reduces the balances of the other banks, and so narrows the basis of credit, makes money dear, brings the market rate of discount into some connection with the official rate, influences the foreign exchanges, and increases the probability that gold will be sent to London, or that gold which arrives will not be taken for export. By this roundabout process the Bank finally arrived at its object of protecting or increasing its reserve.

It has been said that by borrowing money the Bank of England reduces the balances of the other banks; this it did either directly by borrowing

part of their balances from them, or indirectly, by borrowing from the bill-brokers and finance houses, who paid it what they lent with cheques on the banks, which to that extent cancelled the balance of the banks in question at the Bank of England. The banks in question, having their balances at the Bank thus reduced, either reduced the credits that they had based on them, or more probably restored their balances by calling in money from the bill-brokers, their loans to whom have already been described as their second line of defence, after their holding of cash in hand and at the Bank of England. The bill-brokers, from whom these loans were called in, first had recourse to the other bankers and money-lenders, trying to fill the gap that has been made in the funds on which they work their business, but were finally, as it generally happened, driven to the Bank of England, whence they had to borrow part of the money that it had borrowed from the market, and would have to pay for it at or over the official rate, which was thus made effective, and became a controlling factor in market rates. The system was thus clumsy and artificial, and, as has been observed, was comparatively novel, having been brought into existence by the great development of the activities of the other banks, which had manufactured credit so successfully that part of the output had sometimes to be absorbed by the Bank of England, which did not want it, but had to prevent the evil consequences that might result from its over-abundance.

The bill-brokers, whom we have seen to be the first sufferers when the Bank of England thought it necessary to reduce the overgrown mass of credit, generally waxed eloquent concerning the absurdities of the system, the hardship involved to all legitimate users of credit when it was thus artificially controlled, and the monstrous interference with the natural laws of supply and demand, which ought, they contend, to be left to regulate the value of money like that of every other commodity.

Their position was certainly one with which a disinterested observer could readily sympathize, for they were constantly tempted, not to say forced, by the free credit facilities given by the other banks, into taking bills at rates which had an adverse effect on the foreign exchanges; and then the Bank of England, in order to rectify the position, had to reduce the mass of credit, and the bill-brokers found themselves, with their portfolios full of bills taken at low rates, artificially deprived of the wherewithal to carry them, and obliged to pay an unexpectedly high price for money to finance their bills, or rediscount them with the Bank of England at a loss.

Nevertheless their appeal to economic first principles, and the natural laws of supply and demand, does not seem to bear examination. Even in the production of agricultural and industrial commodities the law of supply and demand, if left unfettered, brings many evils in its train, the most obvious among which are the periodical spells of

exuberance and depression to which the producing industries are habitually exposed, to their own loss and that of the community as a whole. For some time past the civilized world has submitted to these evils as inevitable or as small in comparison with the great benefit arising from the increase in production that has taken place under the system of unrestricted competition ; but there are very plain indications that this acquiescent attitude is being modified. The modern trend of production is certainly in the direction of co-ordination, co-operation, combination, and regulation, and unrestricted competition seems to be gradually retiring into the obscurity of obsolescence.

But in this matter of the supply of credit and of credit instruments it has long been recognized that regulation is essential, and that the free play of supply and demand cannot be left to itself because of the vast and wide-spreading disasters that result to the whole of a community from any dislocation in the machinery of credit. Moreover, it must be remembered that supply and demand cannot possibly work as effectively in the case of money as in that of an ordinary commodity, because of an important and essential difference which sets a great gulf between money, in the modern English sense, and concrete and tangible commodities. This difference lies in the fact that the cost of production of money is a negligible factor in its price. If the farmer is bid £1,000 for his crop, his answer will be strongly influenced by

the amount of work and capital that have been spent on producing it, and will be required for producing another ; when a banker is bid 4 per cent. for a loan of £1,000 for six months, in other words, is offered £1,020 six months hence for £1,000 to-day, the sum that it will have cost him or somebody else to produce that £1,000 will hardly enter into his calculation ; for it will be merely a matter of cheque drawing and book entries involving a certain amount of penmanship, and whether the loan is for £1,000 or £1,000,000 will make little difference—very likely none at all—to the cost involved to the producer of it. It was quite otherwise when money consisted of metal that had to be dug out and treated ; but now that money is a matter of book entries and pieces of paper, which are brought into being according to the varying views of bankers, as to how much may safely be based on a given quantity of gold, the supply of money can obviously be multiplied without any question of cost, so long as borrowers have security to offer, and bankers are prepared to make book entries.

Regulation is in fact already an accepted part of our monetary system, and we have seen that the Bank Charter Act carefully and precisely regulated the number of bank-notes that might be created. If the bank-note had retained its position as the most important of our credit instruments, Bank rate would have retained its control of the money market, that is to say, the rate at which the Bank

of England was prepared to provide borrowers with notes would have remained the dominant factor in the price of money. But we have seen that the regulation arranged by the Bank Act has been set aside by the development of the use of cheques, and the dominant factor in the price of money is now the rate at which the other banks are prepared to provide borrowers with the right to draw cheques.

This price, however, at which the other banks are prepared to lend has, since the war, been much more closely controlled by the Bank of England as already recorded.¹ At present, owing to the increase in the cost of banking facilities, as of nearly everything else that the poor old public buys, depositors get a rate which is not $1\frac{1}{2}$ but 2 per cent. below Bank rate, and bankers lend to bill-brokers at a rate which is 1 per cent. above the deposit rate and so within 1 per cent. of Bank rate. The bill-brokers are able to get money cheaper from other lenders, but the bulk of what they call their "good" money—that is, of money that they can generally count on as likely to stay with them in normal circumstances—has its price thus regulated by Bank rate.

But the Bank of England's control of the market rate has been reinforced by several other important changes in the position of itself and the other banks.

In the first place, owing to the process of amalgamation and consolidation that has reduced the

¹ See *ante*, page 113.

number of banks in England and Wales from sixty in 1908 to twenty in 1929, there has been a great elimination of small comparatively weaker brethren, whose naughtiness in the matter of inadequate cash reserves and over-creation of credit was a cause of anxiety to the leaders of the banking world at the earlier date. Hence the unwieldy supply of surplus credit which used so often to reduce Bank rate to a mere empty symbol has been largely absorbed by the growing needs of the country's business, and in these days, unless either the market or the Government is "in the Bank" as a borrower, it is safe to expect stringency. And though, as will be seen, the Bank still sometimes takes measures to prevent credit from becoming too cheap, it also often has to work in the opposite direction and take measures to ease the position for the market.

Its power to carry out these manoeuvres has been strengthened by the immense increase in the Government debt, especially the floating debt, owing to the exigencies of war finance, and the consequently much greater importance of the Government as a factor in the money market. Its position as manager of the debt and as lender to the Government whenever large interest payments oblige the Treasury to seek extra accommodation, give the Bank convenient help in controlling the market, though at the same time obliging it to use the control gently and tactfully and with an eye to the Chancellor of the

Exchequer's desire to get his Treasury bills discounted on favourable terms.

It was stated above that stringency may be looked for in the market unless either the Government or the market is "in the Bank." The Government borrows from the Bank usually in order to meet interest payments for which the ingathering of taxes has not provided the necessary funds. This is especially likely when the half-yearly dividends on the £2,000 odd million War Loan falls due in June and December. In the weekly figures of national revenue and expenditure for the week ended December 1, 1928, interest on debt required £34½ millions and sinking fund took another half-million. Current revenue only exceeded ordinary expenditure by one million (as we all know, it is during the March quarter that the tax-gatherer is most effectively busy), and so the Chancellor had to borrow £34 millions, of which £23 millions came from advances by the Bank of England and nearly £7 millions from Treasury bills.¹ In the following week more than £3 millions were borrowed from the Bank, and in the two succeeding weeks the whole of these advances were repaid.

As to Treasury bills, before the war the outstanding amount of these short-dated official promises to pay was modest. Taking a date at random, there were £20 millions of them on January 17, 1914, of which 11½ had been issued by

¹ *Economist*, December 1, 1928.

public tender. On May 11, 1929, the figure was over £700 millions, and every week the market is invited to tender for anything from £30 to £45 millions of them.

Evidently the management of this immense mass of floating debt gives great opportunities for manipulation of the market by the Bank in conjunction with the Treasury. By reducing the amount of Treasury bills offered in any week, and finding money by drawing the Government balances low, or by borrowing from some Government department that happens to be in funds, it is possible to make money easier, and *vice versa*.

Moreover the Bank itself naturally holds large amounts of these and other forms of short-dated Government debt and by increasing and decreasing these holdings can influence the market in the direction of ease or stringency. The *Economist* of May 18, 1929, tells us that "a feature of this week's strong Bank¹ return is a fall of £2 millions in bankers' deposits, reflecting, probably, further sales by the Bank of Treasury Bonds. It is believed, also, that the decline of £2 millions on discounts and advances resulted from the Bank's becoming a considerable seller of bills, with a view, presumably, to bringing market discount rates into closer correspondence with Bank rate." This was an occasion when the market rate had slipped down to little better than 5 per cent. at a time when the New York Stock Exchange was bidding

¹ The Bank Return will be explained in the next chapter.

15 per cent. for call money and the New York exchange was very near gold point. Bank rate was $5\frac{1}{2}$ per cent., having been raised from $4\frac{1}{2}$ per cent. early in February in order to protect the Bank's stock of gold against the drain threatened by the high rates current in America.

Contrariwise, it often happens, now that stringency is almost a normal feature on the monetary *menu*, that in order that the Chancellor may sell his Treasury bills at reasonable rates, or for some other reason, the Bank wants to let the market off the expense of borrowing from it, or discounting bills with it at the official rate. It does so by buying bills from bill-brokers at or about the market rate, through an intermediary. When this happens the market talks of having been relieved by "the hidden hand."

It is also, in these times, itself a larger operator in bills on account of European central banks, which hold sterling bills as part of their cash reserves and as a means of maintaining the exchange value of their country's currency. For example, if Germans have heavy payments to make abroad and their demand for foreign currencies is depressing the exchange value of the mark, the Reichsbank is able to support the mark if it has a store of sterling bills held on its account by the Bank of England which it can instruct the latter to dispose of for it, and so supply it with money in London, which can always easily be turned into any other money. The Bank is thus a much more active

factor in the discount market than it used to be, and this fact gives it further powers of control, though the requirements of its customers may not always suit its policy as controller.

Another important change that has eased the task of the Bank in regulating the market, is the closer touch that it now keeps with the other banks and with the bill-brokers. The Committee of London Clearing Bankers now meets periodically at the Bank of England, and its meeting is attended by a representative of the Bank and the proceedings include lunch. The Governor is also in constant personal touch with the working men—bankers, bill-brokers, or others—of the market and is always accessible to any one of them who want to see him. A representative of the discount houses pays a weekly visit to the Governor and conveys to his colleagues in the market any comments on the position that may have been put before him. The Bank also takes a much closer interest in the activities and position of the bill-broking companies and firms, requiring periodical balance-sheets from them and sometimes expressing paternal solicitude concerning the conduct of their business to an extent that rouses humorous references to the “orderly room.”

In these and other ways the Bank is now much less an institution apart from the rest of the City, and can convey its views and wishes more directly than of yore. Its policy and methods are often criticized and grumbled at, but, on the whole,

generally respected and followed, with a docility that sometimes surprises old-fashioned observers. An interesting example happened at the time when, in order to facilitate our return to the gold standard, the Bank intimated that foreign loans (which, it will be remembered, turn the exchanges against us ¹) were inopportune. This ukase had no force in law, as need hardly be said, for even the Home Secretary cannot prevent any of us from issuing a loan for Beelzebub if we want to, and if we can find subscribers; and it was questioned by some critics, who said that it sent good business from London to New York, and that New York, having pocketed the issuing commission, sold the bonds to London and so put the exchange against us after all. But it was obeyed.

Connection between Bank rate and market rate, as between Bank and market, is thus much closer than it was; and though, as has been shown, the Bank still often has to take exceptional measures for checking a downward tendency in discount rates, when bills are scarce and Continental banks are wanting them, the wide divergence that formerly made the Bank's task difficult has been to a great extent corrected.

In fact, so much is the market nowadays controlled by manipulation and what it calls "wangling," that changes in Bank rate seem likely to be much less used than of yore as a means of regulating credit. By "open market policy," as

¹ See page 181.

it is called—contracting and expanding its holding of bills and securities—the Old Lady is able to keep the market so closely tied to her apron-strings that ups and downs in the price of money should be less frequent and extensive, if and when the international banking authorities can learn to get together and row like a crew. Some people say that all this ingenuity is artificial and ineffective and that a twist of Bank rate is worth a ton of open market policy ; but stabilization, standardization and rationalization are nowadays the “ only wear,” and it is surely better that vagaries in the credit machine should be corrected, if it can be done, without inflicting dear money on industry and trade, at a time when they have more than enough difficulties to struggle with.

CHAPTER XIII

THE BANK RETURN

THE account issued every Thursday by the Bank of England, giving a statement of its position on the previous day, is generally regarded as the key to the condition of the London money market as a whole and is so awaited and examined with keen interest. Much ingenuity is often required in unravelling the meaning of the movements in the various items, for the return is by no means a model of lucidity, though gréatly improved in this respect by some changes made in November, 1928, at the time when the Treasury notes, issued in 1914, were taken over by the Bank and fused with its own notes. Some attempt at comprehension of the return is so essential to those who wish to grope their way through the mysteries of the money market, that we must try to arrive at some sort of distant acquaintance with it. Further than that we need not expect to go. It may be said of all balance-sheets that they are useful as a general indication, but apt to be misleading if used as a basis of detailed inferences, except by those who can go behind the figures and find out what they really mean. In the case of the Bank return, which may be said to be a balance-sheet of a kind,

THE BANK RETURN

BANK OF ENGLAND.

AN ACCOUNT pursuant to the Act 7 and 8 VICT. cap. 32, for the week ending on Wednesday, the 1st day of July, 1908.

ISSUE DEPARTMENT.

	£		£
Notes Issued . . .	55,484,385	Government Debt .	11,015,100
		Other Securities .	7,434,900
		Gold Coin & Bullion	37,034,385
		Silver Bullion . . .	
	<hr/>		<hr/>
	<u>£55,484,385</u>		<u>£55,484,385</u>

Dated the 2nd day of July, 1908.

J. G. NAIRNE, *Chief Cashier.*

BANKING DEPARTMENT.

	£		£
Proprietors' Capital	14,553,000	Government Secur-	
Rest	3,214,385	ities	15,231,766
Public Deposits—		Other Securities .	36,347,819
(including Ex-		Notes	25,508,120
chequer, Savings		Gold and Silver	
Banks, Commis-		Coin	1,573,008
sioners of Na-			
tional Debt, and			
Dividend Ac-			
counts)	9,648,021		
Other Deposits .	51,197,083		
Seven - Day and			
other Bills . . .	48,244		
	<hr/>		<hr/>
	<u>£78,660,713</u>		<u>£78,660,713</u>

Dated the 2nd day of July, 1908.

J. G. NAIRNE, *Chief Cashier.*

BANK OF ENGLAND.

AN ACCOUNT for the Week ended on Wednesday, the 3rd day of July, 1929.

ISSUE DEPARTMENT.

£	£
Notes Issued—	Government Debt . . . 11,015,100
In Circulation . . . 369,100,858	Other Government Securities . . . 234,995,760
In Banking Department 45,424,140	Other Securities . . . 9,149,368
	Silver Coin . . . 4,839,772
	Amount of Fiduciary Issue 260,000,000
	Gold Coin and Bullion . 154,524,998
£414,524,098	£414,524,998

BANKING DEPARTMENT.

£	£
Proprietors' Capital . . 14,553,000	Government Securities . . 37,281,855
Rest 3,457,544	Other Securities—
Public Deposits* . . . 28,296,091	Discounts
Other Deposits—	and advances . £52,321,206
Bankers . £75,558,462	Securities . 22,957,540
Other	75,278,748
Accounts . 37,297,824	Notes 45,424,140
112,856,286	Gold and Silver Coin . . 1,180,933
7-Day and other Bills . . 2,753	
£159,165,674	£159,165,674

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

Dated the 4th day of July, 1929.

C. P. MAHON, *Chief Cashier.*

only the broadest and most guarded deductions are possible, and they should be accepted with caution. Parliamentary wisdom, expressed in the Bank Act, decreed that the note-issuing business of the Bank should be separated from its banking business, and that this separation should be shown in its weekly account, which gives two separate statements, one showing the position of the Issue Department, the other that of the Banking Department. It has frequently been suggested that this distinction is unreal and only darkens counsel, and that the Bank return would be clearer and simpler if the two statements were put together. There is something to be said for this view, but perhaps hardly enough to justify an alteration which would change the face of the return so completely and confuse comparisons with its predecessors of the past eighty odd years. On pages 228-9 are specimens of the account as now presented, and as presented in 1908; their figures are influenced by their being the last return of a half-year, so that the Other Deposits and Other Securities are increased by the Bank's provision of emergency credit. But they will serve as illustrations.

In the presentation of the Issue Department's figures, the changes made have saved the inquirer some trouble, but, except in one important item, have not told him anything that he could not find out by doing a sum or two. On the left side, in the old account, was the one figure of the notes issued and outstanding, from which, in order to arrive at

the circulation, one used to have to subtract the notes held among the assets of the Banking Department. The modern return works this out for us, showing notes in circulation and notes in the Banking Department. It should be remembered, however, that the notes in circulation are not only those which we carry in our pockets and pay across shop-counters, but also those which are held by the other banks to meet daily demands on them for cash.

There is also this important difference between the Bank of England notes of 1908, or of any date up to November 21, 1928, and those of to-day. The old notes were of not less than £5 denomination, and so were rarely used for ordinary pocket-money transactions, except on race-courses and other places where one was apt to have dealings with folk whose cheques one would not be eager to take in payment for a debt. For large commercial transactions, cheques were the almost universal form of payment; and Bank of England notes were seldom used to complete a bargain except when houses and land were changing hands. They were thus, in pre-1928 times, chiefly used as part of the cash reserve of the other banks, which could—and on rare occasions did¹—use them to meet demands on them from customers for cash, when they had not, or feared that they might not have, enough sovereigns to give the customer the choice. Usually, however, “How will you take it?” was

¹ See *War and Lombard Street*, by H. Withers, page 13 *seq.*

the invariable cashier's question when a customer wanted cash, and most of us generally took sovereigns up to 1914, and when they had been swallowed up by the war, £1 or 10s. Treasury notes. Why these war-time excrescences on our monetary system were ever permitted, and why, when our sovereigns had to go to the front, the Bank of England was not at once empowered to issue £1 and 10s. notes, perhaps we shall some day be told, if anybody is still interested in the question. Sufficient for to-day is the fact that the Treasury notes which took the place of our gold currency, have now been replaced by Bank of England notes, which are thus (though gold coins, if one happens to meet them, are still legal tender) practically the only form of legal tender money—that is money which creditors are bound to take in payment—for all transactions of more than £2, up to which silver may be used. The notes of to-day are thus much more really in circulation than their £5 forbears. Formerly, when the public wanted more cash, sovereigns were taken from the Bank; or, between 1914 and 1928, Treasury notes were issued by the Currency notes department. Now, the demand falls on the Bank of England notes held by the Bank of England's banking department, with the result what is called its reserve is subjected to big fluctuations when cash is wanted for holiday or other purposes.

It is worth while to note that this periodical pressure on the Bank's reserve, owing to demands for

home circulation of cash, is not, as is sometimes implied by writers who have grown up since the war, a new and rather serious liability that the Bank has to face. It is only a reversal to pre-war conditions. Then, sovereigns went into circulation. They went out of the stock of coin and bullion held in the Issue Department and the notes issued against them had to be cancelled. Notes in circulation obviously could not be cancelled; so notes held in the Bank's banking department had to be reduced and the Bank's reserve was diminished.

On the assets' side of the Issue Department's statement, we find some important changes. These assets are the items on which the notes are secured. First comes the Government debt, swollen to over 11 millions from the £1,200,000 to lend which to Dutch William's Government the Bank was originally founded; this is not represented by any holding of stock, but is a book-entry between the Government and the Bank. Originally, it was the largest item in the securities which the Bank was allowed by the Bank Act of 1844 to use as backing for its notes, to the extent of £14 millions. Above this limit, every note had to have metal behind it. The notes which had not metal but promises to pay behind them, were called the fiduciary, or confidential, issue; it was limited to £14 millions, but the Bank was allowed to take over two-thirds of the authorized powers of issue of any bank which thereafter might let its note issue lapse. By means of these lapses, which happened chiefly when coun-

try banks were absorbed by companies which had London offices and therefore were barred from note issuing by the Bank of England's monopoly, the fiduciary issue had grown to £18,450,000 in 1908, and to £19,750,000 in 1928, when it took over the Treasury notes.

To enable it to do so, the Currency and Bank Notes Act of 1928 was passed, by which the fiduciary issue was raised to £260 millions, and it was also provided that silver coin to an amount not exceeding £5½ millions might be included in the securities to be held against it. As to the rest of the securities, the only thing specified about them in the Act was that they should be "of an amount in value sufficient to cover the fiduciary issue for the time being" and that the Bank should from time to time "give to the Treasury such information as the Treasury may require with respect" to them.

This absence of any restriction on the kind of securities by which the fiduciary issue might be backed, was believed to have been a momentous change in the law, by people who were under a mistaken impression that the old Bank Act only allowed the Bank to hold British Government securities in the Issue Department and thereby (so they contended) limited the elasticity of the note issue. In fact the Act of 1844 only instructed the Bank to transfer the Government debt of £11 millions to the Issue Department and "other securities" to an amount sufficient to back the

fiduciary notes. It could, if it had wished to do so, always have based part of the fiduciary issue on bills of exchange, which some reformers wanted it to do ; but in fact it was always believed that all the securities in the Issue Department were obligations of the British Government.

As long as the whole of the Bank's fiduciary issue was less than £20 millions, this question was comparatively unimportant. Now it is another matter, and the Bank has recognized it as such by not only putting some non-Governmental promises to pay behind its notes, but also by publishing the fact as part of the increased information which it has, without any legal obligation, given in the new form of its return.

Silver, by making its reappearance in the assets of the Issue Department, is an interesting example of the whirligig of time bringing in its revenges. Under the terms of the Act of 1844, the Bank was allowed to include silver bullion in the metallic backing behind its notes, the silver not to exceed one-fifth of the total metal; and silver was actually so held from September, 1844, when the first return was published under the Act, until August, 1853, and again between November, 1860, and July, 1861. Since that date no silver had been held in the Issue Department, and the Bank's power to hold it there had been almost forgotten—though a line, silver bullion, with a blank opposite to it, appeared in each week's return ; but the existence of this power was brought home to the City in 1897, when the

Chancellor of the Exchequer and the Governor of the Bank seriously discussed a proposal for its exercise. The arrangement was evidently due to pressure brought to bear on the Government of the day by the Bimetallists, who believed that gold and silver could be made to circulate on equal terms at a fixed ratio, to the benefit of all concerned, and this mooted concession on the part of the Bank of England was part of a scheme for improving the position of silver. But it was nipped in the bud very early in its history. *The Times* found out what was afoot and exposed the scheme with dramatic effect. There was a great outcry in the City, where it was feared that the inclusion of silver in the metallic backing of the Bank of England note might impair public confidence in its convertibility into gold. This convertibility was regarded as the rock on which our gold standard was founded and any suggestion of a change that might run the risk of weakening it, even in appearance, was a shock to the practical sense of the City. No more was heard of the project, and gold remained and remains the sole basis of every note that is issued by the Bank above the limit fixed by law for its fiduciary issue.

Silver, however, has slunk into the Issue Department through the back door opened for it by the Currency Act of 1928, which allows it to be included among the securities behind the fiduciary issue, but not as part of the metallic backing of the notes.

All these items—Government Debt, Other Govern-

ment Securities, Other Securities and Silver Coin—the return now adds up for us to show that they are equivalent to the sum of the fiduciary issue, £260 millions, and the gold coin and bullion complete the assets by which the notes are technically secured, though in the eyes of the general public at home and abroad, the real security lies in the fact that the note has been issued by the Bank of England.

It is in the figures of the Banking Department that the new form of the weekly Bank return gives the most important new information, through the subdivision of the Other Deposits and Other Securities. The first item that we see on the liabilities side is the proprietors' capital, which speaks for itself, being obviously the amount subscribed by the original stockholders of the Bank, with subsequent additions. It differs from the capital of the other English banks by being in stock instead of shares, and by being fully paid up, whereas it is now the fashion for banks to have a reserve in the shape of a liability on their shareholders for uncalled capital. But though the stock of the Bank of England is fully paid, authorities differ as to whether there is further liability on it. It is not a practical question, however, or one that need keep proprietors of Bank stock awake at night, and Parliament has distinguished the stock by including it among the investments open to trustees.

The next item is the Rest, under which quaint name the Bank holds what most other banks and

companies, which are fortunate enough to possess one, call a reserve. That is, it is an accumulation of profits which have not been distributed as dividends but kept in hand to strengthen the Bank's position. It may seem at first sight puzzling that the possession of a liability should strengthen a company's position, but this liability, like the subscribed capital, is a liability only between the Bank and its shareholders, and is, of course, represented by assets on the other side of the account, so that the proportion of assets to real outside liabilities—the demands that the Bank's customers can make on it—is strengthened by its existence. Unlike the reserve of an ordinary bank or company, however, the Bank of England's Rest constantly fluctuates, and it may be supposed that it more or less contains the Bank's profit and loss account balance. But it is shifted about from week to week in a manner which an outside observer can note, but not understand, and apparently most of the profit and loss balance is included in the Other Deposits, which will be dealt with later, and is transferred to the Rest when it is wanted to pay dividends withal. At any rate, it is not unusual to see a large amount suddenly added to the Rest at the end of February and August when the Bank completes its half-year, and from the amount of the Rest at those dates it is possible to calculate what the distribution will be when the Bank Court assembles for the "making of a dividend." For the Rest is never allowed to fall below 3 millions,

and the amount above that level at the end of the half-year is roughly the sum available for distribution. It may be noted that this three-million level of the Rest has been constant since 1844, and has not been increased in accordance with the addition to the Bank's outside liabilities. In September, 1844, the Rest was £3,564,729 and the total deposits were £12 millions odd.¹ At the end of June, 1929, the Rest is just under 3½ millions, and the total Deposits are 141 millions odd.

The Public Deposits are the balances of the various departments of the British Government, which are held and administered by the Bank of England as its banker. They fluctuate according to the briskness or sluggishness of the revenue payments, and the rapidity or slowness with which the Government is making its various disbursements. A large sum is taken off them, when the dividends on War Loan and other Government stocks are paid, and this sum is transferred to the Other Deposits, or ultimately finds its way there. The payment of the Government dividends thus tends to make money abundant, for it means that a credit at the Bank of England has been taken from the Treasury and turned into "cash in hand and at the Bank of England" in the control of the other banks, who can use it as the basis for the manufacture of more credit. On the other hand

¹ See the first return published under the 1844 Act, reproduced by photograph in the Midland Bank's monthly *Review*, December, 1928.

in the March quarter of the year, when we are all paying our income-tax and house-duty, the Public Deposits swell, the Other Deposits dwindle, and money tends to become scarce, or "tight" in the City phrase, though the Treasury generally uses much of the funds so acquired by paying off maturing Treasury bills.¹ It is important to remember that an increase in the Public Deposits means an increase of credits over which the Bank keeps command and control, but an increase in the Other Deposits means an increase in its liabilities to the general public and in the "cash at the Bank of England" which is used, like gold or notes, as a basis for credit-making by the other banks.

"Other Deposits" used to be the comprehensive title under which the Bank included all its liabilities on deposits to anyone but the British Government. By subdividing it into bankers' deposits and other accounts, the new form of return has thrown an important new light on the monetary position. Under the old way of presenting the accounts, movements in the Other Deposits could not be trusted to show us how much credit at the Bank of England the other banks held, because an increase or decrease might affect some of the Bank's other customers, such as the Indian or some foreign Government. Now we are told each week how much the banks have got at their credit with the central bank, and we are thus a step, and a long step, nearer to knowing what are the total resources

¹ See *ante*, page 221.

of the banks—the amount of their cash in hand we can only get from the monthly statements of the London clearing banks, which appear about the 12th of the month following that which they depict and from the half-yearly or yearly reports of the rest ; what, on each Wednesday, they have in the books of the Bank of England we can see next day in the Bank return. The banks included in this item are the London clearing banks, and those domestic banks which do not bank with another bank but only with the Bank of England. It should be noted, however, that some of the balances included in this item are kept by the other banks, not in Threadneedle Street, but at the Bank of England's branches in the country.

The Other Accounts are, by the process of exhaustion, already explained. They include the balances of all the Bank's depositing customers, except the British Government and the banks, as defined above. And the last item on the liabilities side, a few thousand pounds' worth of seven-day and other bills—"a trifle, some eightpenny matter," as Prince Hal says—represents an old-fashioned form of remittance still used for certain revenue payments.

We now turn to the other side of the account to consider the assets which the Bank holds against these liabilities to its stockholders and customers. We have seen that the two first liabilities, capital and Rest, are owed by it only to its proprietors, and are therefore not a debt in the same sense as the

others, and, when working out the proportion of cash to liabilities, it is only the liability to customers, the Government and other depositors, and the holders of seven-day and other bills, that is included in the calculation.

In its treatment of the liabilities side of its account we found that the Bank to this extent had always given fuller information than other banks, in that it separated the Public from the Other Deposits; but on the assets side its statement, even in its new and improved form, is still distinguished by obscurity. It makes no distinction between its investments and its other assets, and its subdivision of the Other Securities, though illuminating to anyone who understands it, might easily mislead an uninstructed inquirer.

Here, again, Government means only British Government, and the item Government securities covers the Bank's holding of Consols and other British Government stocks, Treasury bills, Exchequer bonds, and other short obligations of the Government, and any loans that it may have to make to the Treasury in the shape of Ways and Means advances, when the exigencies of "supply" or of dividend payments compel the Government to draw on its banker. As these temporary borrowing operations by the Treasury are indicated more or less by the weekly returns of public income and expenditure, published in the *Gazette*, it is possible with their assistance to get a dim glimpse of the meaning of the movements in the Government

securities in the Bank return ; but these Government returns are slow in appearance, inadequate in information, and obscure in expression, and any one who attempts to find his way with their help towards a comprehension of the relations between the Government and the money market is entering a path full of pitfalls. It is rather curious that the money market, which so often has to come to the assistance of the Government by subscribing to Treasury bills or otherwise, submits patiently to handing over its money to a borrower whose operations are veiled in so much mystery, and at the same time are of such great importance. Broadly, however, it may be stated that when the Government securities item rises, either the Bank has been increasing its holding of Government obligations, funded or unfunded, or else has been making some sort of an advance to the British Government ; and when it declines, it goes without saying that one of the contrary operations has taken place, that the Bank has been selling Government stocks, or having an advance repaid by the Government ; but there is yet another possibility, for the Bank may have been borrowing from the market and giving some of its Government stocks as security. When it borrows in order to curtail the supply of credit it is usual to see a decrease in the Government securities, and sometimes in the Other Securities likewise. But it is important to remember that when the Bank lends money to the market its holding of Government securities is not thereby

affected; even when it lends on the security of Government stocks, this security is only collateral and the borrowers' promise to pay is what it relies on first, and it therefore includes advances to any borrower but the British Government under Other Securities, nowadays under the subheading, Discounts and Advances.

Other Securities are now divided into two heads, Discounts and Advances, and Securities. By this change the Bank has again done a great deed for the cause of enlightenment. The separation of the bankers' from the rest of the Other Deposits helps us to see better what is the position of the market. The subdivision of the Other Securities helps us to see better how it has got there. At the same time it must be admitted that as it stands the new form of the return seems almost designed to mislead anyone who tries to read it without a key to the cryptogram. An intelligent inquirer, reading these items in the light of ordinary experience, would naturally infer that Discounts and Advances mean what they say—bills bought and loans made by the Bank—and that Securities represent its holdings of stocks and bonds other than obligations of the British Government.

But the real distinction is quite different. It was explained in the *Economist* of December 1, 1928—and I have good authority for saying that the *Economist's* explanation was, as was to be expected, correct—that “Other Securities have now been divided so as to show the extent of market indebted-

ness to the Bank, this being substantially what is meant by the new item, 'Discounts and Advances.' The important distinction is this: Where a bill is discounted at the Bank on the market's initiative, the Bank will rank it as a 'Discount.' When the Bank buys bills on its own initiative as part of its open market policy, it will rank as a 'security' —'Government' for Treasury bills and 'Other' for commercial bills."

This new classification is thus based not on different classes of assets, but on the way in which certain assets came into the possession of the Bank; and whatever a scientific accountant may say about this psychological method of book-keeping, it unquestionably tells us much that never could be guessed, not only by the old method of one comprehensive item "Other Securities" but also by a conventional subdivision into loans, discounts and investments.

What we want to know is, what the market has been doing with the Bank in the way of discounting with it or borrowing from it, and what the Bank has been doing with the market in the way of contracting or expanding credit, by disposing of securities, reducing advances or *vice versa*. This the new distinction shows, at least to some extent. When the bill-brokers have to go to the Bank for accommodation, by borrowing from it or discounting bills with it, there will be an advance in Discounts and Advances. If the Bank prefers that the market should not be squeezed by having to

discount with it at the official rate, and so buys bills from it at market rates through the "hidden hand," the advance will be shown in the Securities. A further caution, however, is necessary. When we speak of the market's initiative, we must not use the market in the usual narrow sense. "Market borrowing," when one sees the phrase in the City articles, means borrowing by the bill-brokers. If Discounts and Advances only covered this kind of borrowing, we should be led to infer that ever since the new return came into being the bill-brokers had been in the Bank, which is by no means true. By "market initiative," the Bank means any discounts and advances which it may arrange for any of its borrowing customers, apart from the British Government. When anybody comes to it for money, it is market initiative; when it goes into the market to lend or borrow, it is pulling the strings through its "open market policy," and regulating the supply of credit.

To outside inquirers it may seem that by throwing this new light on the position the Bank has only made darkness more visible, owing to the technical obscurities involved by these explanations. To those who deal in money, however, the change has been welcomed as a real increase of information. From the point of view of the general public, all that need be remembered is, that any increase in the Bank's holding of securities, whatever label may be attached to them, will *pro tanto* increase the supply of money, and any decrease

will reduce it. For since every amount lent means a corresponding credit in the Bank's books, an increase in the securities causes a corresponding increase in the deposits, either Public or Other; and if the Public Deposits have been increased by an advance from the Bank it may be assumed that this has been done because the Government has payments to make, and that the increase will shortly be transferred to the Other Deposits, and so will be added to the "cash at the Bank of England" in the books of other banks, which is regarded as equivalent to notes or gold as part of the basis of credit. Or the increased credit may be employed in the withdrawal of actual currency from the Bank, which will so be added to the cash in hand of the commercial community.

And now we come to the last two items on the assets side of the account, which taken together constitute what is generally spoken of as the reserve of the Bank of England. It should be noted that this reserve is, in accordance with the confusing habit of economic phraseology, a reserve in quite a different sense from the reserve or reserve fund of another bank or company. Ordinarily a company's reserve means an accumulation from profits which have not been distributed as dividend but kept in hand for use in case of need. The Bank of England, as we have seen, possesses a reserve of this kind, and calls it its Rest. But when we speak or write of the Bank's reserve we mean its holding of cash in the Banking Department.

It consists chiefly of notes with a small proportion of gold and silver coin ; the coin may be called the Bank's small change till money that it has in hand to meet cheques drawn on it, and for other ordinary banking business. Nowadays, we may probably assume that practically all the gold that comes into the Bank's hands goes into the Issue Department, and notes are issued against it and put into the assets of the Banking Department. These notes, now that they have taken the place of the gold coin that we used to carry, are the form of currency on which all demands, home and foreign, are likely to fall. When we want more money for holiday purposes, Bank of England notes go into circulation. When a foreign demand for gold reduces the gold stock in the Issue Department, notes issued against it have to be cancelled ; and as the notes in the hands of the public or the banks clearly cannot be cancelled, those in the Banking Department's reserve have to be diminished by the amount of gold that has gone abroad, unless the Bank exercises the power given to it under the Currency and Bank Notes Act of 1928 and, with the permission of the Treasury, expands the fiduciary issue by uttering more notes against securities.

CHAPTER XIV

THE GOLD RESERVE

AS originally written, most of this chapter and of the rest of the book was devoted to a discussion of the alleged inadequacy of the Bank of England's stock of gold and of the cash reserves of the other banks, and of various suggestions made for repairing this fault. Since then the Money Market's problem has been radically changed by developments already noted, chief among which are—

(1) the establishment of a link between Bank rate and market rate, through the rule by which the Clearing banks regulate the price at which they lend money to bill-brokers by Bank rate ;

(2) the many changes in the position which have given the Bank of England a closer hold on the market ; and

(3) the process of consolidation and amalgamation which has absorbed into stronger units a number of comparatively weak banks.

That old complaint on the part of the big banks which kept substantial cash reserves, of over-trading in the production of credit by their weaker brethren is thus now a thing of the past. The Clearing banks now all publish monthly statements showing their average weekly balances during the previous

month, and they represent about 90 per cent. of the country's banking resources. And though "window-dressing" is still criticized (by bankers as strongly as by anybody), it is rather as a silly and undignified practice than as an indication of weakness.

So far, indeed, have we moved from the opinion that the proportion of cash held by the banks is inadequate, that their most austere critics nowadays congratulate them when they increase the fabric of credit that they raise on the basis of their cash. In its Banking Supplement of May 11, 1929, the *Economist*, after displaying a table showing that the nine English clearing banks had increased their deposits (by expanding their advances and discounts) by £66·7 millions between March, 1928, and March, 1929, while their cash had only risen by £0·7 million, said that "the first lesson to be drawn from this table is that the clearing banks have merited a great tribute from the nation for increasing the supply of credit granted by them to their customers during a year when their own supplies of cash remained virtually unchanged." So the naughtiness of one generation becomes the virtue of the next, and the process which used to be suspected as over-trading in credit, when some of the small weak banks had almost negligible cash reserves (which they did not show), now merits a great tribute from the nation when it is done by banks which have consolidated themselves into positions of commanding strength.

With the power of the Bank of England over the London money market strengthened as it has been shown, its task of protecting the country's gold reserve has been made easier. At the same time it has been made much more difficult and tangled by the rise of the United States to a position of immense importance in international finance, and by the enormous scale of international indebtedness left as a legacy of the war. It has also been complicated by the appearance of a host of critics, ranging from Mr. J. M. Keynes, an economist of outstanding ability and world-wide fame, to amateurs who believe that the way to make humanity happy is to provide it with heaps of money, forgetting that what we consume is not money but goods and services. Between these extremes are a host of business men, who think that they could do more business if they had more credit and accuse their bankers, or the system under which their bankers have to work, of stinting the supply of credit. Then there are the political critics, who maintain for example that "a considerable portion of the available supply of credit, as well as a similar proportion of the national savings which are permanently invested, is in the national sense wasted in the support of enterprises which are nationally useless and may even be noxious"; and go on to urge that the governing body of the Bank of England should be made responsible to the community and not merely to individuals, and for this purpose should include representatives of the

Treasury, the Board of Trade, Industry, Labour, and the Co-operative Movement.¹

These many voices have produced among them a big volume of sound, so much so that *Punch* thought them worthy of expression in a cartoon, in its issue of December 12, 1928. In it John Bull, dressed as a traffic-regulating policeman, was depicted as beckoning to a portly Old Lady of Threadneedle Street about to cross the way, and saying, "Step a bit more lively, ma'am; you're holding up the traffic." The Old Lady holds a bag marked "Obsolete Policy," and behind the policeman, waiting for the Old Lady to give them a chance to move, are vehicles labelled "Industrial Development," "Trade Enterprise" and "More Employment."

In fact, while in 1908 the gold standard was recognized generally as the monetary system which had been proved the most practical and workable, both for England and for international trade, by the experience of a century, there are now some doubters, with high theoretical authority behind them, who think that the gold standard is an obsolete barbarism, and there are many more sceptics who, while acknowledging that it is still the only workable system, are highly critical about it and its effects and doubtful about the spirit in which it is worked. In other words, the gold standard, though re-established, is on its trial.

¹ *Labour and the Nation*, Supplement on Banking and Currency Policy.

Before we can look into these criticisms, we have to make up our minds about what we want from a banking system and what are the objects for which we can ask our Bank of England and the central banks of other countries to work. In other words, what are the qualities which we want the money, the supply of which they regulate, to possess ?

Our answer to these questions will depend, to a certain extent, on the kind of work that we do and our position in the economic world. To the great majority of us, wage-earners, salary-earners, and professional and other workers whose fees and payments are more or less fixed by custom, what we want to be sure about is that the money that we earn can be trusted, when we spend it, to buy for us as much as it did last week or last year or as long as we can remember ; and that any money that we lend or invest will buy as much when it is repaid in a year, or in fifty years, as when we lent or invested it. That is, we want our money to be stable in value, and in purchasing power over the goods and services that we need for our existence and comfort. If it is not, if we find that everything, or most of the things, that we want cost more, so that our money does not go so far, we begin to suspect either that somebody is making too much out of us, or that there is something wrong with the money in which we are paid ; and we grow discontented and think that we ought to have higher wages or salaries, or that the fees that we are paid

for pulling out teeth if we are dentists, or for writing articles if we are scribes, ought to be raised. From the wage-earner with three pounds a week to the leading barrister with forty thousand a year, this quality of steadiness in buying power is what we want most from our money.

Some of us may go further and think that it would be pleasant if the money that we earn should rise in value and buy us an increasing amount of the things that we want—that is, we should like to see a steady fall in the prices of goods and services. This would certainly pay us best, as long as we continued to be paid the same wages or salaries or to receive the same fees for our professional jobs, and if at the same time we were able to sell our work with the same ease and readiness. Under these conditions falling prices are a boon to us. But we cannot count on these conditions continuing. As will be shown when we consider what is wanted from money by employers, merchants and business organizers, falling prices are generally believed to be bad for business. They certainly tend to reduce the profits of industry, and when they are prevalent, we are in danger of having our wages or salaries reduced if we are wage or salary earners, while professional workers are likely to find that those of their customers whose incomes depend on the profits of industry will go to cheaper doctors and dentists, send their children to cheaper schools, think twice about expensive lawsuits with K.C.'s at fancy prices, and reduce the advertising in

newspapers which helps the scribe to sell his "copy."

Steadiness in buying power, with a slight bias in favour of its increase, is thus what most of us want from our money, which means that we want the general level of prices to be steady, or to fall slightly as long as it does not produce business depression, which will ultimately affect us, by falling.

From the point of view of the employers and organizers and all who, as shareholders, live on the profits of industry, the wind is on the other cheek. To them steadiness in the buying power of money is desirable, but with a bias in favour of a decrease in its buying power, that is of rising prices for the commodities and services that they produce or handle. They, or nearly all of them, whether makers or dealers, manufacturers or merchants, are obliged by the nature of their business to hold a stock of goods and to be chronic borrowers of money.

The bootmaker has to have his stock of leather and also his stock of half-finished and finished boots, the silk merchant has his stock in his warehouse waiting to be sold. If prices of these articles are falling, both maker and merchant will get less money when they sell their goods, their stock in trade when they make up their balance-sheets at the end of the year will have to be written down to current prices, and unless they have succeeded in cutting down their working costs by reducing wages, salaries, advertising and other charges, or by greater

efficiency in management, they will show less profit. Some of their expenses, commonly called overhead charges, they certainly will not have been able to reduce—such as taxes, rates, rent and other charges fixed by long contracts. Falling prices are thus a cause of inquietude and apprehension to the business organizer, and make the manufacturer hesitate about expanding his production, the merchant think twice before he takes more goods from the maker, and the retailer—the shopkeeper, from whom we ultimately buy—give orders less freely to the travellers who come to solicit them. It has been argued that falling prices, by thus making it more difficult for the organizer to earn profits, give him a stimulating flick with a whip and force him to improve his organization; and there is probably some truth in this theory. But being flicked with a whip is not pleasant to anybody and it is highly desirable that the people who do the organizing job, which is of such immense importance to the trade of the world as a whole, should do it in a spirit of wholesome confidence and not be driven by a lash of apprehension.

When prices are rising, all is for the best from the organizer's point of view. His stock of raw materials shows him a profit before he begins to manufacture it, his stock of finished goods is in ready demand from the merchants who want to replenish their own before prices go further against them and he is encouraged by the fact that prices are going the right way for him, to buy more

materials, expand production, take on more hands, improve his machinery and generally to set the wheels of trade spinning faster. If the rise is not too fast, it probably helps him to do his work better. But just as we saw that falling prices act on him like a whip, so rising prices, if they go too far and too fast, are apt to make him fat and lazy and careless. During the time of the great inflation during and after the war it was waste of time to try to do business well, because anyone who had a stock of goods only had to sit and watch them rise in price and then pouch the fat profits that were assured by the mere rise in prices. That state of things is bad for everybody.

As a chronic borrower—for active business men can nearly always use more money than they, or the companies for which they work, actually own—falling prices are again bad for the organizer. If the bootmaker owes his bank £100,000, and expects to be able to meet the debt by selling 100,000 pairs of boots, and then finds when the debt is due that he can only get 17s. 6d. a pair for his boots because there has been a fall in prices in the meantime, he is evidently paying back to his banker money which is more valuable, when reckoned in boots, than it was when he borrowed it. The fall may have been due to the conditions of the trade—more competition, inventions which have cheapened production or any of the other causes which tend to cheapen goods. But whatever be the reason, falling prices are bad, in some ways, for trade borrowers; and

rising prices, which enable them to repay loans in money which has become less valuable than the money which they originally borrowed, are good for them; and when we remember that all the enterprising people whose initiative and driving power set and keep the wheels of trade and production spinning, are generally in debt to their bankers for temporary loans, and very probably also to investors for money lent for long periods on bonds or debentures, we see here another reason why they should want stability in prices, if they cannot have the rising prices which suit them best.

To creditors and investors, who receive fixed amounts from time to time in interest and expect to be repaid, some day, the money that they have lent falling prices are evidently a blessing, for they are continually paid in money which gives them a better command over goods and services. As long as the process does not go so fast that it ruins their debtors, they sit and see their "real" incomes—their incomes measured in goods and services—increasing through no effort of their own. But investors who are not creditors, but ordinary shareholders, who take their share of any profits that are left after all charges and interest payments have been met, are hit by falling prices and benefit by rising prices owing to their effects, already noted, on the profits of enterprise.

We thus see that price movements affect two great classes of people in opposite ways. One class, by far the more numerous, is composed of

wage-earners, salary-earners, professional fee-earners, creditors, annuitants and all who receive payments which are more or less fixed. These want prices to fall as long as they can continue to earn or receive at the same rate in money. The other, much smaller but immensely important because their energy drives the wheels, want rising prices, and as long as the rise does not go so fast as to make them slack, will probably work better when they are prevalent.

An all-powerful monetary dictator, in the light of these considerations, would probably decide that, in so far as prices can be affected by the policy that he pursues in creating money, it would be better for everybody and more likely to produce stable conditions of business, if he kept the general level of prices steady. If he could do that, then neither of these classes would be either discouraged or made discontented owing to anything that was done by their money, and neither of them would be getting any benefit at the expense of the other.

If, then, our supposed despot, ruling the money of all the world, came to this conclusion, how much could he do towards securing the ideal of steady prices all round? The answer to this question depends on the degree of importance to that we ascribe to what is called the Quantity Theory of Money, which tells us that the general price level depends on the relation between the quantity of money in existence and the quantity of commodities that are being bought and sold.

Broadly, the truth of this theory seems to be self-evident if you think it over, and its truth was clearly shown during and after the war when a general increase in the volume of money, because the Governments of all the nations concerned found it easier to get new money created than to take it out of the pockets of their subjects by taxation, was accompanied by a general rise in prices, roughly corresponding to the increase in money. Obviously if we all found ourselves with twice as much money in our pockets and in our banks, and there were no more commodities to be bought, we should all feel nice and rich for a few minutes, but when we tried to spend our money we should find that its buying power had been halved, after much dislocation and adjustment, with benefit to some and loss to others. And, of course, *vice versa*—if the money of all of us were halved, we should feel terribly poor, but we should find that the competition of those who had commodities to sell would bring prices down, so that the community as a whole would be roughly as it was with regard to its command of necessaries and comforts, though the process of adjustment would hit some and help others.

It therefore seems to follow that if the monetary despot can keep the amount of money in roughly constant relation with the supply of commodities he could keep the general level of prices fairly steady, as long as the public which handles the money turns it over at a fairly uniform pace. This question

of the "velocity of circulation" is one that we have to allow for before we ascribe too complete power to the quantity of money as an influence on prices; and another rock of which we have to steer wide, is the fact that when we expect the quantity theory to work "according to plan" we have to include among commodities many articles which are generally left out of the Index Numbers by which statisticians usually measure the general level of prices. A very interesting example of this difficulty has lately been presented by the United States, where in spite of a great increase in the volume of money, as compared with the estimated volume of goods, prices of commodities have been stable with a slight fall.

Dr. Benjamin Anderson, economist to the Chase National Bank of New York, sets forth these facts, with pleasant gusto, in the *Bulletin* of his bank dated May, 1929. After displaying a formidable array of figures, he says: "We are now ready to test the quantity theory on the basis of American statistics for the past ten years, measuring prices, volume of money, volume of bank credit, velocity of circulation of money and credit, and volume of trade, in accordance with the usual methods of the quantity theorists. I regret to have to inform you that the ten-year test ends in a tragedy. The beautiful theory is crushed by the weight of facts. Prices would have to be 83 per cent. higher than they are, if the quantity theory of money were true. . . . The expenditure of ammunition in the form

of credit expansion has been tremendous. The effect on commodity prices, on the face of the record, has been *nil*. But we have financed a magnificent real estate speculation, chiefly in urban and suburban districts, though in one case covering a whole State, Florida, and we have financed a stupendous stock exchange speculation."

Dr. Anderson thus gleefully dances on what he thinks to be the corpse of the Quantity Theory, in which he is a stalwart disbeliever. But it may be suggested that he has only proved, not that the theory is wrong, but that in order to make it cover all possible conditions we have to include so many things under the word commodity, that by the time the theory is watertight, it is so all-embracing as to be of not much practical use. He himself admits that if the credit expansion had not taken place, the American commodity price level would be lower when he wrote than it was. The expansion had had its influence not in raising prices but in maintaining them, and by interesting and indirect ways. It had enabled America, a creditor nation with very high tariffs, to show a great export surplus, through the flotation of a huge volume of foreign securities; it had stimulated immense activity in the building trade and other constructional work, such as road-making, and the financing of instalment buying with bank credit had gone much further than would have been possible without it.

It thus appears that the power of a monetary

despot to influence commodity prices by expanding or contracting the supply of money is by no means as complete and simple as it seems to be thought, by some of the people who assume that a stable price level is one of the boons that we can fairly demand from our central banks. It seems probable that they can certainly rely on their power to check a rise in commodity prices, by contracting the supply of credit, by raising its price, through advances in their official rates of discount, by putting difficulties in the way of borrowers and by reducing their holding of investments ; but this is a weapon which has to be used with caution, since if wielded with a rough hand it might start a panic, which is sometimes easier to start than to stop. But the raising of prices by expanding credit is a much more difficult matter because banks cannot expand credit by advances unless they have borrowers to take them, and there are times when trade is so depressed that borrowers could hardly be tempted by the offer of money for nothing ; and if central banks created credit by investment it might just lie idle, and money has to go to market and buy before it can affect commodity prices. And, as the American example has shown, one can never be sure about the use to which any new credit, if it is used, may be put. Still, the mere knowledge that plentiful credit is to be had cheap, may always have some effect in restoring the confidence of the enterprising organizer.

But if the raising of prices by credit expansion

is difficult, there is always the consolation that falling prices are a boon to an immense number of people as long as they do not produce depression. They are so generally supposed by business men to produce depression, that one hesitates to doubt it, but here again we get an American example to the contrary. In the *Economic Journal* for June, 1928, in an article on the Business Prospect in the United States, Mr. L. H. Sloan wrote :—" We have witnessed the phenomenal spectacle—unbelievable a few years ago—of rising prosperity on a generally declining price level. Indeed, paradoxical as it may seem, falling prices have given one of the evidences of our prosperity."

Moreover, even if a monetary despot could be certain of being able, like the man in Browning's poem,

" his world to make
To contract and to expand
As he shut or oped his hand,"

it would not follow that the securing of a straight level of commodity prices would cure all the ills that trading flesh is heir to, as is too often assumed. By playing on the credit concertina, central banks could only affect the general average of prices, as marked by the Index Numbers. But an unaltered average price level may quite possibly be accompanied, for example, by a heavy fall in cotton offset by a sky-rocketing rise in copper ; and to the business man what is important is the price of the article

or articles which he uses, and sells as manufacturer or merchant. It is no comfort to him to be told that the general price level has, through skilful manipulation by a central bank, been kept on a nice even keel, if at the same time the violent rockings of his own particular commodity have upset his balance and his balance-sheet.

But when all this is admitted concerning the limits on the power of monetary authorities to control the average price of commodities and their inability to control the fluctuations of any one commodity, it is still clear that stability in the price level is a general benefit at which we can ask them to aim, as far as their policy and action can secure it.

And we are fortunate in having this ideal of stability publicly stated by a most distinguished exponent of central bank policy as an object for which they ought to work. The late Mr. Benjamin Strong, Governor of the Federal Reserve Bank of New York, has already been mentioned as having done work which was of incalculable benefit to all the world in assisting the reconstruction of Europe and the establishment of international financial co-operation. He was also one of the brilliant team of monetary experts consulted by the Royal Commission on Indian Currency which issued its Report in 1926. He said in the course of his evidence: "We shall all admit that the object of perfecting monetary systems is the achievement of a stable domestic and international purchasing

power for the currency—a goal unattainable by any one party acting alone and only possible through co-operative effort. Because a gold currency ” (by which he presumably meant a currency based on gold) “ is that one which has had in the past the most stable buying power both at home and abroad it is naturally the one which we all now seek to secure.”

Governor Strong thus brings us to the second quality that we want from money—stable purchasing power abroad. This quality is of the highest importance to all who trade with foreign countries and so directly to all of us who consume foreign goods. Stability in the exchange value of our money when we turn it into the money of any other country that uses the gold standard or has a money that is hitched to gold, is secured by the existence of the gold points which impose limits on the fluctuations in rates of exchange. How great this benefit is will be remembered by all those who tried to trade with foreign countries in the after-war period when the gold standard was in abeyance, and fluctuations in exchange made foreign trade into a gamble. Stability in exchange is not, of course, the same thing as stability in purchasing power, but it does mean that the prices of goods which have an international market will be approximately the same in all the gold-money countries. As long as the pound and the dollar are kept within reasonable distance of parity the price of cotton in England and America will keep step. And so

stability in purchasing power, if it can be secured at home will be secured abroad also, at least with regard to those goods which have an international market.

It would also be much more comfortable for the business community if stability could be secured not only in the purchasing power of money at home and abroad, but also in the rate of interest that borrowers have to pay for its use. We have seen that nearly all active promoters of trade and industry are chronic or at least frequent borrowers from their banks, and upward jerks in the price that they have to pay for this accommodation are clearly inconvenient to them. If a manufacturer has embarked on an expansive programme involving a large amount of temporary credit, and suddenly finds that the price of it has been twisted up, he is likely to jump hastily to the conclusion that there is something wrong with our monetary system, especially if he finds that his banker's charge has been raised to follow a rise in Bank rate—and the price of bankers' advances is usually regulated by Bank rate, being generally $\frac{1}{2}$ to 1 per cent. above it—and that the rise in Bank rate happened because our gold was going to America because high rates were being paid there for financing that "stupendous stock exchange speculation" referred to by Dr. Anderson.

It is easy to exaggerate the effect on costs of production of such fluctuations in the price of short credit, which are, in fact, almost negligible—it was

stated by Mr. P. D. Leake, a distinguished accountant, in a letter published in the City article of the *Times* of Feb. 13, 1929, that "spread over industry as a whole, it may fairly be estimated that the raising of the Bank rate by 1 per cent. increases the cost of production by an amount nearer to 1*d.* per £100 than to 5*s.* per £100." Nevertheless, the effect on the minds and sentiment of business men of rises in Bank rate, which have always been looked on as danger signals, indicating unsettled monetary conditions, may be very marked; and at least we can ask our central banks not to inflict these psychological shocks on our industrial and commercial organizers unless it is really necessary to do so. The latter sometimes accuse the former of thinking too exclusively in terms of gold reserves and gold problems, and not giving enough consideration to the effect of their policy on the trade of the country. Whether there is any real foundation for this suspicion, may be doubted. Bankers—even central bankers—are shrewd enough to know that a sound financial policy is only sound if it works for the prosperity of the community, and that if the gold standard is a hindrance to production and trade it will not long stand against the acid criticism with which most of our institutions are nowadays—sometimes to their great benefit—assailed. And here again we can take comfort from an official exponent of central banking ideals. Sir Ernest Harvey, then Comptroller now Deputy-Governor of the Bank of England, gave an address

on Central Banks to the Victorian branch of the Economic Society of Australia in April, 1927. Among the functions of central banks he included the duty of ensuring to the public the “provision of adequate banking facilities on reasonable terms.” This phrase is clearly capable of various interpretations; the public’s idea of reasonable terms is likely to differ from a banker’s. But we may fairly claim that it implies terms which are as near to stability as is possible under the monetary and commercial conditions of the moment.

Having thus seen what we want from our money and how much, or how little, a central bank can do to secure it, we can go back to the *Punch* cartoon referred to a few pages ago and the discontent with the Bank of England’s policy which it expressed and see how much reason there was for them. Jokes, even when uttered by professional humorists, are supposed to have a point, but when we look into what had been done by the Bank of England during the very difficult year that was closing when *Punch* jested on December 12, 1928, it is hard to see why the Old Lady should have been accused of holding up the traffic by her “obsolete policy.” The year’s difficulties were caused by high rates for money current in America in connexion with that “stupendous stock exchange speculation,” the consequent assumption by London, for the first time since the war, of the whole burden of financing the autumnal shipping of cotton and cereal crops from west to east, and added to these problems,

a quite unexpected demand for gold on German account. How did the Bank of England meet these responsibilities? "The fundamental fact," says the *Economist* of January 5, 1929, "of the year's history is that it witnessed first a gain by the Bank of England of £24 millions in gold and then a loss of £22 millions without any change in Bank rate. . . . This alone marks out 1928 as being an unusual year." It does, and it also shows that the Bank, in spite of very great difficulties and vast gold movements in both directions, had given the market all the stability in the price of money that can be secured by an unchanged Bank rate. It had, in fact, far from sticking to an obsolete policy, gone further than some critics thought wise in the use of a brand-new one. "Last year," says the *Economist* again, "it deliberately abandoned changes in its rate as an instrument of control. In its place it relied entirely on its open-market policy, which it used in the direction of neutralization." In other words, as gold came in it reduced its securities and as gold went out it replaced them, and so kept the supply of credit and the price of money as near to stability as its policy could make them. And the other banks, that work on the basis of the credit supplied by the Bank of England, had, as has already been shown, been expanding the credit that they granted to their customers, with the result that at the end of the year the deposits of the general public—which are potential buying power—in the banks of the United Kingdom,

showed an increase of £66 millions during the course of 1928.

It is true that during the year there had been a slight fall in the prices of commodities as measured by the Index Numbers. But this fall can hardly be attributed to any contraction of credit, because, as has been shown, credit had been expanded. Judged by the events of 1928, the Bank of England and the other banks seem to have worked the gold standard in the interests of industry and the public with remarkable success. They kept the price of money, as measured by Bank rate, even, and they provided the public with £66 more millions of purchasing power. Short of abandoning the gold standard and starting to slide down the slippery slope of inflation, it is hard to see what they could have done to satisfy their critics. Is this what the critics wanted ?

CHAPTER XV

OTHER RESERVES

EFFODIUNTUR opes irritamenta malorum—so said the Latin Grammar, doubtless on the authority of Horace or some other sententious Roman poet. And we still dig up riches and they still cause evil because we are stupid about them. Week by week the ships come in from the Cape bringing gold from the mines of the Rand, consigned by the South African banks to the Bank of England, which acts as a warehouse for it. Then it is sold in the bullion market to the highest bidder, and it goes partly to “the trade,” which uses it for purposes of ornament or dentistry, partly into use as money, either in the form of coins, or more probably lying in the vaults of the Bank of England or some other central bank as backing for a note issue, and partly to India to be hoarded.

It is thus the usual fate of gold, as has been happily observed by a facetious chronicler of the bullion market, to be dug up at one end of the world and buried again at the other either in a Hindoo backyard or a central bank vault. In India it comforts its possessor with the thought that there it is if he wants it. In a central bank it comforts users of the country's money with the

knowledge that it secures the maintenance of that money on a parity with the moneys of other countries that have gold buried in their vaults. This knowledge is an enormous advantage to all who are engaged in foreign trade ; but this advantage may be dearly bought if, in order to acquire big heaps of gold, the central banks compete for it by putting up their rates of discount and inflicting dear money on the trading community. The trading community wants good money but it wants good trade still more ; if it suspects that trade is being sacrificed to money it begins to say unkind things about its bankers.

It would evidently be much pleasanter if we could get rid of all this fuss about gold movements and agree to have a central reservoir somewhere, and that the note issues of the central banks should be backed not by gold in their vaults, but by bills of exchange or other claims payable in the currencies of gold-standard foreign countries. This would ensure the maintenance of parity with other currencies, because the central bank would always have foreign money at the disposal of those who need it, and would be more profitable to the central banks. This is the system known as the gold exchange standard which secures the convertibility of notes not into gold coin or bullion but into foreign currencies at a fixed price, and its general adoption would solve many problems.

Unfortunately, it is considered more dignified for a country to back its notes with gold in its own

possession than with claims to gold elsewhere, and the experience of the last war showed that the system might have awkward consequences if ever war came again. Central banks all strive—and have been advised, as will be shown, by the Governor of the Bank of England to strive—to work their way through the gold exchange standard to the gold standard, by replacing foreign assets with gold in their vaults. Very well then, but it surely should be within their power to set about this object, as he advises, sensibly and through mutual agreement. It is their business to see that the gold standard is, as it should be, a public benefit and not a public nuisance.

Governor Strong's pithy defence of it has already been quoted: "because a gold currency is that one which has had in the past the most stable buying power both at home and abroad it is naturally the one we all now seek to secure."

This testimony to the stability of prices secured in the past by the gold standard is endorsed by the most distinguished of its critics, Mr. J. M. Keynes, who says in his *Tract on Monetary Reform* (page 164) that "the success with which gold maintained its stability of value during the changing world of the nineteenth century was certainly remarkable." It has also been very practically accepted by the great majority of the civilized countries of the world. A Memorandum prepared by Sir Henry Strakosch for the Finance Committee of the League of Nations and printed in a Supple-

ment to the *Economist* of November 10, 1928, points out that "the monetary standard chosen by all the countries of Europe that have stabilized their currencies during the last five years is the gold standard in its various forms. Some of them have adopted the 'gold specie standard,' which involves the obligation to exchange the local currency on demand for gold coin; others" (including Great Britain) "have elected to establish the 'gold bullion standard,' involving the obligation to exchange it into gold bullion; and others, again, the 'gold exchange standard,' which makes the local currency exchangeable into foreign gold exchange. And there is finally a numerous class of countries in which the local currencies are convertible at the option of the currency authority into either gold or gold exchange, or in which convertibility into gold exchange is intended to be merely a transitional stage towards the ultimate establishment of the gold specie standard. Looking beyond Europe, we find that the trend of development in monetary organization has proceeded on very similar lines to that of Europe." Sir Henry goes on to conclude "from the action of the countries concerned that they are content to link the purchasing power of their money to what gold will buy—that is, to tie their general price levels to gold (and through gold to the price levels of all other gold standard countries)—in a word, to join in a great monetary partnership with gold as their common bond."

But he lays stress on the consequent necessity for the maintenance of stability in the buying power of the commodity which forms the common bond, and recalls the resolutions of the Genoa Conference, which recommended that the central banks of the gold standard countries should co-ordinate their credit policies with a view to keeping the buying power of gold stable.

This is the big problem which has to be tackled by the banking authorities of the world. The nations, in Sir Henry Strakosch's nautical metaphor, have all moored their currency and price-level ships to a gold buoy. Before they can have ceased to be at the mercy of the elements, their captains of the ships must agree to co-operate closely in applying the machinery at their command to manœuvring their ships in such a way as to keeping the buoy in a "pre-determined and safe position."

If we have all tied ourselves to a buoy that is going to drag prices down, then, as was shown in the last chapter, there is danger of trade depression and unemployment; if it is going to carry prices into the whirlpool of inflation, because gold and the credit based on it, are increased more rapidly than goods, then we are faced by a period of rising prices in which industry will enjoy big profits and activity at the expense of wage-earners and salary-earners (unless they can kick hard enough for higher pay) and of creditors and all who receive payments at fixed rates. Somewhere between these evils we

want the monetary buoy to be anchored. It will probably have to swing on a longish cable, for absolute stability can scarcely be reached even in the general level of prices. But at least the benevolent monetary despot, who is, or might be, represented in practical fact by the central banks of the world working in harmony, if ever they can succeed in doing so, can secure that changes in prices shall not be due to the existence of too much or too little money.

First of all they have to learn to work together, and not puzzle and exasperate the trading world with apparently unnecessary gold movements and rate movements. As Governor Strong said, "stability is a goal unattainable by any one party acting alone and only possible through co-operative effort." Can they give us this co-operative effort? Judged by recent results, their endeavours to do so, after a promising start, have landed them in a bunker out of which they are still struggling to emerge. Co-operation did a great work in assisting the stabilization of European currencies and went still further in 1927, when a gathering of central bank representatives, held in New York, is believed to have led to the adoption of a policy by the Federal Reserve banks which caused the return to Europe and other parts of the world of part of the immense mass of gold that had gone to America during and after the war. The Federal Reserve bank rates were reduced from 4 to 3½ per cent. early in August, in spite of a protest by the

Chicago bank, and by the end of June, 1928, the American gold stock had declined by £116 millions from the level of May, 1927, when it reached its highest point. This redistribution inflicted no scarcity of credit upon America, owing to the wide margin that existed between her legal reserve requirements and her immense holding of gold. During the period of gold exports the bills discounted by the Federal Reserve banks for the "member" banks or Reserve system—the ordinary trading banks of the country—had expanded by £120 millions. The result was that while the total on both sides of the Federal Reserve balance sheet was practically unchanged at about £1,000 millions, the proportion of reserves to liabilities had fallen from 78·8 per cent. (which looked extravagant) on May 27, 1927, to 68·7 (which was still far more than ample) on June 28, 1928.¹

So far, so good, but in the meantime there had begun that struggle between the Federal Reserve Board and the Wall Street market in which the former set out to check that "stupendous stock exchange speculation" of which we have already heard. During 1928 Federal Reserve rates were raised from 3½ to 4 per cent. in February, 4½ per cent. in May and 5 per cent. in July. Gold began to go back to America and at the same time the high rate, 7 per cent., maintained by the Reichsbank was pulling gold into Germany, and the Bank

¹ These figures are taken from the *Federal Reserve Bulletin*, July, 1928.

of England, as already recorded, lost in the last four months of 1928, £22 out of the £24 millions of gold that it had gained during the first eight.

These movements did not look much like co-operation, and there was probably much truth in a comment on these events published by the Federation of British Industries at the beginning of 1929 in an Economic Supplement to its Bulletin, *British Industries*. "The death," it said, "of Governor Strong of the New York Federal Reserve bank last October must undoubtedly have disturbed the delicate personal relations between New York and London which constituted one of the most important of the incalculable factors controlling the movement of gold between the countries." Certainly the critics of the gold standard and its working were given plenty of material by the reasons which were causing these movements in the metal. Gold was being sucked back to America, not because it was needed to provide credit for industry, but because money-lenders of other countries were wanting to take advantage of the high rates current in Wall Street—in other words gold was going to America to assist the speculation that the American monetary authorities were doing their best to check. And gold was going to Germany not because the state of German trade and Germany's financial position gave her a call on the world's gold stock, but because the Reichsbank was maintaining an abnormal rate for money, and was taking money so borrowed in the form, unprofitable

to it and inconvenient to other centres, of gold. Gold movements based on genuine transactions of trade and finance can be accepted with resignation, but when they can only be explained by conditions which appear to be artificial, unnecessary and irrational, business men are likely to give a ready ear to those who cast doubt upon the gold standard.

But there was worse to follow, for having come through 1928 with an unchanged Bank rate in spite of all these uncomfortable happenings, and having been cheered at the beginning of 1929 by the reduction, at long last, of the Reichsbank's rate from 7 per cent. the international money market found that it had relied quite wrongly on the usual movement of the dollar in favour of England and Europe after the turn of the year, that money was still so much wanted in New York for financing the bull speculation which the authorities had failed to check, that high rates offered there for call and time money continued to pull in gold, that the Bank of England lost gold so fast in January and February that it raised its rate from $4\frac{1}{2}$ to $5\frac{1}{2}$ per cent. early in February, followed by the Bank of the Netherlands and other central banks, the Reichsbank going up to $7\frac{1}{2}$ per cent.

And so we had the exasperating and absurd spectacle of British and European industry trying to struggle up again, like an old cab-horse that has fallen, after a period of great difficulty—especially for England which had been treated to a general strike and a coal stoppage—and being kept down

because the creditor of all the world had got its monetary arrangements into such a muddle, that it was sucking in gold which other peoples wanted and it did not, because gold arrivals in New York were likely to stimulate the bullish enthusiasim which the Federal Reserve Board was trying to stop.

Such happenings do not help to make the gold standard popular. Could they have been avoided? And if not, what is the rest of the world to do, faced by a position in which its monetary arrangements are at the mercy of the whims of Wall Street? When a country is the chief world creditor, the world can surely expect it to be a cheap and free market for capital and credit and a free market for goods and services. England was both when she was world creditor, and she and her customers went ahead and prospered. America has lately been bidding up to 20 per cent. for money for Wall Street and has been discussing a new tariff Bill which will make it more than ever difficult for her debtors to pay their debts in goods, while the shipping subsidies which have supported her mercantile marine at the expense of the American taxpayer, have checked the supply of transport service by the ship-owning debtor countries.

Was it necessary for America to become a borrower at exorbitant rates, when the interest of all the countries to which it has lent such huge amounts called on it to ease the monetary position as far as possible? The Federal Reserve Board seems to

have thought that speculation in stocks had to be checked and we on this side have little idea of the extent to which the speculative fever had taken hold of all sections of the American community. If it had to be checked restriction of credit for speculative purposes appeared to be the only way to do it, for the public was deaf to all appeals from its monetary leaders and could only be checked by lack of the sinews of war. The Federal Reserve authorities have been criticized first for not raising rates sooner, and afterwards for not raising rates further instead of trying to induce the member banks to cut down credits granted to Wall Street. But when prices were rocketing as they were during the height of the boom, Federal Reserve bank rates would have had to go up to a point which would have inflicted real hardship on industry and possibly panic before they could have been certain to check speculators who were raking in profits at the pace then prevalent. The other way, diverting credit from the Wall Street channel, was more difficult, especially as some of the member banks openly worked against the Federal Reserve Board's policy and the whole course of events showed the American money market utterly failing to work together as a team, a knack which it will have to acquire before it can make New York into a monetary centre in which the world can have confidence. In the meantime a higher rate for money has been inflicted practically on the whole of producing and trading humanity.

Concerning the necessity for these measures, the rest of the world, which has had to help to pay the price of them, cannot judge; but it can note that it was doubted by many people in America, who maintained that the Wall Street boom merely expressed the well based confidence of the American public in its country's future, that the boom would have boiled over and subsided without doing any serious harm if left alone, and that in the meantime it was inflicting no damage on genuine trade which was, in the aggregate, rising to heights of unparalleled prosperity. We can also see that the reserves of the Federal Reserve system have never fallen nearly to the legal limit laid down by the Federal Reserve Act. When the rate for call money went up to 20 per cent. in Wall Street, the system's ratio of total reserves to deposits and note circulation combined was over 70 per cent.—nearly twice the figure required by the Act. With this great unexhausted reservoir of possible credit expansion America's debtors can only wonder why it seemed good to their creditor to inflict dear money upon us. Experts tell us that there are technical difficulties in the way of further credit expansion in America, beyond a certain point, because there is not enough "eligible paper" to be borrowed on. Bankers here smile widely at this suggestion and hint that the American banks and their customers could very easily and quickly produce any quantity of eligible paper required. And this view is confirmed by Dr. Burgess, assistant Federal Reserve

Agent of the Federal Reserve Bank of New York, who says in his lucid and interesting book, *The Federal Reserve Banks and the Money Market*, that "almost all member banks have on hand at all times amounts of government securities and other eligible paper on which they could borrow much larger amounts than are necessary except in extreme emergency."

In short, the spectacle of this great and ingenious people, hugely rich, hugely prosperous, with huge gold reserves and huge possibilities of credit expansion, and with a commodity price level that shows not the faintest trace of inflation, borrowing from its impoverished customers and debtors, and sucking in gold from their depleted money boxes, is one of the strangest anomalies in economic history.

But if anomalies of this kind are inevitable until America has learnt to do its job as the strongest monetary power, is it also inevitable that the rest of the world should submit to the infliction of monetary disturbance, without endeavouring, by means of the co-operation of which so much has been heard, to mitigate the nuisance? The power of the United States is immense, with their big favourable balance on visible trade, and a great sum (estimated at £150 millions for 1928) due to them year by year on Governmental and commercial debts. They only have to reduce their expenditure on foreign travel, their charitable remittances to needy relatives in the Old World, and the pace of their investment abroad, and their

position as creditor turns the exchanges in their favour and pulls in gold. This being so, it is surely bootless for their debtors to try to resist their demands by quoting higher rates for money, with the only result that money is everywhere dear and the gold standard is discredited as an international monetary system. If it is going to degenerate into a gold scramble, with all the central banks bidding against one another so as to increase their gold stocks, the future does not look pleasant.

Recent events have rather indicated that this is the programme to be expected, with the Reichsbank holding on, in the autumn of 1928, to its 7 per cent. rate and so taking gold from London at a most awkward time for London, with the result that when London went up in February, 1929, Berlin, having in the meantime come down to $6\frac{1}{2}$ had to go up again to $7\frac{1}{2}$ per cent. And yet the report of the Agent-General for Reparation Payments, dated December 22, 1928, had said that "the gold reserves of the Reichsbank now stand at the highest point ever reached and for the greater part of the past year the reichsmark has been one of the strongest currencies in the world, from the standpoint of the foreign exchanges"—then why hold on to such a rate as 7 per cent. ?

The Bank of France ended 1928 with a gold stock of over £257 millions, and a still larger amount in "foreign assets," sight deposits and bills acquired during the "flight from the franc," and owing to the inactivity of France, as compared

with America and England, as a long-term foreign lender since the war. This enormous holding of foreign currencies relieved it of any possible fear of depreciation of the franc, and easily enabled it, if it had chosen to do so, to follow the good old rule for working the gold standard, by which those centres which were strong in gold, quoted low rates and lent freely. Instead of which, in 1929 France took up the running as the most conspicuous importer of gold that it did not need. At the end of September, when the Bank of England's stock of gold had been reduced to £132 millions, and its rate was raised to $6\frac{1}{2}$ per cent., the Bank of France had a gold stock of £317 millions, and still held over £209 millions in foreign assets. It certainly quoted a low official discount rate, $3\frac{1}{2}$ per cent., but its charge for advances was $5\frac{1}{2}$ per cent., and the other French banks were making their customers pay rates up to 7 per cent.¹ And so, with this huge store of gold and foreign currencies, the Bank of France, while quoting a low and meaningless official rate, was keeping money actually dearer than in London, and assisting the American infliction to paralyse the international money market. It has been explained that the Bank of France has been heaping up this pile of gold in order to restore Paris to the position, to which it has every right, of a great monetary centre. But a great monetary centre is not one that hoards gold, but one that

¹ *Times*, September 20, 1929.

lends freely and so promotes trade and development. With her huge foreign balances, Paris ought to be a cheap market for capital, turning those balances into long-term investments. Instead of which, she has preferred to turn them, or part of them, into gold and sit on it.

Surely it is high time, in view of America's irresistible pull when she takes it into her head to bid for money, for the European banks to reconsider their attitude with regard to this habit of all tugging at different corners of the gold blanket, and to make up their minds whether their object in life is to get or keep gold, at whatever cost to one another, or to "ensure to the public," as Sir Ernest Harvey puts it, "the provision of adequate banking facilities on reasonable terms."

On this subject we have had, thanks to the Indian Currency Commission, a statement made by Mr. Norman, the Governor of the Bank of England, in the course of his evidence before it.

"Europe and other countries," he said, "are now gradually trying to climb back, not only to stability, but first of all to a gold exchange standard, and then eventually to a gold standard. They are all trying to do that by a method which I believe to be fundamentally sound—and to be recommended to any others who are considering this question. That is first of all to adopt a gold exchange standard with little or no gold, and then to look to it over the years to replace gradually the gold exchange, the valuta security, by gold security. . . . Therefore, already, the stabilization of Europe . . . is dependent on having over a series of years a certain supply of gold by which those various countries

can gradually substitute gold for valuta—gradually, possibly, transfer gold exchange standard into gold standard to the extent of having their note circulation covered more and more by gold and less and less by valuta; never going back, as I expect, absolutely to a gold circulation, but nevertheless, over the years, each one gradually getting a higher proportion of gold against their note issue. That, I believe, is the way in which Europe, and countries beyond Europe, may eventually solve the questions of stability, of security of note issues, of prices, of co-operation one with another—all moving forward together. . . . I believe that the advantage of the many as well as the advantage of each one, is that this progress should be gradual and united.”¹

Much will evidently depend on the sense in which the central banks of Europe and the rest of the world interpret and apply the ideal towards which they are described by Mr. Norman as striving. If they give most attention to increasing their gold and reducing their foreign credits, as backing for their note issues, an interesting but unpleasant future seems to be ahead in the matter of the monetary arrangements of the world. If they concentrate on co-operation and “all moving forward together,” they will recognize that getting gold is not the object of their existence, but so adapting the supply of gold to the needs of the producing and consuming public that the course of business shall never be warped by scarcity or over-abundance of credit.

If once they or a sufficient number of the most

¹ *Royal Commission on Indian Currency and Finance*, vol. v, page 193.

important of them, get it into their heads that the supply of gold is not the ruling factor in the monetary problem, but that the ruling factor is the public's need for a certain supply of money, which need not vary with the supply of gold but can be based on gold as far as gold is to be had, then the whole question alters its aspect. It becomes in some ways more complicated and baffling because it will always be difficult to know how much money the public really needs, but at least it will not depend, for an answer, on the chances of goldmining. There will always be enough gold, if the central banks will cease to scramble against one another for it and agree to use it as basis for the structure of credit that is required by public needs.

That some such agreement is feasible is clear from another passage in Mr. Norman's evidence before the Indian Commission. "I am only trying," he said, "to state principles, and I am quite convinced that the principles of banking are dynamic and not static and will have to be developed and frequently modified." If he will go so far as to modify the very principles of his art, a mere detail such as a reconsideration of the amount of gold to be held, in the special circumstances of a difficult position, should be a gnat easy to swallow; and he has himself by his Bank-rate policy in 1929, shown other central bankers how to swallow it.

If then the banks on this side of the world would follow the good old banking practice of paying out

readily and even eagerly, any money that they are asked for, because that is the best way to stop a run, they would soon cure America of adding to its already immense stock of gold, which costs it so much to sit on. England and Europe, owing America huge sums payable in gold, are interested to see to it that gold is not overvalued by scarcity. If they compete for it among themselves they will make it seem scarce when in fact there is plenty of it, if they only modify their ideals as to the amount of it that they need to keep. They have—or easily can get from the politicians who pass Acts,—powers of expanding their note issues, if necessary, and a symposium of British and Continental banking authorities, agreeing to work on a lower gold basis, would show the world that they recognize that the gold standard is not a golden shackle on trade and progress but a golden wire to supply them with power and energy.

We in England can at least feel that our central bank has played the game with calmness and courage, and we can quote authoritative foreign testimony for the fact. Professor Cassel of Stockholm (quoted by the *Morning Post* of October 21, 1929) has stated in *Scandinaviska Kreditaktiebolaget* that “the Bank of England, with apparent unconcern, has let its gold reserves be drained on month after month by the continuous export of gold. Only when this drain, towards the end of September, seemed to be assuming too menacing proportions, did the Bank consider it necessary to

proceed to an increase in the discount rate. The gold reserves had then fallen considerably below the figure of 150 million pounds sterling, which, according to the Cunliffe Committee, was to be regarded as a normal minimum. The Bank has thus plainly shown that it considers that the gold reserves exist in order to be used in the case of abnormal requirements, and not to be immobilized in accordance with stereotyped rules. It seems incontestable that the Bank of England has thereby done the world a great service, as its example will apparently continue to be universally regarded as a standard of sound bank policy."

Let us hope that its example will not only be so regarded, but also followed. In the meantime, it may be added that, at the end of October, the Bank of England gave another example of courage by leading, with New York and Amsterdam, the downward movement in rates that may herald a new era in the international money market.

But if the present discontent is allowed to grow, and the gold standard is seriously discredited, Heaven knows what wild experiments may be devised for providing a substitute. That a more scientific substitute will be found some day, is probable not to say certain. But in the present state of world trade, monetary experiments are the last thing wanted. Let us get back first to something like pre-war prosperity and growth before we dream dreams about ideal forms of international currency.

In the meantime we may comfort ourselves with the thought that recent events have been coloured by special causes. Germany had to face a fresh Reparations inquiry which may have modified her monetary policy. France had to meet the possibility of paying £80 millions to America in August, 1929, and was considering problems of debt ratification agreements and their reactions and consequences. With a boiling maelstrom of speculation in Wall Street agitating the monetary sea it was small wonder that the skippers of those currency ships of which Sir Henry Strakosch wrote should have found the gold buoy uncomfortable moorings. These things have passed and co-operation will, perhaps, be helped by the establishment of the proposed Bank for International Settlements. This proposal, the necessity for which has never been demonstrated by the distinguished gentlemen who framed it, is fraught with serious dangers, but at least it ought to be able to provide the governors of central banks with a pleasant club-house, where mellowed by good cheer—the cuisine and cellar will be of the highest importance to the future of humanity—they may discuss the development and modification of banking principles, in the interests of the workers and consumers of all nations.

With co-operation and common sense, they should easily solve their problem of securing stability in the prices of commodities, so far as a supply of money keeping step with the output of commodities can solve it. If prices rise too fast,

restriction of credit by joint action is easy and effective. If prices droop, because, as leading authorities fear, the output of gold will not keep pace with the output of commodities, the reconsideration, already suggested, of the ratio to be preserved between gold and credit will show the way to a remedy for that evil. A slight and general lowering of ratios is all that would be needed.

At the same time, it may be suggested that the power of central banks to make trade good is less effective than some of their critics seem to think. Credit expansion needs a borrower as well as a lender. Industry finding itself depressed, sometimes because it is not doing its job right, is apt to think that it is somebody else's fault—the Government's for not giving it enough Protection, or the banks' for not giving it enough money. When the fault is industry's, nothing that banks can do will pull it out of the mire.

CHAPTER XVI

SUMMARY AND CONCLUSION

AFTER this long ramble through rough country, it is perhaps worth while to review and sum up the conclusions arrived at in its course.

Money, then, is the stuff with which we buy and sell things.

It consists, nowadays, of coins minted by Government, notes issued by the Bank of England and cheques drawn on banks.

Of these, Bank notes and coins are used for pocket money and small change, and cheques for larger transactions.

Bank notes, beyond the £260 millions of fiduciary issue, must be backed by gold, and are convertible into gold bullion for export purposes. By this provision our money is kept on a parity with that of other countries with a gold (or more or less gold) standard—an immense benefit to international trade and so to all consumers.

Cheques can be drawn to any extent that the banks may permit, by creating deposits by lending to customers and investing.

Since these deposits are payable on demand, the extent to which the banks can create credit is governed by the proportion which they think right

to maintain between the cash that they hold and the deposits that they owe.

The cash held by the banks consists to a very small extent of gold and silver coins but chiefly of Bank of England notes and the balances at the Bank of England that the other banks keep and treat as equivalent to cash.

Bank of England notes can be increased at any time beyond the legal limit by agreement between the Bank and the Treasury ; and credits at the Bank of England can be increased through advances, discounts and investments made by it to an extent that is only limited by its discretion.

Since we want our money to be stable in buying power, and since the Quantity Theory of Money, which tells us that stability in prices depends on the supply of money keeping pace with the production of commodities, appears to be more or less true, we can ask our banking authorities to see, in so far as it is in their power to do so, that this relation between money and production is maintained.

Since fluctuations in the price of money—or the rate of interest—are bad for business, we can also ask them to do all that they can to avoid these fluctuations.

In view of the possibility of expansion of Bank of England notes, of credits at the Bank of England and of credits given by the other banks, there should be no need to fear scarcity of money if our banks make free use of their powers, and if their

customers assist them by applying for credit and providing the necessary security.

But since, owing to the benefit of stable exchanges, it is essential to maintain the gold standard, and since, if our banks expanded credits while those of other countries did not, our gold might be drained away, it is necessary that the central banks of all the leading countries should co-operate, with a view to economizing the use of gold and co-ordinating credit policies, so as to give us all the stability that banking policy can provide, in the prices of money and of commodities.

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