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MONEY

AND THE

MONEY MARKET IN INDIA

BY

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PREFACE

THIS volume, like its predecessor *The Wealth of India*, has been inspired by the hope that our study and discussion of topics of a somewhat abstruse and perplexing nature may bring us nearer to the truth, and may help towards the formulation of a definite monetary policy for India, based on incontestable monetary principles and facts. The complexities of the social organisation of our times make the task of grasping the truth difficult; but if the few who can understand have in them the love that constitutes the foundation of all life and well-being, we shall have the Kingdom with us here and now. The present work, like its predecessor, has been prompted by the faith that money, even money, may be cleansed of the pollution that attaches to it; that albeit hitherto it has been a factor in the creation of enmity and disunion, its real use lies in the making of friends, the linking of the nations together in a fellowship of love. The peace that Britain brings to India may become the peace of God; there is no harm in Cæsar's getting the things that are his, if only the God of Love receives His dues. The business of this world need not be done in masks: and so long as there are men and women who love their neighbours, traders who give full measure,

parents who desire their children to be honest rather than rich, so long there is hope that those who have power and exercise authority over us may, by a righteous use of that authority, earn the title of benefactors. We send this book forth in the trust that the peace and order still associated with the thought of Rome may one day be transfigured into that larger life of enduring freedom for the nations, whose symbol is Jerusalem.

P. A. WADIA.
G. N. JOSHI.

HORMAZD VILLA, MALABAR HILL,
BOMBAY.

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CHAPTER I

INTRODUCTION

The Importance of Money

The economic basis of our modern civilisation involves, as of old, the satisfaction of the necessities of physical existence, which acquire a more and more complex and refined form as civilisation develops. Life becomes more complex as it advances, with closer interrelation between the parts of the organism and greater specialisation on the part of each member. Modern economic life is based upon large-scale production, carried on with the help of constantly accumulating capital, and involving the use of money, which is far more than a mere medium of exchange. Our social and political life is intimately connected with our economic life, and the latter is essentially interpenetrated by and woven into the system of money and prices. It is indeed necessary to remember that all trade is ultimately barter, and that the world cannot consume more than it produces; but it is equally necessary to be reminded of the significance of money, which plays so large a part to-day in settling or unsettling the conditions of economic welfare.

Our economy has been called a money economy; everything that man values has a price, from the tools and raw material used for productive purposes to the labour of the human beings who work with them. There is too often a tendency to exclude from the category of economic goods things that have no price attached to them. The economic value of every commodity is based

upon an estimate of the money for which it can be bought and sold. It has been observed that human interests and activities to-day tend to gravitate round money. Even the standing of our artists and writers of fiction, our poets, dramatists, and editors, is determined by the money value of their services and the price of their work.

Most of the problems of the world are acknowledged to be problems rooted in monetary policy, in currency measures, in exchange regulation, in credit control. "Without trustworthy money Europe is paralysed as a brain without wholesome blood. She cannot act, she cannot move. Employment becomes impossible, and production dies away. Our civilisation is materially a cash and credit system, dependent on men's confidence in the value of money."[1] Industry, trade, commerce, the entire productive machinery on which depends the satisfaction of the fundamental needs of life, presuppose confidence in the stability of prices, confidence in the stability of the monetary unit. Mr. Keynes and many others who agree with him are inclined to attribute all the evils of modern economic life — trade depression, unemployment, destitution—to clumsy handling of monetary policy, and they dream of a continuous era of peace and prosperity for the world, following upon scientific control of credit and wise management of the monetary system.

It is possible to organise society on a basis different from that of modern economic institutions ; but if the evils and harmful consequences incidental to our present economic life are to be avoided it is necessary to undertake a dispassionate analysis of our institutions, and such an analysis will irresistibly thrust upon our attention the dominant part that money and monetary policy play in the development of our economic life. An institution like that of money, which has in our times helped and

[1] Compare, for example, the havoc caused to economic life in France by the issue of assignats in the early years of the Revolution, and the ruin of Russian economic life by the Bolshevist handling of the currency.

stimulated production and has offered to society the means of guaranteeing to every member the physical requirements of life, releasing his energies for creative work, for social service, for the furtherance of the spiritual potentialities of human life, needs to be carefully guarded and preserved, instead of being abolished; but it also needs to be purified of the evils which have incidentally resulted from its being regarded as an end in itself, instead of as a means to an end. Money, capital, machinery, large-scale production are all instruments which a developed humanity has devised for the furtherance of spiritual life, for the realisation of God's Kingdom on earth; they are manifestations in their own way of the upward urge of life that points to God. If to-day they have brought in their train inequalities, poverty and destitution, crowded and smoky habitations where life itself is stifled, if they have multiplied misery and vice and brought about conditions of existence which perhaps operated long ago in the animal world, it is because the institutions intended to serve the purposes of human life have been turned into masters and worshipped as masters. Instead of being moulded into the image of a higher humanity, they have been allowed to degrade humanity into their likeness. There is no nobler work for the enlightened humanity of to-day than that of controlling money and monetary policy, of regulating the supply of capital and the level of prices and the habits of consumption, in the general interests of mankind.

CHAPTER II

THE ORIGIN AND EARLY HISTORY OF MONEY

THE earliest economic unit to which history takes us back is the primitive hunting or fishing horde, sharing in common the flesh or the fish obtained by any member. Each group was a self-sufficient unit in clash or conflict with neighbouring groups; the contact between group and group was one of war; and exchange of things that have value was conducted on a basis of robbery and violence. But when the hostile relation was replaced by a more peaceful form of contact, trade in its most primitive phase ensued, that of simple barter or exchange of commodities for commodities. Materials such as stones suitable for axes or beads could only be found in definite regions, and exchange was effected by dumb barter and by guest-gifts.[1] Both these forms of exchange still survive amongst tribes in West Africa and Brazil. Business was effected by a direct transfer of commodities; there was neither money nor any other medium of exchange. Every one was at once buyer and seller. But the inconveniences attending the system of simple barter—the double coincidence of wants and possessions—even in the simple conditions of primitive life led to the use of some article intrinsically valuable and not too perishable, which could be generally accepted in exchange for things for which other men had no immediate use. Thus amongst hunting tribes furs and skins were taken as

[1] Cf. Herodotus' description of the Carthaginian traders, Carey's trans. iv. 196. See also Muller-Lyer's *History of Social Development.*

representing value.[1] Leather money circulated in Russia as late as the times of Peter the Great, and we have traditions about the use of leather as currency in ancient Rome and Carthage. Amongst pastoral tribes sheep and cattle form the most valuable of possessions, and we have abundant evidence that amongst the Greeks and the Romans,[2] as well as amongst the Iranians and Indians, cattle and sheep, horses and camels and oxen, served as the measure of value and as a medium of exchange. Perishable as cattle may be over a period of years, they served as the store of values, being amongst pastoral tribes the source of living and well-being. But we also find along with cattle such things as beads and shells, amber and engraved stones or tusks of ivory in use as money, for such articles were used as ornaments and were therefore generally esteemed, besides being more durable than cattle. These serve to bridge over the gulf between primitive forms of money and the metallic currency of our own times. Amongst agricultural tribes we find corn in use as a medium of exchange and a measure of values. Maize in Central America and olive oil in the Mediterranean region long served as currency. As late as 1732 we find the legislature of Maryland making tobacco and Indian corn legal tender, and in 1641 there were similar laws concerning corn in Massachusetts.[3]

The early history of the various objects used as money is that of the selection of different articles adapted to differing conditions of economic life, but all alike owning certain common characteristics. These are, in the first place, the intrinsic value of the article thus selected,

[1] Cf. Job ii. 4: "Skin for skin, yea, all that a man hath will he give for his life."

[2] Latin *pecunia* from *pecus*, cattle. Anglo-Saxon *feoh* (from which we have "fee")—money or cattle. Thus in Homer the brazen armour of Diomedes is worth nine head of cattle, that of Glaucus, which was of gold, is worth a hundred, and a skilful slave is worth four head of cattle. So among the Celts *Cumal* means at the same time a slave and the value of three cows.

[3] See W. S. Jevons, *Money and the Mechanism of Exchange* (1902), pp. 19-28.

whether some kind of grain in agricultural surroundings, or cattle in pastoral times, or dried fish or skins and furs in still more simple conditions of society. It was because such articles were valued for the services they could yield that men naturally transformed their surplus possessions into this commonly valued commodity by exchange. Money was, in the first instance, a store of value. As it gave its possessor purchasing power over other commodities it also became simultaneously a medium of exchange and a standard measure in terms of which all other commodities could be exchanged. It seems to us unprofitable to discuss the question which of these three functions was the earlier or more fundamental. They are all interconnected : nothing could be accepted readily as a medium of exchange, and therefore serve as a measure of value, unless it possessed intrinsic value for those who accepted it, unless, in other words, it served as a store of value. On the other hand, an article which was esteemed for its intrinsic worth could be most conveniently used as a medium of exchange.

It is needless to consider the history of the origins of the precious metals ; but once mankind stumbled across the bright, lustrous metals their sense and appreciation of the beautiful made them cherish the discovery and preserve the new-found possession as they had in earlier times preserved with reverential awe the bright flame of the fire. These precious metals were soon found to be peculiarly well fitted to serve as money. Long before the use of coined money, metals were familiar as a standard of value to the Assyrians, Babylonians, and Phœnicians. In the earliest phase they were weighed in every single transaction ; with the lapse of time they were shaped into rings and discs and roughly cut pieces ; but even then the scales were indispensable for those who bought and sold. The earliest coinage of money is usually attributed to the Greeks of Asia Minor. Tradition assigns to Pheidon, king of Argos, the credit of having first struck silver money in the island of Ægina about

895 B.C. At any rate Homer does not speak of coined money, and it was known in the days of Lycurgus. In Athens, Solon in the sixth century B.C. changed the fines imposed by Draco, which were cattle fines, into real money fines, the price of a sheep being fixed at one drachma and that of an ox at five drachmas. The transition from the cattle standard to coins is also evidenced by the fact that some of the early Roman coins were stamped with representations of oxen and sheep. The badges or devices placed on early coins generally are reminiscent of the principal product used as money before the introduction of the metal. Thus the tunny of the coins of Cyzicus and Gades indicated the importance of that fish as the chief staple of commerce in earlier days, and similarly the badge on the coins of Metapontum was the ear of wheat, while the sheep appeared on the coins of various towns of Palestine.

The final stage in the evolution of money is marked by the introduction of tokens, more especially substitutes in the form of pieces of paper, which can represent any desired value, thus facilitating the rapid payment, exchange, and transport of enormous sums, which it would be difficult to effect with metallic money. The first issue of paper money may be traced back to the twelfth century in the form of bills of exchange. The State issued paper money in France in the eighteenth century, and the rapid development of banking in our times has multiplied a thousandfold the substitutes for metallic currency.

CHAPTER III

THE FUNCTIONS OF MONEY

OUR brief survey of the evolution of money throws considerable light on the functions which money performs in social life.

(1) In the first place, money serves as a medium of exchange. The inconvenience of simple barter was so great as to force mankind at an early stage of economic development to resort to the use of a commodity which would be in general demand by all men, for which people might exchange their surplus goods, and with the help of which they could obtain the things they needed. Corn or bread, fish or olive oil, were at first resorted to as the medium of exchange ; in other cases cattle or the skins of animals. It was soon discovered that corn or fish might deteriorate, and oxen or sheep might die, whereas no such conditions attached to a commodity like silver or gold, which would also be in general demand. The introduction of money as a medium of exchange facilitated division of work between tribe and tribe in the first instance, and between the members of the tribe themselves in the next.

(2) In the second place, money serves as a common measure of values. Exchange of commodities for commodities can take place on a large scale only when all commodities can be measured by a common unit, and this unit in terms of which all goods can be valued is money. The uncertainties arising from the attempt to measure one commodity in terms of others, in the absence

of a common unit of measurement, would make all exchange difficult if not impossible. The commodity that functions as a medium of exchange also functions as a measure of values; every article bought or sold can now be valued in terms of the common unit, and the value of a commodity measured in terms of money constitutes its price.

(3) But if money is a medium of exchange and a measure of values, it is because the people who accept it in exchange actually value it for its own sake; if money is generally acceptable, it is because it is intrinsically valuable, by reason of the belief that it is a commodity for which there will always be a demand. It is a store of values, the most convenient and reliable form in which people can preserve the fruits of their labour which give them a claim over commodities and services. It has been said that money is simply a medium of exchange, that it is not with money that things are purchased. Money is a sort of ticket or order which a man can present for payment at any shop that he pleases; and the farmer who pays his labourers in these tickets is paying through these tickets their real income, which is the labourers' share of his corn, cattle, and hay.[1] Ricardo and Mill, who use this argument, are the predecessors of the modern Socialist, who would banish the use of the precious metals from an organised society that is to avoid the evils of unequal distribution of possessions. But apart from the Socialist there are in our times economists who maintain that the sole functions of money are its services as a medium of exchange and as a measure of values, and that though in the early stages of the evolution of money the material selected was a commodity which possessed intrinsic value, such functions could best be performed to-day by paper money.

[1] J. S. Mill, *Principles of Political Economy*: "The mere introduction of a particular mode of exchanging things for one another, by first exchanging a thing for money and then exchanging the money for something else, makes no difference in the essential character of transactions."

Those who argue in this strain forget that one of the early functions of money, and that a primary function, was to serve as a store of value ; and that even if people to-day are prepared to convert their money into credit, such credit ultimately rests on the confidence and certainty of reconverting the credit into cash, into the precious metals which possess intrinsic worth, which are articles that satisfy the taste for beauty, and have a consumption value.[1]

(4) From the use of money through the ages there has slowly emerged another function which has come to acquire vital importance for economic life in our own times. If from the earliest times men exchanged their surplus produce for the precious metals, they did this from the confidence that they felt in the relative stability of the purchasing power of those metals. Grain or maize or olive oil might deteriorate and lose their value in terms of other commodities, cattle might perish and deprive the owner of all his stored-up wealth ; but the precious metals would endure, and for reasons that we shall consider later their value in terms of other commodities

[1] Thus, for instance, Henry Lowenfeld in two works recently issued, *Back to Prosperity* (1923) and *Money in Fetters* (1924), argues that the present functions of currency are confined to its surviving as a medium of exchange and as a measure of values. " We no longer compare the value of goods with that of gold, but, on the contrary, compare by means of the money conception the values of saleable things with one another, and these we express by currency units, just as we denote words by the aid of letters of the alphabet."

" The precious metal composing the coins used to be the actual thing which we bargained for, and it was passed on in the shape of money units. Now we bargain for quite another thing—namely, the right to receive goods and services corresponding in value to that which we gave for it ; and not the currency unit as such but its purchasing power is transferred to us by means of the currency unit." So also Mr. Keynes in his *Tract on Monetary Reform* : " Money is only important for what it will procure ". Paper money based on index numbers might be the best monetary system, only if the psychology of human beings was different from what it is to-day. So long as a large majority of men prefer gold as a store of value and regard this as an important function of money, they will not accept inconvertible paper as a medium of exchange. And, further, the want of confidence in the honesty and wisdom of those who control the issue of inconvertible paper will be a powerful factor in shaking its efficacy as a measure of values.

remains steady over relatively long periods of time. Most of the transactions in the business world of to-day are transactions that involve deferred payments or agreements to pay in the future (even wages involve deferred payment), and it is necessary that the money promises in terms of which you part with your goods or services to-day should retain the same purchasing power a month or six months hence, when these promises are fulfilled and transmuted into gold or silver. In earlier days, when credit instruments were not developed and goods were exchanged on a cash basis, the buyer and the seller knew what values in the shape of purchasing power they were parting with or receiving. To-day, when most of our exchanges involve promises to receive or pay in the future, it is essential that such promises should convey a definite meaning as regards purchasing power, and this involves the relative stability of the value of money. Money serves to-day as a standard of deferred payments.

(5) It may also be of some use to note that money—more especially in the form of the precious metals—serves to-day what is an equally vital purpose as the foundation of all credit, the basis on which people effect a much larger number of exchanges than the metallic currency would by itself permit. It has often been observed that over 90 per cent of the trade and commerce of civilised society to-day is effected and settled by means of credit and without the intervention of metallic money. The use of credit in exchange runs parallel with the development of large-scale production. As the introduction of a medium of exchange for primitive humanity marks an epoch-making achievement which led to economic differentiation and expansion in production, so the use of credit resting on a metallic basis has alone made possible the concentration of capital and co-operative production that have such vast potentialities in the direction of linking the world together into a single economic family.

CHAPTER IV

THE QUALITIES OF THE MONEY MATERIAL

THE answer to the question, "What are the qualities which good money should possess?" depends on what purposes good money is to serve and what functions it performs. (1) The primary qualities any material used as money should possess are utility and value. As money is intended to be a medium of exchange, it should be something valuable in itself, and must have utility, the power to serve some want, to satisfy some desire of human nature. All the articles that have been employed by men at one time or another in the history of the evolution of money were articles that possessed utility and value, whether corn or skins, tea or olive oil, tobacco or salt. Even the shells so often used in the East were valued as ornaments before they were used as money. So again, if money is to be a store of values, it is necessary that the material used as money should have intrinsic worth. Men will not accumulate the surplus goods intended to give them command over other commodities in the form of an article which is not esteemed and demanded for its own sake.[1] Now both these functions are peculiarly

[1] "Nothing which is not itself valuable can serve as a medium of exchange. If, in order the better to obtain other goods in exchange, one gives economic goods for money, one should be assured that the money has equal value with the goods parted with. No one would consciously give away commodities of value for a medium of exchange which was notoriously lacking in value, and which he might possibly be obliged to hold for a time. Otherwise the whole purpose of exchange would be defeated; since for a worthless medium of exchange one could not obtain other goods" (Laughlin, *The Principles of Money*, p. 18).

well served by the precious metals. They are in general demand in all parts of the world as commodities which can satisfy the human desire to adorn the person; the lustre and the beauty of these metals have always attracted universal admiration, and at an early period they came into use as the material of money. It has been said that once men get accustomed to a particular form of currency, and to passing it on freely at steady ratios of exchange for other objects, they may accept it as a medium of exchange, even though it may be made of worthless material. Thus it has been pointed out that in our days men freely accept bits of paper in exchange, and that by far the larger number of business transactions are settled by such bits of paper (bank notes or cheques). Therefore, it is urged, the money material need not possess intrinsic worth or be generally desirable. Force of habit may often lead people to accept money of this kind in circulation; but it is doubtful whether the most powerful Government could oblige its subjects to accept and circulate as money a worthless substance which they had no other motive for receiving.[1] As a matter of fact, in our monetary systems to-day we must distinguish between money as a standard of values and money as a medium of exchange. The actual medium of exchange in countries with a well-organised credit mechanism is not metallic money, but substitutes in the shape of notes and cheques; but their effective circulation depends on the public confidence in their convertibility into the standard unit, and though, therefore, it cannot be directly asserted about the actual media of exchange that they should always be intrinsically useful and desirable, yet so long as the efficacy of such media depends upon their convertibility into the standard coin, it may safely be maintained that the material of which money is composed should possess utility and value.

(2) The substance of which money is made should be capable of being conveniently handled in exchange—

[1] See Jevons, *Money and the Mechanism of Exchange*, pp. 29-39.

should be neither too heavy and bulky nor inconveniently minute. It should possess portability. Many of the commodities used as money in earlier days were sadly wanting in this quality. Oil or nuts, corn or skins, though possessing intrinsic worth, were too heavy to be carried about conveniently in large quantities. Metals like iron or copper suffer from the same disqualification. A ton of iron would have to be transported from one place to another to effect a payment which we could now effect by a hundred-rupee note or a cheque. In Sweden, where in the last century and earlier copper was the principal medium of exchange, merchants had to take a wheelbarrow with them when they went to receive payments. Gold and silver possess this quality to a much greater extent than other substances ; one can carry large sums from place to place without much trouble at small cost. Where money is made of a material whose cost of transportation from one place to another is relatively high, the value of money will be comparatively unstable, as the conditions of supply and demand cannot be readily equalised. Where the cost of transportation, as in the case of the precious metals, does not exceed 2 or 3 per cent of the total value, the money material commands relatively greater uniformity of purchasing power over the world. As there are substances too inconvenient to carry on account of their bulk, so there may be others so costly that small values would require the assistance of the chemical balance or the microscope. Diamond, for example, is weight for weight about 500 times as valuable as gold, and the value of £20 would be represented by a tiny stone weighing 4 grains. The rationale of a subsidiary coinage of copper or bronze or nickel is to be found in the portability of the coin representing a value which silver or gold would be too inconveniently small to represent. From the point of view of portability alone paper money would be an ideal form of money, enabling us to carry about huge sums at a cost of transportation that does not count at all.

(3) Indestructibility is another quality which the money material should possess. The great objection to corn or cattle, oil or fish, as money is the perishable character of these commodities. If money is to serve as a store of values, gold and silver satisfy this requirement better than any other commodity. The precious metals undergo relatively fewer changes over long periods of time than other commodities, though the replaceable character of paper money makes it a rival of the precious metals in respect of this quality.

(4) Homogeneity is another quality which we look to in the money material. Equal weights of money should have equal value. If money is to give us a unit of measurement, all units must be equal and similar. Beads or precious stones, when they are used as money, are found to be lacking in this quality. Diamonds or rubies differ in quality even when they are of the same size and weight; and even the precious metals in their crude form suffer from this lack of homogeneity. Our modern methods of refining and coining have enabled us to obtain coins of a uniform degree of fineness with equal weight and equal values.

(5) So also the material of money must possess divisibility. Divisibility does not simply mean our ability to cut up the material into small parts; by divisibility we mean in addition that the total value of the parts obtained by division must be the same as the value of the original undivided mass. Cattle used as money were not divisible into parts; so also furs and skins, though they could be cut up into parts, lose their original value when they are so cut up; and the value thus lost in the parts is irrecoverable. On the other hand, gold and silver could be cut up into small parts without losing in value, and the parts could be melted down again without appreciable loss. The value of the precious metals varies precisely with their weight.

(6) It is desirable that the substance which is used for money should admit of being easily recognised and

distinguished from all other substances. We describe this quality as cognisability. Money circulates freely from hand to hand, and if the money substance has to be carefully tested and examined before it is received in payment, its free circulation will be hampered ; and where confidence is the basis of the institution—confidence in the genuineness of the money substance, and confidence that others will readily accept it in exchange—the lack of cognisability may drive the substance out of use as money. Precious stones suffer from this defect, as experts alone could judge the value of stones and distinguish between stone and stone.

(7) More important than the qualities we have hitherto mentioned is the one that remains to be noticed, a quality associated with the functions of money as a store of values and a standard of deferred payments. The money material is a commodity whose value, like that of other commodities, is subject to fluctuations according to the changing conditions of demand and supply. A failure of harvest and the resulting scarcity might send up the value of corn in terms of other commodities ; or a sudden discovery of diamond mines might bring about a sudden fall in the exchange value of diamonds. Where such commodities are used as money, people find that they are liable to sudden reverses in fortune, and such uncertainty in the purchasing power of the money material prevents the rapid expansion of commerce and the division of work that underlies all economic progress. The precious metals have been discovered to possess relatively greater stability of value or of purchasing power than all other commodities. This advantage is the resultant of factors that bear both on the demand and on the supply of the precious metals. The demand for money is the demand for all other commodities that can be obtained with the help of money. The supply of the precious metals includes the existing supplies and the annual additions from the mines. The total stock of gold and silver in existence

is so large as to be unaffected by the annual production from the mines; the supply is thus a steady quantity over short periods of time, and thus secures that stability in the purchasing power of the metals which is so largely lacking in other money substances, on account of sudden variations in demand and supply.

CHAPTER V

THE PROBLEM OF THE STANDARD

Gold Standard and Relative Stability of Purchasing Power

The fundamental problem of a sound monetary system is the problem of securing relative stability in the purchasing power of the monetary unit in terms of commodities. All the functions of good money or of the commodity which is selected as good money—that it should serve as a medium of exchange, as a measure of values, as a standard for deferred payments, and as a store of values—may be summarised in this one main function: that its value as measured in terms of commodities should remain stable over relatively long periods. The whole history of the evolution of money, which is a history of the gradual adoption of the precious metals as the most desirable commodities for a standard, bears witness to the fact that the one essential requirement of money on which society insists is that of stability of value. It is true that very many articles may be discovered which fulfil much better than the precious metals the single function of serving as a medium of exchange or as a measure of values.[1] What mankind have in-

[1] "Of course, no hard and fast line can be drawn between that stability of value which is required to make a currency act as a satisfactory medium of exchange for immediate business, and that which is required to enable it to act fairly well as a standard or as a store of value for long period contracts and deferred payments. This difference is one of degree; but its general character is definite" (Marshall, *Money, Credit and Commerce* (1923), p. 16).

stinctively sought, however, in the selection of the money commodity, is something that will fulfil all these functions as a whole ; and since the enormous production of gold during the latter half of the nineteenth century, the preference of the business world has been crystallised in favour of gold in a long series of legislative acts.[1]

It is not difficult to understand why relative stability in the purchasing power of the monetary unit should be regarded to-day as the most important attribute of good money. The entire commercial and industrial organisation of the society of our own times rests on a contractual basis. The savage in primitive days was more like an animal living purely in the present. It is the privilege of man to rise above his animal environment, and it is the attribute of the civilised man that he should look before and after, that he should reach out through his understanding to his roots in the past and link up his present with the future, which is pregnant with the fulfilment of his aspirations. And as it is with the individual, so is it with society. A progressive society, even in its bare economic aspect, ceases to live from day to day ; its prosperity is rooted in the accumulation of the labours of earlier generations, and is equally dependent on the other hand on a credit superstructure which implies a faith in the potentialities of a reliable future. The economic organisation of the civilised world to-day rests on credit or deferred payment, and on contract which defines the manner and time of payment. The

[1] Cf. Laughlin, *Principles of Money*, p. 40, footnote: "The very reasons which cause us to-day to prefer gold led Ricardo nearly a century ago to prefer silver: 'Silver, too, is much more steady in its value in consequence of its demand and supply being more regular ; and as all foreign countries regulate the value of their money by the value of silver, there can be no doubt that on the whole silver is preferable to gold, as a standard, and should be permanently adopted for that purpose.' But the extraordinary and rapid fluctuations in the value of silver, even in comparison with commodities in general, in the six months of 1876 and in the period immediately after 1890, have put it out of the contest with gold on the ground of stability of value."

process of production becomes more and more protracted with every advance in division of labour and specialisation of functions and services, and the time element becomes more and more accentuated. Thousands of contracts are entered into between the purchase of raw materials and the final delivery of goods to the consumers. Some of these contracts may be short-term contracts like the weekly or monthly payments of wages to workers. Others, however, may involve the lapse of months or years between the day on which they are entered into and the day they are carried out, as in the case of the delivery of finished goods like machinery or railway rolling-stock. All these contracts are founded on the assumption that the purchasing power of the monetary unit in terms of which they are made will remain relatively stable in the interval between the framing of the contract and its performance.[1] It is of course true that when entering into a long contract every man knows that he takes a risk of alterations in the value of money in terms of commodities ; and it is also true that the larger part of the debtor class are capitalists and business men with obligations far in excess of their actual capital. But debtors and creditors, wage-earners and capitalists all alike work on reasonable assumptions with regard to the relative stability of the value of the monetary unit. The demand for such stability is an organic demand of industrial life to-day, and accounts for the feverish search after a commodity like gold, or even a possibly

[1] " A merchant orders a consignment of goods from a manufacturer in October to be delivered in January at an agreed price. The merchant must be able to rely on selling the goods through the retailers to the consumers at approximately the prices he anticipated ; the manufacturer must be able to rely on producing them at approximately the cost anticipated. A man starts work on Monday under agreement to receive £3 on Saturday. All around him commodities and services are on offer at prices with which he and his employer are both more or less familiar. In order that the bargain may be carried out in fact as well as in name, these commodities and services must be on offer at substantially the same prices on the Saturday as on the Monday" R. C. Hawtrey, *Monetary Reconstruction* (1923), p. 49).

better article, that has marked the multitudinous proposals regarding the standard of value since the war.

The Foundations of Credit

For the purposes of both internal trade and international trade the civilised world to-day has resorted to the use of credit instruments which serve as an effective substitute for metallic money in discharging the function of a medium of exchange. But the use of credit presupposes the basis of metallic coins that serve as a reserve; and it is only the metallic commodity that makes the use and expansion of credit possible by inspiring confidence in the relative stability of their purchasing power.[1]

Moreover, the motive to save on the part of the individual will be considerably influenced by the certainty or uncertainty of his knowledge as to how much he is saving, in other words of his knowledge as to the amount of commodities over which his present forbearance will give him a command in the future. The relative stability of the purchasing power of the monetary unit in terms of which he saves, and the assurance that a stable Government will guarantee the undisturbed enjoyment of the savings, are the foundations on which a capitalistic society erects its enormous structure of wealth out of the bricks and mortar of individual accumulations. Our economic organisation rests on a basis of credit which is placed at the disposal of entrepreneurs who work the industrial machinery with borrowed capital, and every individual who contributes his share to the creation of credit by his savings works on the assumption that the unit he

[1] "A standard of deferred payments which shall never work hardship to any individual must be recognised as unattainable. The most just and the most nearly ideal standard to which society can remotely hope to attain is one where, consistent with the minimum of discouragement to both debtor and creditor because of the terms of the contract, the greatest available foresight is employed to ensure that the benefits of industrial advance shall on the whole go to those classes in whose encouragement and economic growth society has the greatest interest" (Prof. Fetter, quoted by Laughlin, *Principles of Money*, p. 69).

saves will give him in a relative sense the same amount of purchasing power in the future that it gives him to-day.[1]

The Governments of our times run a merry race in piling up huge debts of a productive or unproductive character. It is true that it would be sentimental in one sense to bemoan the possibility of the increasing burden of these debts, due in the long run to falling prices. However, no loan of any kind could be raised at all by a public or private body if the investor did not feel confident that the money which he forbore from directly transforming into consumption goods would remain approximately stable in its purchasing power over a reasonably long interval of time.

It may be true that the value of the money material in terms of commodities has throughout history undergone alterations due to "the impecuniosity of Governments and the superior political influence of the debtor class"; and that the course of prices during the nineteenth century strengthened the belief in the stability of money contracts, an illusion not justified, according to Keynes, by the history of the progressive depreciation in the standard of value ever since money was first devised in the sixth century B.C.[2] But if our economic society to-day rests on a basis of contracts which scarcely exclude from their scope any important section of society, the uncertainty in the meaning of contracts which results from sudden alterations in the value of the monetary

[1] During the nineteenth century there grew up what Keynes calls a system of *investment* which made it possible for business men to call to the aid of their enterprises not only their own wealth but the savings of the whole community, and under which the professional and propertied classes found employment for their resources. "For a hundred years the system worked, throughout Europe, with an extraordinary success and facilitated the growth of wealth on an unprecedented scale." "But amidst the general enjoyment of ease and progress, the extent to which the system depended on the stability of the money to which the investing classes had committed their fortunes, was generally overlooked; and an unquestioning confidence was apparently felt that this matter would look after itself" (*Tract on Monetary Reform*, pp. 7-8).

[2] *Tract on Monetary Reform*, p. 11.

unit would sap the very foundations of economic life, disturb the existing distribution of wealth, and involve a denial of that impartial, even-handed treatment of debtors and creditors alike which makes possible present-day co-operative production on a large scale.[1]

Relative and Absolute Stability

The history of the evolution of money is thus a history of the search after a commodity which can guarantee stability in its purchasing power in terms of other commodities. Down to the middle of the nineteenth century this relative stability in the value of the monetary unit was secured by the joint or alternate use of gold and silver, suitable as they were for such purposes by reason of their attractiveness, durability, and other properties. By the end of the nineteenth century all civilised countries except China had discarded silver in favour of gold. Gold was preferred to silver for those very reasons for which other money commodities were discarded in favour of the precious metals. Violent fluctuations in the gold price of silver in the nineteenth century, owing to increased production, shook the confidence of the civilised world in the stability of the value of silver. There were also other reasons for the universal adoption of gold as the standard of values in the West. The industrial and commercial expansion that marked the nineteenth century resulted in the growth of large stocks of capital, and in an all-round rise in wages, rents, and incomes. It has often been pointed out that a rich and prosperous nation demands a currency that carries

[1] Keynes points out how rising prices mean injustice to the investing classes and are unfavourable to saving, and falling prices mean impoverishment for labour and enterprise by leading entrepreneurs to restrict production, which is disastrous to employment. Any sudden change in the value of the monetary unit is thus to be deprecated, and so concerned is the Cambridge professor about the evils of these changes that he is prepared to rise above the prejudices of humanity by declaring gold "already a barbarous relic", and to advocate a system of managed currency which will dispense with the use of gold.

great value in small bulk.[1] Naturally the prosperous Western nations preferred the use of gold for the purposes of the monetary unit, not only because it was more precious, but also because it enabled large values to be carried in small bulk.[1] This was all the more necessary in view of the phenomenal expansion of international commerce following upon the invention of steam and gas and oil power, which has annihilated distances and linked the nations into a society of co-operating producers and consumers in a single market. For the purposes of this expanding commerce, the nations required a common medium of exchange capable of carrying large values in small bulk, and found it in the gold standard.[2]

Briefly, then, a monetary system that fosters economic well-being, that stimulates industrial expansion and develops commerce, is capable of these achievements only in so far as it secures relative stability in purchasing power. We have also suggested that a standard of values not liable to sudden fluctuations in its purchasing power secures even-handed and impartial treatment as between the different sections of society ;[3] and through

[1] Cf. Conant, *Principles of Money and Banking*, pp. 316 and following: "There has been a strong tendency in progressive society to advance gradually from a cheaper to a more precious article as the material of money and the standard of exchanges. This has been the natural result of two causes—the accumulation of a larger surplus fund of capital for investment in the medium of exchange, and the rise in the scale of wages and prices."

[2] "As one nation after another adopted the gold standard, the reasons multiplied for its adoption by the rest. This was partly, but not solely, due to the fact that the adoption of the gold standard brought the nation which adopted it into relations of stable exchange with the richer nations and pre-eminently with England. It was also because every accession to the list of gold standard countries increased the stability of gold by spreading over a wider field possible fluctuations in its exchange value arising from changes in the total supply or in the demand in any one country" (Conant, *Principles of Money and Banking*, vol. i. p. 319). See Taussig, *The Silver Standard in the United States*, p. 124: "The wider the field over which a given medium of exchange is used, the less likely is it that changes in its quantity will affect its value."

[3] "Unstable monetary units are morally injurious because they are

a long process of trial and error gold has been sifted out as the one commodity that fulfils the functions of good money. Apart from other considerations, the large stock of gold in the world and the fact that the annual production is small as compared with the total stock have combined to secure relative stability in its purchasing power in terms of commodities. The preference for gold as the one commodity that can adequately fulfil the requirements of money cannot be dismissed as merely sentimental. It is based upon an instinctive appreciation of its economic potentialities and on an adequate analysis of its economic virtues by the civilised and thinking sections of humanity.

It has been suggested that under an ideally sound monetary system we should have absolute stability in the purchasing power of our monetary unit ; and it has been readily recognised that it is beyond our human capacity to think of a commodity that undergoes no changes whatsoever in its purchasing power.[1] It may, however, be permissible to ask if the conception of a progressive economic society is consistent with the assumption of an absolutely fixed level of prices. Are we not confusing the stability of price level in a relative sense with its absolute rigidity ? And all that we assert with regard to the economic soundness of the gold standard as a monetary system is that gold, more than any other commodity, proved itself adequate to the work

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unjust. As a matter of justice the dollars returned in payment for a loan should be the same as the dollars borrowed—the same in the only quality that matters, their purchasing power. Dollars are not standards of deferred payments unless their command over the general range of commodities remains virtually the same, year in and year out. When their purchasing power changes, either the debtor or the creditor loses more than justice demands. Men sow where they do not reap and reap where they do not sow" (Foster and Catchings, *Money* (1924), p. 23).

"The dominant economic need of the world is not 'abundant money', not 'easy money', not 'a more elastic supply of money', but a money that is a true standard of value" (*ibid.* p. 75).

[1] " An ideally perfect unit of general purchasing power is not merely unattainable ; it is unthinkable " (Marshall, *Money, Credit and Commerce* (1923), p. 28).

of good money. "To be sure, gold may not be a perfect standard, but the mere fact that it has been chosen by the most enlightened commercial nations—by a demand from within, not by imposition from without—is strong proof that it is the fittest single commodity for practical use as a standard. While possessing all the other qualities of a desirable money material (portability, indestructibility, homogeneity, divisibility, and cognisability) it possesses, for natural reasons, more than any other article, the one requirement of stability of value, so far as causes affecting itself are concerned ; and that requisite is the most essential thing in the function of deferred payments." [1] Even Mr. Keynes, who till 1922 believed in the relative stability of the purchasing power of gold and in the effectiveness of the gold standard as sound money, and who now doubts the stability of the purchasing power of gold under the obsession of the abnormal conditions of the war and post-war experiences of inflation, admits that "the metal gold might not possess all the theoretical advantages of an artificially regulated standard, but it could not be tampered with and had proved reliable in practice ".[2]

[1] Laughlin, *Principles of Money*, pp. 40-41. Cf. Hawtrey, *Monetary Reconstruction*, p. 50: "The seeker after an ideal monetary standard is met at the very outset by a theoretical difficulty. What he wants to secure is that a given debt shall represent in some sense an invariable command over wealth. But the relative values of different kinds of wealth are themselves always varying. If the unit represents the same command over one kind of wealth, it will vary in relation to another. Averages and index numbers will give an approximate test of general purchasing power, but at the best will contain an arbitrary element.

"The gold standard represents a rough and ready solution of the problem ; it fixes the price of one commodity. The commodity is a material so durable as to be almost indestructible, and one of which, therefore, the accumulated stocks are very large in proportion to the annual fresh supply. Gold tends, therefore, to have a remarkably steady value."

[2] *A Tract on Monetary Reform*, p. 12 (1923). Writing in 1922, however, in the Reconstruction Number of the *Manchester Guardian Commercial*, Mr. Keynes observes: "Hitherto only one good solution (of the problem of stabilisation) has been found, a world-wide gold standard. . . . I see no other solution of stabilisation practicable now, except the

traditional solution—namely a gold standard in as many countries as possible." "The arguments in favour of stabilising rather than improving the currencies of Europe are, in my judgement, more solid. They can be expressed shortly. If gold standards could be reintroduced throughout Europe, we all agree that this would promote as nothing else can the revival not only of trade and of production, but of international credit, and the movement of capital to where it is needed most." (Section I. pp. 3-4.)

CHAPTER VI

THE PROBLEM OF THE STANDARD (*continued*): SUBSTITUTES FOR THE GOLD STANDARD

THE GOLD STANDARD AFTER 1914

EVEN before the outbreak of the war economic thought had recognised the fact that the value of gold in terms of commodities has varied greatly from time to time. During the twenty years preceding 1809 gold prices doubled, and during the next forty years the situation was reversed. From 1873 to 1896 there was an appreciation of gold in terms of commodities by about one-quarter, and from 1896 to 1914 there was a depreciation of gold by about one-third.[1] These variations in the purchasing power of gold had already led to the formulation of various proposals for the introduction of a tabular standard, a corn standard, a labour standard,[2] as improvements on the gold standard. The war brought with it enormous temptations to the belligerent countries, to which they too readily yielded, with the exception of the United States of America, and the enormous issues

[1] The index of commodity prices in England compiled by Sauerbeck, based on the average of 1867–77 as 100, shows a rise from 74 in 1849 to 111 in 1873 and a fall to 61 in 1896.

[2] Cf. Prof. Marshall's view about labour as a possible measure of the value of gold (App. to the Gold and Silver Commission Report, 1888, Q, 9625): "I would like to say that when it (the appreciation of gold) is so contrasted and used as denoting a rise in the real value of gold, I then regard it as measured by the increase in the power which gold has of purchasing labour of all kinds—that is, not only manual labour, but the labour of business men and all others engaged in industry of any kind."

of paper money destroyed the monetary mechanism of the civilised world, which had as the outcome of centuries of experience selected gold as the monetary unit. The Finance Ministers of Europe, unbalanced by the sudden demands of the war expenditure, perhaps too readily disposed to yield to a policy of makeshift dictated by untrained legislative majorities, resorted to inconvertible paper money for meeting liabilities which might have been better met by unfunded and funded loans.[1] The gold standard was abandoned, gold disappeared from circulation, and a new and changeable standard of prices and contracts took its place. The enormous over-issue of paper money led to a phenomenal rise in prices, the value of money began to depreciate, the monetary unit became entirely unreliable, and there followed an economic chaos which in its effects can well be compared to the havoc produced by an earthquake in the physical world.[2] The experiences of the war and of post-war finance have led some economists to believe that gold has been weighed in the balance and found wanting, that gold must now be definitely abandoned in favour of some other device for the purpose of securing stability of prices. And yet if there is any one lesson more effectively taught than any other by the war and the post-war history of currency legislation and regulation it is this—that the only monetary system that secures relative stability in prices is one that is based on a gold standard. The Cunliffe Committee, writing at a time

[1] The following figures will indicate the increase in note circulation in some of the European countries :

	1913.	1919.
United Kingdom . . .	£30,000,000	£450,000,000
France	£230,000,000	£1,500,000,000
Italy	£110,000,000	£700,000,000
Belgium	£40,000,000	£200,000,000

[2] In Austria paper money was poured forth from the printing presses until it cost more to print a krone than a krone would buy. The thrifty proprietor of "Kronen Bier" used paper money for labels in order to reduce his printing bill. In Russia it took more roubles than one's pocket would hold to buy a copper cent's worth of bread.

when the end of the war was not yet in sight, observed : " We have found nothing in the experiences of the war to falsify the lessons of previous experience that the adoption of a currency not convertible at will into gold or other exportable coin is likely in practice to lead to over-issue, and so to destroy the measure of exchangeable value and cause a general rise in all prices and an adverse movement in the foreign exchanges ".[1]

Substitutes for the Gold Standard

The variations in the purchasing power of gold have attracted considerable attention in our times, not merely on account of their adverse effects on trade and industry and on economic progress generally, but also on account of the inequities of the exchange as between creditors and debtors which such variations involve. A change in the standard implies that the amount of money which the borrower will repay at the stipulated time will purchase more or fewer commodities than at the time when the borrower obtained the money. There may be some truth in the argument that changes in the price level due to variations in the purchasing power of money, as apart from changes affecting the prices of individual commodities, are a social product, and therefore that the gain to him who obtains it is an unearned increment, and the loss an unearned decrement ; but the impossibility of fixing on society the loss or gain arising out of the private contracts of individuals has led a few economists, dissatisfied with the use of gold as a standard, to search for a standard which will work more equitably as between debtor and creditor, and whose variations will correspond with the changes of economic conditions.

The Tabular Standard

It is often assumed that greater equity as between debtor and creditor could be secured by a device which

[1] Final Report, para. 2 (1918).

ensures the return of the same quantity and quality of goods as were borrowed. But changes in price levels may often make the return of consumption goods, the same in quantity and quality as those borrowed, a return of different value and different utility. Wheat has been urged as a suitable single commodity for the standard.[1] The course of wheat prices in the last fifteen or twenty years is a sufficient justification for rejecting the proposal.

What a single commodity may fail to achieve may, however, be achieved by a number of staple commodities, and the tabular or multiple standard proposes to constitute a standard of values from the prices of a long list of articles at a given time, the quotations being collected by a Government Commission, and averaged daily, weekly, monthly, and yearly. The unit is the same quantity of the same goods at any time. It can be translated into money, or money can be translated into the multiple standard, by the table of prices. For instance, if 100 Rs. bought a definite quantity of the articles on the list in 1900, and in 1920 the same quantity could be bought for 90 Rs., a contract could be discharged in 1920 for the sum of money which could buy the same amount of goods as 100 Rs. bought in 1900. Government will enforce contracts drawn in terms of the multiple standard, but its use is to be purely optional.[2]

[1] Cf. Adam Smith, *Wealth of Nations*, Bk. I. ch. ii. Cf. also Laughlin, *Principles of Money*, p. 59.

[2] The following illustration is borrowed from Walker's *Political Economy*: I sell a house to-day for $20,000, one half of the amount to be paid at once, two-tenths in two years, and three-tenths in five years, with interest on the last two sums. One half is paid in money. For the rest purchaser and myself look to the last published statement of the Government Commissioner and find the value of a unit of the tabular standard to be $12.50; that is $12.50 will now purchase the bill of goods that form the standard. The purchaser then gives me two notes, one for 320 units payable in two years, and one for 480 units of the tabular standard, payable in five years with interest at 6 per cent. At the end of the first year the two parties look in the official gazette and find the value of the unit at the time to be $12.75. The interest on one note for the year will then be 19·2 units, which obligation is discharged by the payment of $244.80 in current money, and in the case of the

The tabular standard does not introduce a new medium of exchange. Its use brings to our notice a fact which is often apt to be overlooked, that the media of exchange need not be identical with the standard. But the fact that the tabular standard can be used only in combination with money prices also constitutes its weakness. Assuming that simple barter is impracticable in our times, changes in the price level are often accompanied by changes in the marginal utility of goods, and if prices fall during a given period the creditor who receives in payment of his loan a quantity of commodities equal to the quantity which he originally lent will be a loser, while the debtor will gain to the same extent. Thus the tabular standard will work the same inequity—perhaps greater, as it hits the creditor—as the gold standard. Professor Jevons urges in favour of this standard that it would render commercial crises less intense: "The intensity of the crises would be mitigated because as prices fell the liabilities of the debtors would decrease approximately in the same ratio".[1] But if commercial crises often occur as the result of temperamental causes affecting the mind of the producer and the trader, their frequency and intensity are not likely to be affected by the use of a particular standard. Gold has never been subject to rapid fluctuations in its purchasing power over relatively short periods of time, and the employment of a tabular standard does not introduce a factor sufficiently important to affect the periodic occurrence of crises.

The working of the tabular standard, moreover, presupposes the use of index numbers. Changes in the purchasing power of money may be ascertained by a series of index numbers on the basis of an unweighted

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second note by the payment of $367.20. When the principal of the first note is to be paid, if the value of the tabular standard is $12.25, the obligation will be discharged by the payment of $3920. If the value of the unit be $131, it will be discharged by the payment of $4160.

[1] *Money and Mechanism of Exchange*, p. 333.

arithmetical average. But from the point of view of the purchasing power of the community's income, a rise of 1 per cent in the price of bread may be much more important than a fall of 50 per cent in the price of pepper. Changes in the relative proportions of expenditure for consumption to be obtained for a definite sum of money create difficulties which are met by the construction of weighted index numbers ; but the attempts to discover correct means of weighting according to the relative quantities consumed are generally found to be futile, as these amounts are constantly changing from time to time.[1]

Finally, it has been pointed out that whilst the tabular standard aims at restoring the same utility as was loaned, it fails to take account of one of the elements of utility and value. Utility depends on power to satisfy physical and psychical needs ; and the tabular standard would be roughly equitable so far as utilities like wheat and other necessaries of physical life are concerned. The utilities that satisfy our psychical wants depend for their value on shifting conditions like social esteem and changes in fashion ; and the tabular standard cannot be successfully applied so as to secure justice as between creditor and debtor in such cases.

The Compensated Dollar

Even before the war, Professor Irving Fisher proposed to overcome the difficulties connected with the fluctuations in the purchasing power of money by a plan outlined in 1911.[2] This was developed in 1920 in his well-known work on the stabilisation of the dollar, and embodied in 1923 in a bill introduced in the House of Representatives and referred to a Committee. According to this plan all gold coins in the United States are to be abolished, and the present gold certificates are to be

[1] Laughlin, *Principles of Money*, pp. 159-165.

[2] *The Purchasing Power of Money.*

converted into gold bullion dollar certificates, entitling the holder to dollars of gold bullion of such weight as may be officially declared to constitute a dollar for that date. Unrestricted deposit of gold is to be maintained, as well as unrestricted redemption of the bullion dollar certificates. An ideal composite or "goods dollar" is to be constituted, consisting of a representative collection of commodities, worth, at the outset, a gold dollar of the present weight, and an index number is to be established for recording at stated times the market price of this goods dollar in terms of the gold bullion dollar.[1] The weight of the gold bullion dollar is to be adjusted at stated intervals, each adjustment to be proportioned to the recorded deviation of the index number from par.

On this plan gold would be available for the adjustment of foreign trade balances; convertibility of the internal currency would be maintained in much the same way as on the gold standard basis, and slow changes in the value of gold would no longer be of any consequence, as they would not affect the standard of value.

The underlying assumption of Fisher's plan, like that of other plans of a similar character, is that the general level of prices is simply and exclusively determined by the amount of money in circulation; that if there is an efficient paper currency, coins need not circulate; that a rise in prices would be checked by adding to the metallic value of the coin, and a fall by deducting from it. If it is possible to show that the general level of prices is not exclusively determined by the quantity of money in circulation, we are to that extent rendering difficult the simple working of our price regulator.

In the next place, its unfamiliarity has been rightly

[1] "We have now a gold dollar of constant weight and varying purchasing power, we need a dollar of constant purchasing power and therefore of varying weight. If prices tend to rise or fall we can correct this tendency by loading or unloading the gold in our dollar, employing an index number of prices as the guide for such adjustments" (*Stabilizing the Dollar*, General Summary, pp. xxvii-xxviii).

pointed out as a serious objection to its working.[1] An effective gold standard offers a security against undesirable manipulation of the currency which can never be offered by a system that ultimately involves a pure paper circulation.[2] It has also been pointed out that the compilation of an official index number based on the actual trend of prices would not suffice of itself to give us a regulator of values ; that the state of employment, the volume of production, the effective demand for credit as felt by the banks, the rate of interest on investments of various types, the statistics of foreign trade, and the level of the exchanges must be taken into account.[3] If all these factors enter into the determination of credit control, as they did enter in pre-war days in England, and as they have done during the last three or four years in the case of the Federal Reserve Banks in the United States, one may well ask if there is any reason at all for substituting for the present gold basis a compensated dollar involving periodic readjustments of weight in the standard based on index numbers, which, when they are arrived at, may cease to represent the exchange relations between commodities which originally suggested their construction.

[1] "There is reason to fear that Professor Irving Fisher's scheme would be a cause of much bewilderment, and that if it were adopted by a large number of nations, it would make questions of exchange more difficult than ever to unravel" (H. Withers, *Bankers and Credit*, p. 249).

[2] Cf. Lehfeldt, *Restoration of the World's Currencies*, p. 52.

[3] Keynes, *Tract on Monetary Reform*, pp. 188-189.

CHAPTER VII

MR. KEYNES ON AN IMPROVED STANDARD

MR. KEYNES recognises that gold maintained with considerable success its stability of value in the changing world of the nineteenth century. This was due to several causes: progress in the discovery of gold mines kept pace with progress in other directions; and a steadying influence on its value was exerted by its absorption into the arts and into the hoards of Asia. The war, however, has effected a great change; most countries have abandoned the gold standard; the supply of gold would prove redundant. Gold to-day stands at an artificial value, as the United States has been burying in its vaults what the miners annually bring to the surface. Confidence in the future stability of gold will depend on the policy of the Federal Reserve Board and the management of reserves by Central Banks.

Gold has thus, for Mr. Keynes, lost its stable value: "I reject the policy of restoring the gold standard on pre-war lines. . . . I regard the stability of prices, credit, and employment as of paramount importance, and feel no confidence that an old-fashioned gold standard will even give us the modicum of stability that it used to give."[1]

Arguing on the assumption that in case we cannot have both stability in the internal level of prices and stability in foreign exchange, we must be prepared to subordinate and even sacrifice the latter to the stability

[1] See pp. 163-176, *Tract on Monetary Reform.*

of internal prices, Mr. Keynes suggests a non-metallic, regulated and managed standard with the object of securing stability in price level. A sound monetary scheme must provide "(1) a method for regulating the supply of currency and credit with a view to maintaining, so far as possible, the stability of the internal price level, and (2) a method for regulating the supply of foreign exchange so as to avoid purely temporary fluctuations, caused by seasonal or other influences and not due to a lasting disturbance in the relation between the internal and the external price level."[1] He points out: "I do not see that the regulation of the standard of value is essentially more difficult than many other objects of less social necessity which we attain successfully".[2]

Mr. Keynes finally gives us a sketch of the details of his scheme. Gold is not to be employed in circulation. The Treasury and the Bank of England have hitherto been in a position to determine the price level of the United Kingdom. The stability of internal prices being the primary objective, the Bank of England should regulate the Bank rate, not by the dollar exchange or the value of gold, but by an objective standard of value, "an official index number" registering the price of a standard composite commodity, being modified from time to time in accordance with changes in the relative importance of its various components. The gold reserve is to be separated from the note issue, and the volume of paper money is to depend upon the conditions of trade and employment. The only use of gold is to serve as a store of value to be held as a war chest against emergencies and as a means of rapidly correcting the influence of temporary adverse balances.

Mr. Keynes starts, and rightly starts, with the assumption that the fundamental object of a sound monetary system is to secure stability of prices. But he goes on to point out that in pre-war days we "all plumped for stability of exchange as against stability of prices".

[1] *Tract on Monetary Reform*, p. 177. [2] *Ibid.* p. 170.

He suggests that, " if the external price level is unstable, we cannot keep *both* our own price level *and* our exchanges stable ". Now we are not prepared to admit that in the case of some countries like England, whose chief anxiety is to " export sufficient manufactures to supply her population with its daily bread ", stability of internal prices may not be so important as stability of exchange.[1] If the paramount problem of monetary economics is that of stability of prices, there need be no conflict at all between stability of prices and stability of foreign exchange. A fairly constant rate of exchange between any two countries becomes established as soon as each country secures the stability of the purchasing power of its own monetary unit in its own markets. The depreciation of the mark and the krone and the rouble has led many people to imagine that these units can never satisfy the purposes of foreign exchange. If only the rouble or the krone acquired stability of purchasing power in the home market, it does not matter at what level of prices, it would make foreign trade possible at that level. If we can only secure a relatively stable and therefore reliable level of prices within the country, the foreign exchanges may safely be left to themselves, and we may be pretty certain that they will remain fairly steady within limits.

It is, moreover, not quite accurate to suggest that we all plumped for stability of exchange as against stability of prices in the pre-war days. It was just because, as Mr. Keynes himself suggests, the price fluctuations experienced in the hundred years before the outbreak of the war were confined to narrow limits, that the world did not think of price control through regulated money ; the attention of the banks was naturally confined to securing stability of exchange through a control of gold

[1] See the remarks of Sir Charles Addis, *Economic Journal*, June 1924, p. 168. Mr. Keynes himself seems to support a view of this kind. "The right choice", he observes, "is not necessarily the same for all countries. It must partly depend on the relative importance of foreign trade in the economic life of the country" (p. 155).

supply from without. It was the complete dislocation of trade and production brought about through the gamble in paper money during the war that arrested the attention of men for the first time and made them realise the supreme necessity of securing through the monetary unit stability in the level of prices.

We come, then, to the main issue: Will stability in the internal level of prices be secured in a more effective manner by Mr. Keynes' scheme than was secured or is likely to be secured in the future by a return to the gold standard? In the first place, Mr. Keynes is not prepared to discard gold altogether. He would retain gold for an important rôle in his system. "As an ultimate safeguard and as a reserve for sudden requirements, no superior medium is yet available." [1] His scheme is only one step forward towards the complete adoption of a non-metallic standard which a more enlightened humanity may devise in the future. So that gold to-day cannot be regarded quite as "a barbarous relic". This apart, we are told that the pre-war monetary system was on a gold basis in England, and the total amount of money (including coins, notes, and cheques) could only be increased in quantity by bringing in more gold from abroad. The war converted the gold standard into a fiction. The money market was financed on a basis of cash provided by the Government's borrowing from the Bank of England and the printing of paper currency. To-day, argues Mr. Keynes, we have already gone a long way towards the ideal of directing Bank rate and credit policy by reference to the external price level, and not by reference to the amount of gold reserve in the banks or the level of the dollar exchange. His own scheme is only a further development of existing arrangements by which gold is to be dispensed with for the purposes of internal currency and only to be kept as a reserve against emergencies. Now those who argue with Mr. Keynes in favour of a managed currency divorced from its

[1] *Tract on Monetary Reform*, p. 197.

linkage with gold as in pre-war times seem to forget altogether the evil and disastrous effects of the rise in prices that followed the disappearance of the gold standard—the enormous addition to the cost of the war, the violent changes in the distribution of income, and the suspicion, suffering, and social unrest. Without the accumulation of capital, economic development is impossible ; and fluctuations in the price level may frighten the capitalist out of existence. If the European countries to-day are so wrung with the sense of the economic agonies they have been enduring, and from which they desire to escape through remedies of a heroic type, the last thing they should forget is that these agonies followed on the enormous issues of paper money divorced from its linkage with gold. It is not gold that has lost its pre-war stability of purchasing power ; it is the abandonment of the effective gold standard and the resort to unlimited issues of inconvertible paper that are responsible for the chaos ; and it would seem that the only way out of the chaos would lie in a return to the gold standard. To the monetary theorist it may appear barbarous to tie the purchasing power of money to that of a single metal ; but " can any one who has lived through the Great War have any doubt that a barbarous age is precisely what we have for the moment to provide for? . . . We barbarous mankind are still divided into suspicious and malevolent tribes, occupying territories which we regard as our tribal properties. There is not the least chance of the various nations agreeing on any uniform system of limitation of currencies by prices which would give us the stability of international exchanges which we possessed before the war." [1]

[1] Edwin Cannan in the *Economic Journal*, June 1924, p. 160. So also Dr. T. E. Gregory (*Economica*, June 1924, p. 170) : " The belief that gold has a kind of intrinsic value must be abandoned, though it is interesting to see that Mr. Keynes in the first portion of his book points to the practical stability which the value of gold possessed in the nineteenth century. Certainly that value fluctuated, but it fluctuated over long periods of time, and we who have seen currencies go to almost

What are the grounds on which it is urged that the restoration of the gold standard will not give us complete stability of internal prices? They are briefly these: (1) In the past the discovery of gold mines kept pace with progress: for the last twenty-five years no important deposit has been discovered. (2) In the past a sufficient portion of the gold supply was absorbed into the arts and into hoards. To-day most countries have abandoned the gold standard; gold stands at an "artificial" value which is determined by the Federal Reserve Board of the United States. Even if other countries return to a gold basis, either they will economise the use of gold for currency purposes, and the supply will be greater than the demand; or they will return to pre-war conventions about reserves, and there will be a serious shortage of gold. (3) There is the possibility of a partial demonetisation of gold by the United States, if the latter is not foolish enough to go on accepting gold which it does not want.

In the first place, we are not quite sure about the accuracy of the statement that the fresh discovery of gold mines is not likely to keep pace with economic development. The recent discovery of mining fields in Canada gives ample promise of increasing supplies in the future.[1] But even if Mr. Keynes' contention is correct, a return to the gold standard by the European countries would seem to offer the only reasonable prospect

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nothing in value in a period of twenty-four months or even less may well think that the instability of gold is nothing as compared with the instability of paper money."

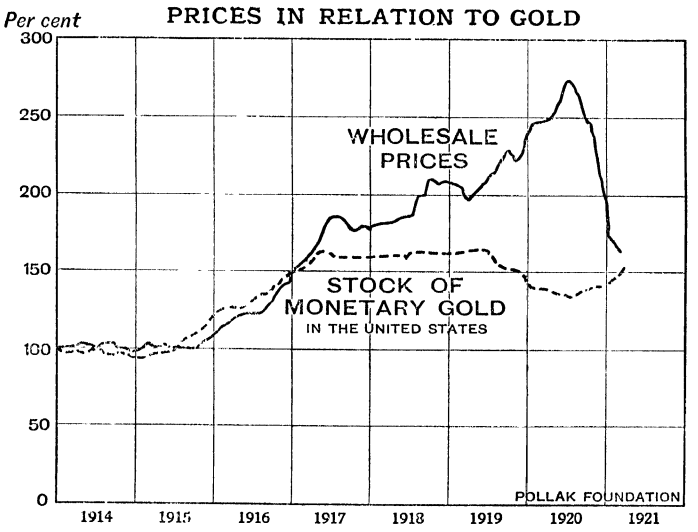
[1] The annual production of gold from 1918 stands as below:

In millions of dollars.

1918 . . .	384	1921 . . .	330
1919 . . .	366	1922 . . .	319
1920 . . .	337	1923 . . .	360

Mr. Kitchin, a leading English authority, estimates that the annual gold production for 1924–27 will be at the rate of $385,000,000, and that for the succeeding years until 1930 it will decline to about $370,000,000 per annum.

of putting an end to the menace which the enormous mass of surplus gold held by the United States offers to the world to-day. If it be true that the annual production of gold is not likely to keep pace with progress, the gradual dispersion of the surplus stocks of gold of the United States amongst the European countries would be the best possible guarantee for the stability of gold values.[1] It must also be remembered that it is only over long periods of time that fluctuations in the pro-



(From Foster and Catchings, *Money*, p. 45.)

duction of gold influence the level of prices. Thus, for instance, during the years 1917, 1918, and 1919 gold reserves in the United States remained nearly constant,

[1] If Mr. Keynes is so anxious about the uncertainties and vagaries of gold prices in the future, the solution of the problem would appear to lie, not only in a return to the gold standard by the European countries, but in the adoption of an effective gold standard by India, which with its large favourable balance from year to year would easily relieve the United States of its surplus stock. There can be no more striking evidence than this of an economically inter-related world, in which the sins of one member work out their consequences amongst the rest in the agonies of unemployment and trade depression.

whilst wholesale prices during the same period rose from 150 to 250. During 1920 and 1921 the vast gold reserves did not prevent prices from falling. From 1900 to 1915 there was a large production of gold without any corresponding fluctuations in the price level.

As for the possibility of a partial demonetisation of gold by the United States of America, it is not likely that the Federal Reserve Banks will see one of their most important assets greatly reduced in value without doing all in their power to keep up that value. The history of the past ten years in the United States may be summed up by saying that, reducing the gold stock in that country to index numbers with 1913 as a base, the gold figure in 1920 would be about 150, and in 1924 it would be 240. The figure for total deposits, with 1913 as the basic year, was 186 in 1920 and 220 in 1924. The price level during these years has, however, shifted from 100 in 1913 to 150 in 1924. In spite of all the conditions favourable to inflation, the price level in the United States has been kept practically stable ; and nothing is more likely in the immediate future than that the United States will assist the return to a gold standard in those European countries which are now reconstructing their monetary policy, rather than assist in a further depreciation in the value of gold. Even as early as January 1923 it was pointed out how, without any further enabling legislation, the Federal Reserve Board could lay aside a billion dollars of gold as a " reserve against contingencies ", to be earmarked for export, so that when the time came it could be shipped abroad, and how the official declaration of such a policy might effectively curb inflation in the present.[1]

But Mr. Keynes urges that gold stands to-day at an " artificial " value determined by the Federal Reserve Board. He points out that gold itself has become a " managed " currency since the outbreak of the war.

[1] *Harvard Business Review*, January 1923, " Federal Reserve Bank Policy."

What he asks us to do is to substitute a managed currency based upon price or unemployment index numbers for a currency based on gold. Stability of sterling prices is to be the primary objective of monetary policy, and not the stability of the dollar exchange. He doubts the wisdom and practicability of a scheme like Professor Fisher's, which works merely by reference to an index number without any play of judgement or discretion. "Actual price-movements must of course provide the most important datum; but the state of employment, the volume of production, the effective demand for credit as felt by the banks, the rate of interest on investments of various types, the volume of new issues, the flow of cash into circulation, the statistics of foreign trade, and the level of the exchanges must all be taken into account."

It seems to us that in the pre-war times under the gold standard these were just the considerations that enabled the Bank of England to secure not merely stability of prices at home, but stability of foreign exchanges by the use of the Bank rate. If Mr. Keynes' objection to the gold standard is to be taken seriously, it rests on the assumption that it is purely automatic in action and does not involve any kind of management. But the human element of control can be no more eliminated from the operation of a currency that rests on a gold basis than it can be from one that rests on price or unemployment index numbers. In either case those who are responsible for currency control are expected to have regard to the course of prices and unemployment, and if a rise in prices precedes an increase in currency, to check the anticipation of credit supply on which the rise of prices is based.[1] A managed currency based on gold has this one immense advantage over a system based on credit control with an inconvertible currency, that it is automatic in its operation and relieves the Central Banks of a responsibility which might not always be discharged with the knowledge and judgement

[1] Sir Charles Addis in the *Economic Journal*, June 1924.

indispensable for the prosperity of national trade and finance.[1] The utmost that can be urged in favour of a managed currency not resting on a gold basis may be that considerable economy is effected by its use, as it enables a nation to avoid the cost of buying and holding gold as a reserve.[2] But under Mr. Keynes' scheme we do not escape from the necessity for buying and holding gold as a reserve against emergencies. And even if we did, is the benefit worth obtaining when we remember what it may ultimately cost the nation ? The stability of our pre-war currencies was secured ultimately by limitation of supply. Gold could undoubtedly be turned into coin in unlimited quantities by any one who could get it in unlimited quantities. Only nobody could do that. There was a limited stock of gold in the world, and more could not be obtained except slowly and at a considerable cost. The paper currency on a gold basis was essentially convertible, and the amount of notes was limited to the quantity that would circulate without depreciation.

The chief purpose of the gold reserve in a system of currency that rests on a gold basis is to prevent depreciation of paper money by adequately providing for its convertibility into gold. Even a Central Bank once freed from the steadying influence of the gold standard will not be able to resist the interests from without that work for inflation or deflation. And if this control of credit is to be transferred to the Treasury in co-operation with the Bank of England, the dangers to the nation of its monetary policy being utilised for the particular interests of a political organisation or a powerful and influential section are immensely multiplied.[3]

[1] " Its supreme value to the community is that it acts as an effectual check on any attempt on the part of Government to manufacture currency " (Sir Charles Addis, *Economic Journal*, June 1924, p. 168).

[2] Cf. Mr. McKenna's speech as chairman of the Midland Bank on January 27, 1925.

[3] Even Mr. Keynes seems to have been alive to this danger when he observes : " Experience has shown that in emergencies ministers of

Once the self-adjusting automatic operation of an effective gold standard is removed, we are likely to be led into a morass of unknown difficulties. If Governments have suspended the operation of the gold standard and resorted to inflation when they knew that they would have to redeem their obligations in gold when normal times returned, it is difficult to conceive any limit to a process of paying off debts by the help of the printing press, which deludes the nation into a sense of security under the spell of rising prices and wages.[1]

The regulation of prices and the maintenance of internal stability by parity with gold which the gold standard secures may not be theoretically as sound as regulation of prices by index numbers. Still, the gold standard is based on the simple and intelligible principle

finance cannot be strapped down." Cf. the speech of Mr. McKenna as chairman of the Midland Bank, Ltd., on January 24, 1924: "The Bank of England is not entirely a free agent although the independence of the Central Bank of issue should as far as possible always be preserved. It is less independent to-day than before the war. It is no longer the principal authority for the issue of paper currency. It is bound to conform to the requirements of the Government, and those requirements have expanded enormously with the growth of the debt and of national expenditure. The monetary policy which the Bank of England might wish to pursue may be overruled by Government necessities."

See also Hartley Withers, *Bankers and Credit* (1924), p. 265: "I think most of us will rule out Government control in view of all the crimes and follies committed by Governments during and since the war in their handling and abuse of our machinery of credit that had been brought so near to perfection by bankers working for industry and commerce. It is rather amazing, seeing that we live in the midst of a world brought very near to utter shipwreck by the failure of Governments to do their international job decently, to find that any one should propose to put new duties of the highest importance to our welfare into the hands of our political rulers."

"When the irresistible power of the free flow of gold cannot assert itself as a directing force, the discount policy of a country becomes easily exposed to the danger of intrigues and attacks by selfish or dissatisfied individuals or classes whose willing mouthpiece is the soap-box politician" (Paul M. Warburg, *Proceedings of the Academy of Political Science*, January 1925, p. 87).

[1] "History, which gives us the accumulated experience of the ages, is the only guide to struggling humanity, fumbling its way to a better and more reasonable world. History, recent history, the history of the

of convertibility, whilst the paper standard, based on index numbers of prices and unemployment, involves a complicated machinery, unintelligible to the ordinary mind, liable to be thrown out of gear by changes that take place while the statistics are being made up. And the criteria of index numbers are themselves not precise. We are not told whose index numbers are to be employed, and at what point of the index number control is to be effectively brought into play. We have, let us say, 8 per cent of the British working classes unemployed. Prices rise, trade expands, and the percentage drops to 4. Are you going to stop at 4 per cent because the average unemployment of the last ten years in Great Britain worked out at 4 per cent ? " We have not yet a criterion that will satisfy the nation that it is sound and can automatically be used to manage trade." [1]

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last four or five years, has taught us in Great Britain and in Europe to beware of managed currencies" (W. T. Layton, *Proceedings of the Academy of Political Science*, January 1925, vol. xi. No. 2, p. 191).

Cf. Cannan, *Money* (1923), p. 55 : " When the value of money is thus surrendered to the discretion of Government issuers, it usually goes down and the general level of prices goes up rapidly. The surrender usually takes place at a time of financial difficulty, so that the very object of destroying convertibility is to remove the necessity the Government or others are under of fulfilling their promises to pay something equivalent to certain definite quantities of bullion. In the present state of economic instruction in all countries there is no Government and no people which is likely to understand what is happening. The issuers find that further issues themselves bring in money easily and apparently cheaply, and very likely at first greatly assist borrowing in other ways by the feeling of ease and prosperity which ' plenty of money ' at first creates. Many other persons profit enormously by the rise in the prices of the things they sell. So there is a strong bias in influential quarters in favour of more and more notes."

[1] W. S. Layton, *Proceedings of the Academy of Political Science*, January 1925, p. 190. Cf. Hartley Withers, *Post Magazine and Insurance Monitor*, December 29, 1923, p. 2073 : " All that these distinguished gentlemen can promise is that the general level of prices as measured by what are called index numbers shall be stabilised. But this steadiness in average prices is quite compatible with violent fluctuations in the price of any particular commodity. For instance it would be possible for a very rapid advance in wheat to be balanced by a very heavy fall in iron and for the index number to remain absolutely

To be brief, the underlying idea of the *Tract on Monetary Reform* is the dread of a policy of deflation. The Cunliffe Committee had recommended deflation even before the war had ended. Professor Cannan at the close of the war had spoken of burning "your paper money and go on burning it till it will buy as much gold as it used to do". Professor Pigou had urged in 1920 a policy of raising the Bank rate for checking credit expansion. R. G. Hawtrey in 1922 wrote in terms which implied that all the miseries of the after-war period were due to bad manipulation of the currency by the United States Federal Reserve Board.[1] Mr. Keynes dreads the consequences of deflation, and the one motive that makes him so anxious for stabilisation of prices by the new currency machinery that he proposes to substitute in the place of the gold standard is the desire to stabilise at the present level of prices. He attributes, like R. G. Hawtrey, all the economic evils of the day to the influence of money and to instability in its value. "Unemployment, the precarious life of the worker, the disappointment of expectation, the sudden loss of savings, the excessive windfalls to individuals, the speculator, the profiteer—all proceed in large measure from the instability of the standard of value."[2] That

stable while these violent fluctuations were taking place in two important commodities. To those engaged in industry it is not enough to know that there is going to be little or no change in the general average of prices. What they want to know is what is going to happen to the particular commodity which they produce or in which they deal. Thus the theory that a stabilised index number would relieve trade and industry from all anxiety concerning a price movement, and would enable producers, manufacturers, and merchants to go ahead relieved of one of the principal fears which now make their calculations difficult, seems to be quite without foundation."

[1] *Monetary Reconstruction*, pp. 93-130.

[2] Preface to the *Tract on Monetary Reform*: "It is often supposed that the costs of production are threefold, corresponding to the rewards of labour, enterprise, and accumulation. But there is a fourth cost, namely risk; and the reward of risk-bearing is one of the heaviest, and perhaps the most avoidable, burden on production. This element of risk is greatly aggravated by the instability of the standard of value."

is why when he discusses the argument that the restoration of a currency to its pre-war gold value enhances a country's financial prestige and promotes future confidence, Mr. Keynes admits that such restoration is possible for countries like Great Britain, the value of whose currencies is within 5 to 10 per cent of their former value, but that it is not necessary, as we are not going to pin ourselves in the future to an "unqualified" gold standard. We do not know what an "unqualified" gold standard is, but the argument as urged by Mr. Keynes is: restoration of a gold standard is possible for a country like England; it will add to its prestige and promote confidence; but it is not desirable, for we (Mr. Keynes!) do not prefer or desire a gold standard. Mr. Keynes is not prepared to stand deflation to the extent of 5 or 10 per cent, because it may bring all the evils noted by him in the preface to his book. But the proper solution of the problem may lie in a waiting policy, in allowing prices gradually to fall by increase in the volume of production, by a policy of the rationing of credit to the benefit of the producer, and not by the rough-and-ready method of stabilising at the present level with an unreasoned and naïve dismissal of the claims of gold.

Mr. Keynes is prepared to recognise the evils of money in a capitalistic society; but he does not perceive that it is the capitalistic organisation as it exists at present, built up by the influence of money, that brings with it the chronic maladies of unemployment and violent changes in the condition of individuals and classes. He is, on the other hand, prepared to defend the soulless corporations of our times by eliminating the element of risk. If the economic maladies of our society are to be remedied, what we need is a drastic reconstruction from the foundations, and not an empiric and purely experimental dose of a managed paper currency. But the capitalism which Mr. Keynes desires to uphold flourishes on the element of risk, and if the gold standard enhances the risk, it is the one thing we need for fostering national prosperity. Needless to add, *we* do not propose to uphold the claims of gold on this particular ground.

CHAPTER VIII

STABILITY OF PRICES AND ECONOMIC PROGRESS

ALL our discussion about the standard has hitherto turned upon the assumption that violent fluctuations in price level are undesirable. Inflation and deflation are alike morally, socially, economically, disastrous. Inflation thrusts the financial burdens of a nation on the people who are least able to bear them, people with fixed incomes.[1] It is a surreptitious and inequitable form of taxation, and encourages extravagance and speculation. It leads to social unrest, encourages reckless borrowing on the part of Governments and public bodies,[2] and demoralises production in the long run. Deflation is equally deprecated in view of the depression it brings in its train, aggravating unemployment and transferring wealth from borrowers who are usually traders, manufacturers, and farmers, to lenders who are sometimes

[1] "Every wage-earner or salaried worker has to speculate, barter, or steal in order to make both ends meet" (J. Szebenyei, *Atlantic Monthly*, March 1922).

[2] "The currencies of all belligerent and of many other countries have since the beginning of the war been expanded artificially regardless of the usual restraints upon such expansion and without any corresponding increase in the real wealth upon which their purchasing power was based; indeed in most cases in spite of a serious reduction in such wealth. . . . Where this additional currency was procured by further 'inflation' (*i.e.* by printing more paper money or creating fresh credit), there arose what has been called a 'vicious spiral' of constantly rising prices and wages and constantly increasing inflation, with the resulting disorganisation of all business, dislocation of the exchanges, a progressive increasing cost of living, and consequent labour unrest" (Brussels Monetary Conference).

economically parasites.[1] But whilst we are all prepared to condemn violent and sudden fluctuations in price level, due either to enormous issues of inconvertible paper, as during the war, or to the regularly recurring phases of business cycles which begin with inflation and end with falling prices and depression, we are not prepared to suggest that an absolutely stable level of prices such as is desired by those who, like Keynes, advocate regulation on a basis of index numbers is in itself economically desirable. Absolute stability of price level would imply stagnation and death instead of life and economic growth. It has often been said that a slow rise in prices tends to operate to the advantage of those who plan and control the working of our industrial system. A rise in price level stimulates the imagination and spurs on the enterprise of the business man, whose increased activities result in increased production. A rise in prices imparts confidence and buoyancy and raises great expectations "by a tropismatic stimulation of the business man's sensibilities if not by logical inference".[2] "When so borne up on the resulting wave of confidence the business men are in a frame of mind for new commitments, which turns the wave of confidence into a wave of prosperity."[3] A progressive rise in the price level, so long as it is not so startling as to generate social disorder or sap the foundations of contract, by adding to the money demand for goods, stimulates also the production of goods by benefiting the pockets of the controllers of industry, and intensifies their energies and activities by putting facilities into the hands of those who feel confidence in themselves, and adds something to the effective brain-power mobilised

[1] *Tract on Monetary Reform*, p. 143.

[2] Veblen, *Absentee Ownership*, p. 179.

[3] Anderson in his *Value of Money* points out "one vital difference between a rise in prices due to a fall in the value of money and a rise in prices due to a rise in the values of goods: in the latter case, there is an increase in the psychological stimulus to industry, an increase in economic power in motivation, which energises and increases production" (p. 57).

in the service of industry.[1] On the other hand, Cairnes long ago pointed out how a depreciating standard which brought with it rising prices might cripple those who lived on fixed incomes and all those whose wages are determined more by custom than by competition.[2] But wages follow the trend of prices in the long run in a progressive society.

It has been stated that declining prices are quite compatible with industrial progress, that improvements which lower the costs of production of articles would affect the general level of prices quite irrespective of the amount of the money commodity.[3] Professor Marshall observed that an ideal currency would, over long periods of time, so reduce the level of prices that people with fixed incomes would steadily secure their share of man's increasing control over nature.[4] Steadily falling prices, spread over a long time, would be an undisguised blessing for those who rightly look with alarm on the improvident increase of public debts in our time, and who believe that Governments may well take a warning from this

[1] D. H. Robertson, *Money* (1922), p. 123. "So long as the control of production is in the hands of a minority rewarded by means of a fluctuating profit, it is not impossible that a gently rising price level will in fact produce the best attainable results not only for them but for the community as a whole": *Ibid.* p. 125. Prof. Fisher points out that high prices are usually accompanied by a high rate of interest. Consequently while high prices tend to injure creditors the high rate of interest benefits them.

[2] *Essays in Political Economy*, pp. 130 and following.

[3] Laughlin, *Principles of Money* (1916), pp. 355, 401.

[4] Referred to by W. T. Layton, *Proceedings of the Academy of Political Science*, January 1925, pp. 188-189. Giving evidence before the Commission of 1888, he observed: "I think that it wants very much stronger statistical evidence than one yet has, to prove that the fall in prices diminishes perceptibly or in the long run the total productiveness of industry; really I could not say that there was any serious attempt to prove anything else than a depression of prices, a depression of interest, and a depression of profits—there is that undoubtedly". "Then," said the chairman of the Commission, "do I understand you to think that the depression in those three respects is consistent with a condition of prosperity?" "Certainly: the employer gets less and the employee gets more."

unfailing accompaniment of progressive societies.[1] A large number of business contracts are short-term contracts for delivery of goods and services or purchase of raw materials. A slow fall in the level of prices will not adversely affect the producer to any appreciable extent.

Absolute Stability

Economic theory to-day is not perhaps quite decided as to what it wants to happen to prices in the long run; but one thing is evident, that absolute stability in price level is neither possible nor a symptom of health in an organism of producers and consumers. Prices in the economic field serve their purpose when they are a sufficient incentive to the maximum production that is possible and desirable; in other words, prices must be adjusted to productive capacity. Now prices cannot play this part unless it is the recognised rule that people labour and produce for as much money as they can obtain for their services and goods. Extreme fluctuations may be undesirable, but so long as these are avoided, producers and consumers may be left to themselves; and any attempts at regulating prices by penalising speculators and profiteers, by fixing maximum prices, by artificial devices of index numbers with an inconvertible paper currency, are likely to defeat the object they have in view—viz. the attainment of security in a stable measure of values. There is another consideration that may be kept in mind in the discussion of the question. The slow movements in the level of prices upwards or downwards are normally anticipated in long-time contracts

[1] It has also been pointed out that a fall of prices may benefit employers as consumers and purchasers of goods. Moreover, debts in our days arise through transactions that bring profit to the debtors, and a fall in prices may cut off profits at the worst. Following Marshall, Flux maintains that falling prices, however they may discourage enterprise, tend to raise the level of competence and of energetic effort by weeding out those relatively less competent and less energetic (Flux, *Economic Principles*, ch. xiii.).

and provided for by adjustments of prices and rates of interest as between borrowers and lenders. The social importance of these movements is to be discovered in the transfer or redistribution of wealth as between different classes of society. Thus the bounty to business men given by rising prices is said to be obtained at the expense of wage-earners and those in receipt of fixed incomes, whilst a fall in prices is alleged to transfer wealth from business men to wage-earners, property owners, and capitalists. Now changes in the value of the monetary unit which involve benefits to one party or class at the cost of another, are not always and necessarily socially undesirable; and where such changes bring about a more equitable distribution of the means of securing well-being in a community, rigid stability in the purchasing power of money is far from being an ideal condition of economic life.[1]

We are not wrong, then, in assuming that a dead level of prices is not possible or desirable. It is not possible because the commodity that is used for the purposes of the standard has a value of its own, either purely due to the demand for monetary purposes or otherwise. Such a demand may fluctuate from time to time or in the long run, and such a commodity has its supply side[2] as well, which may affect its valuation in terms of commodities. All that we want is a commodity whose durability will ensure an accumulation of stocks sufficiently large to make the annual fresh supply a negligible quantity. Gold served this want and answered the requirements of a progressive world, more especially

[1] See Lavington, *The English Capital Market*, p. 61.

[2] See D. Kinley, *Money* (1913), p. 268: "The demand for a standard commodity for use in making payments is one of the causes of its value, and this demand is constantly changing. If there were no actual use of the standard in making payments, so that its value were independent of the demand for means of payment, its fluctuations would be less; but, even then, they could not disappear altogether; for a demand of some kind, whether for monetary purposes or not, is necessary to value, and a demand, although non-monetary, would be bound to fluctuate."

in the hundred years preceding the war ; and that no invariable standard based on index numbers will ever secure stability of prices has been strikingly proved by the history of the last ten years. In the physical sciences we are ready to recognise that our laws are statements of an abstract character which can never be directly applied to the world in which we live and move, and that their value lies in the control which they enable us to acquire over the forces of nature, and therefore in the extent to which they enable us to mould our environment to our human purposes. Our actual levers are never weightless ; at an actual fulcrum there is always some degree of friction ; all our measurements are ultimately dependent on the recognition of a unit of quantity which is itself liable to undergo changes, whether the unit be a length or a duration of time or a unit of weight. But whilst in the physical sciences we are ready to face this situation, we are asked to believe that what is impossible in the rigid universe of masses and lengths and weights is possible in the living world of responsive reason and emotion, that we can have a rigid and inflexible standard for measuring the ever-shifting currents of demand and supply of commodities that satisfy the spiritual wants of a progressive humanity. The student of economics requires a preliminary study of the physical sciences, if for no other reason than that he may not attack the complex and changeful problems of human interests with notions of perfect and rigid standards of measurement which are never literally applicable even in the physical universe.

But if a dead level of prices is not possible, neither is it desirable. Life involves change. Where there is life there is the interplay of organism and environment. The conception of an absolutely stable environment, a material universe that denies the blowing winds and the moving waters and the revolving spheres, is a fancy that has no relation to our universe of shifting hills and valleys and slowly cooling planets. If a gradually

shifting environment is necessary for the evolution of animal life, it is still more necessary for the evolution of humanity; the spontaneity of life that makes for progress by the initiation of responses to a changing environment, expresses itself in the exercise of a rational freedom that makes for increased production and welfare as men respond to a shifting economic environment. In this economic environment a slowly shifting price level plays an important part, and to think of converting an elastic medium that stimulates the economic organism to fresh efforts from time to time, either by expanding production or by refraining from improvident consumption, into a dead, monotonous, unchanging price level, is to think of the most effective measure for securing stagnation and economic ruin.

Assuming, then, that a dead level of prices is neither possible nor desirable, the use of gold by civilised humanity before the war was not a concession to human weakness like the use of jails. Those who have argued in this manner have been thinking of some other evils than those arising from a slowly shifting price level,[1] and the war and post-war developments, far from having discredited the claims of gold as a standard, have borne the most telling witness to the economic truth that the nations who have come nearest to preserving the one most elusive quality of their currency, namely its stability,

[1] See Foster and Catchings, *Money*, pp. 123 and following: "If human beings were quite different, and if their political representatives could be counted on to act with adequate knowledge and complete wisdom, it might be possible to develop monetary systems that would automatically adjust themselves to fluctuating business needs and release for the arts the world's stores of gold. No arrangement seems ideal which requires the hoarding and carrying back and forth across the oceans of vast stores of gold which men have dug from the bowels of the earth and refined only with the hardest kind of labour." If gold functions in production as an indispensable factor, as a store of values, or as a standard, the practice of carrying it from one country to another in the final settlement of the balance of trade is neither clumsy nor a needless expense. One might as well speak of the transport of oil or coal or machinery as involving cost, and therefore clumsy in its function as an item of trade.

are those who have not departed from the gold basis. The United States may not deserve much credit for having deliberately avoided disasters by the preservation of the gold standard. But the fact remains that the gold driven out of other countries swelled American bank reserves, and the Federal Reserve system enabled the country to strengthen and unify credit. The relative stability of prices under the gold standard encouraged enormous savings, and the investments were protected from the extreme fluctuations common to European countries.[1] "The United States was thus able to lend to others, and the American dollar has become a symbol of solidity in the foreign exchanges. Prices have changed according to changes in costs but not because of changes in the standard." [2]

[1] The following table of wholesale prices for the ten years 1913–22 tells its own tale with regard to fluctuations in the United States and Japan as compared with fluctuations in price level in other countries.

Year.	United States.	Japan.	United Kingdom.	Canada.	France.	Italy.	Germany.
1913	100	100	100	100	100	100	100
1914	98	95	101	101	101	95	..
1915	101	97	126	110	137	133	..
1916	124	117	159	135	187	202	..
1917	174	147	206	177	262	299	..
1918	197	192	226	206	339	413	..
1919	212	236	242	217	357	364	..
High	238	288	276	240	423	455	..
Low	197	206	217	205	325	320	..
1920	243	259	295	246	510	624	1965
High	272	321	313	263	588	662	..
Low	189	206	243	214	434	504	..
1921	153	200	188	182	345	578	2130
High	177	219	232	208	407	642	..
Low	148	190	157	168	325	509	..
1922	149	196	155	165	327	562	32,715
High	156	206	160	169	362	601	166,495
Low	138	183	150	162	306	524	4217
1923	154	..	..	..	..	..	..
High	159	212	157	169	424	588	16,170 (millions)
Low	150	184	147	163	387	563	..

The somewhat larger fluctuations in the United Kingdom were due to the issue of Treasury Notes to finance the war.

[2] J. L. Laughlin, "The Madness of Paper Money Inflation", *These Eventful Years*, vol. i. pp. 412 and following.

The Return to Gold

To-day both economic opinion and banking experience in Great Britain favour the return to a gold standard. Professor Pigou could not have expressed himself more emphatically than when he observed some time ago that "so far as the United Kingdom is concerned, until the gold standard is restored more elaborate improvements in our monetary system are not practical politics". Mr. Hartley Withers concludes one of his recent books with the remark that "the gold standard frees us from muddling with our money by politicians, has worked right well in the past, and may do so again whenever the politicians succeed in doing their proper job, of giving us peace and security and confidence and goodwill".[1] And so Mr. Layton, the editor of the *Economist*, speaks of the help which the United States can render by making it as easy as possible for Great Britain to get back to the gold standard by adopting a liberal attitude towards the problem of the European debts.[2] Banking opinion in England is not less emphatic. Sir Felix Schuster, speaking at the International Chamber of Commerce Conference in 1921, expressed the determination of bankers to return as soon as possible to the pre-war gold standard, "whether it be this year, next year, or in five, six, or ten years". Mr. McKenna, as chairman at the annual meeting of the Midland Bank, entered into an elaborate defence of the gold standard, and observed that even if the gold standard were not preferable for other reasons, its universality would be decisive in its favour.[3]

[1] *Bankers and Credit*, 1924.

[2] *Proceedings of the Academy of Political Science*, January 1925, p. 194. Cf. Nicholson, *Inflation* (1919): "Our greatest present need is to get back to a sound monetary system and to get rid of the mirage of inflation" (Preface).

[3] "The gold standard has in existing circumstances great and striking advantages. In the first place, it establishes an international measure of value common to the whole world and universally accepted. It is automatic in its operation, and it relieves the central banks of a responsibility which, notwithstanding our own fortunate experience,

But it is not Great Britain alone that desires to return to the gold standard at as early a date as possible.[1] As long ago as 1920 the Brussels Monetary Conference, which included representatives from some thirty-nine leading countries of the world, unanimously recommended that it was highly desirable that the countries which had lapsed from an effective gold standard should return to it. The Conference observed: "It would be impossible to say how or when all the other countries would be able to return to their former measure of effective gold standard, or how long it would take the newly formed countries to establish such a standard. But in the opinion of the Conference it is useless to attempt to fix the ratio of existing fiduciary currencies to their normal gold value." Two years ago Austria, which was rushing fast into bankruptcy with the disappearance of credit and confidence, was helped out of her financial chaos by an

might not always be discharged with knowledge and judgement. But in the present state of knowledge and feeling, one of the greatest advantages of the gold standard is its moral effect. A nation will think better of itself, will almost regard itself as more honest, if its currency is convertible into gold. The fear of being forced off the gold standard acts as a salutary check on the extravagance of Governments, who might be willing to face a mere fluctuation in exchange but would not dare to suspend specie payment. It is a real advantage to a nation to have a currency founded upon a value which is universally recognised; it inspires confidence and facilitates international transactions. Even if the gold standard were not preferable for other reasons, its universality would be decisive in its favour. The argument may, it is true, be founded on psychological and not on economic grounds, but it is none the less powerful, as we have not yet reached the stage where economic considerations alone guide us in judging the desirability of any particular method or system."

[1] These paragraphs were written at a time when Great Britain had not returned to a gold basis. In June 1924 a Committee was appointed to consider the question of the amalgamation of the Treasury Note issue with the Bank of England note issue. This Committee presented a unanimous report in February 1925 in favour of a return to the gold standard, and subsequently a short Act was passed whereby the convertibility of notes into gold was limited to gold in the form of bullion. The right to take gold to the Mint for coinage was temporarily suspended, though the Bank of England has to buy all the gold offered to it at the former statutory price of £3 : 17 : 9 per ounce.

international loan in which the United States took a leading part. The fundamental feature of the Dawes Plan was the foundation of a new bank of issue with a gold reserve. Sweden has already restored her gold standard with a free market for gold, and it has been observed that if Great Britain returned to the gold standard she would bring with her a group of other European countries — Holland, Spain, Switzerland — as well as the self-governing colonies.

The Situation to-day and its Remedy

The enormous issues of paper money in some countries have undoubtedly led to a rise in prices; but the rise in prices is also due to the fact that there is a shortage in the supply of goods with a simultaneous increase in the demand. If we are right in our view that the rise in prices is partly due to causes affecting the goods themselves, then the remedy lies in encouraging further production and exchange of goods between the countries. From this point of view, what the world may need to-day is fresh credit for productive purposes, even though this means more money in circulation and more deposits in banks; and while production is to be stimulated by credit, we may need as intensive an application of labour service for peace-time as we did in war-time, and we may need to exercise restraint in the consumption of superfluities.[1]

[1] "The maintenance of the gold standard and the maintenance of London's supreme position as a financial centre must in the main depend upon our ability to give an adequate exchange, not merely of banking and financial facilities, but of actual goods to pay for those that come into the country. . . . Even before the gold standard was adopted there was much talk as to the possibility of dearer money as a necessary corollary. We felt then, however, and we feel now, that this question of dearer money rates is not one depending so much upon the adoption of the gold standard, as upon whether we can so reorganise our industries as to ensure larger and cheaper production, thereby increasing our exports and keeping the exchanges in our favour" (*Bankers' Magazine*, (June 1925), pp. 839-840).

In so far, however, as the rise in prices is to be traced to the causes affecting money and not goods, we need in the first place a return to the gold standard in as many countries as possible, with a free gold market; and if this is not immediately practicable, we need in every country the organisation and rationing of credit by central banks. A rise in the rate of discount in the pre-war days may have been an effective method of contracting credit and avoiding inflation; but in the past ten years abundance of money has created a spirit of reckless speculation which refuses to be curbed by the Bank rate; a rise of a few points in the Bank rate is almost an irrelevant detail in the calculations of business men in times of soaring prices and phenomenal profits.[1] A rise in the Bank rate may under present conditions kill precisely that which must be encouraged, the healthy production of useful commodities. The demand for excessive credit by Government and local bodies, with all the superabundant purchasing power that it seems to bring with it, can only be checked by an organised banking system in every country which will refuse to advance money for unproductive purposes both to public bodies and to private individuals and corporations; and it would be necessary for this purpose to make the banks entirely independent of control from without, except such control as is involved in responsibility to a body of enlightened shareholders and depositors. To propose a

[1] Hartley Withers, *Bankers and Credit*, p. 157: "In old days the Bank rate had been effective in small doses because profits were finely calculated and all the conditions that entered into the consideration of those who were carrying on business were so well balanced that a marked change in any one of them was sufficient to divert the course of trade and traffic. Then a rise in Bank rate from 5 to 6 per cent and then to 7 per cent might really have been an important factor in the calculations of producers and merchants. But in 1919 and in the first quarter of 1920 the rise of prices was so quick and looked so unending, and the profits that it was pouring into the pockets of all who produced or handled goods were so fat, that a rise of a few points in Bank rate, and consequently in the price of the credit that they wanted, was almost an irrelevant detail in the calculations of those who were conducting enterprise."

monetary system based on inconvertible paper and index numbers may be more " scientific " in a way than a monetary system based on a metal that fluctuates in value ; but to leave the regulation of this monetary system in the hands of Governments and corporations liable to be influenced by the rivalries of political parties, is to take the one sure and short step towards monetary instability, if not chaos.

The Genoa Conference

The Financial Commission of the Genoa Conference pointed out in resolutions adopted unanimously that all European currencies should be based on a common standard and that the only possible common standard is gold. But realising that the value of gold may be raised again by " the simultaneous and competitive efforts of countries to secure metallic reserves ", and also in view of the fact that in many countries paper money has actually replaced gold as the circulating medium since the war, the Conference recommended a method of economising the use of gold as currency. The currency of each participating country, instead of being convertible into gold, may be convertible at par into the currencies of the others, the parity fixed upon being kept up by credit control of the Central Bank in each country. To secure convertibility, the participating countries will hold reserves of approved assets in one another's currencies. Some of the participating countries will establish a free market in gold. In view of redundant supplies of the yellow metal being thrown on the market, the Conference recommended that credit should be regulated not only with a view to maintaining the currencies at par with one another, but also with a view to preventing undue fluctuations in the purchasing power of gold.

The resolutions of the Genoa Conference briefly recommend a Gold-Exchange Standard on an international scale with gold parity—either the restoration of pre-war parity or the adoption of a new one. But international

agreement of this kind presupposes a change of heart on the part of the nations of the world which is not within immediate view; and even if it were practicable one may well doubt the need for it. The world's stock of gold to-day for monetary purposes is amply sufficient, if equitably distributed. With a free market for gold in some of the larger countries there might follow automatically a redistribution of gold resources. On the other hand, by an international arrangement of the type contemplated by the Genoa Conference we might bring about that very instability in the purchasing power of gold which we then propose to remedy by credit control. The adoption of an effective gold standard by the leading European countries whose exchanges are in the vicinity of the pre-war dollar par will alone secure that relative stability of purchasing power which we are now struggling to reach. We may then have on a gold basis such credit control by a Central Bank in each country as will mitigate the evils of periodic shiftings in the price level due to trade cycles. The war has taught us how we can control credit even with prohibition of exports of gold; the world has now reached a stage in its economic evolution when stability of purchasing power can be more effectively secured by the management of the money in circulation than by the uncontrolled and automatic movements of the precious metals. But management of money that rests on a gold basis is a different thing from management and credit control of inconvertible paper. The working of the Federal Reserve Banks has clearly demonstrated the potentialities of a currency system based on gold but managed by a central institution with a view to preventing fluctuations in the purchasing power of the standard.

A Managed Currency on a Gold Basis

Under present conditions the economic salvation of the European countries depends on wise management of

currencies; but this management is to be exercised within the limits of an effective gold standard which would guarantee the people against meddlesome interference with the mechanism of exchange by Governments and political parties who would not take the far-sighted view of things, and who would be incapable of exercising the restraint of which a body of responsible bankers have been found capable under a gold standard. "The propensity of Governments to expand unduly the manufacture of the instruments of payment has become a commonplace of economic discussion; it is still not so usual to find a frank recognition of the fact that the immediate interests of the business world and even of the bankers themselves exert a constant pressure in the same direction." The duty of preserving a gold standard imposes a restraint on these dangerous tendencies even amongst bankers; and though a gold standard may bring with it the possibility of fluctuations in price level of its own, they are on the whole likely to be less violent and subversive than those it helps to restrain.[1] For countries more especially linked by international commerce with the rest of the world, and for whom stability in foreign exchanges is an object of importance, there are additional reasons for as early a return as possible to the gold standard — gold being the only common medium of exchange. The restoration of the gold standard may not in itself be a royal road to economic prosperity. It will not bring prosperity to the countries reverting to it, if at the same time a depressed Eastern Europe is left to itself, starving and overburdened, in days when the Foreign Offices and the leaders of thought and opinion are everywhere preaching world-brotherhood in clarion voices. Even then the restoration of a gold standard by the countries that are to-day within the vicinity of the dollar par is a measure the accomplishment of which

[1] *Monetary Policy: Report on Currency and the Gold Standard*, by J. H. Clapham, C. W. Guillebaud, F. Lavington, and D. H. Robertson (1921), p. 64.

is worth securing in the light of monetary experience.[1] And as for the weaker countries, loans freely given by the economically stronger Powers may enable them to set up again on a gold basis with the return of better days and with the fuller utilisation of their material resources.[2] It would be a policy worth resorting to even in the interests of the stronger Powers themselves.[3] The restoration of the gold standard in as many countries as can return to it in the immediate future, the utmost economy of the metal in circulation consistently with the convertibility of all actual media of exchange, and

[1] Cf. the *Economist*, December 6, 1924: "Germany is nominally on a gold basis, but her footing is very precarious. If Great Britain returns to a gold basis she would soon be followed by the great dominions and by other countries, among whom Holland, Switzerland, and Spain are likely to be the first. Theorists may have some grounds for arguing that a paper standard might be made more stable than gold, but actual experience of paper standards is not encouraging. We are by no means clear of the period of paper chaos. 1923 saw the lowest exchange records for many countries of Europe, and in France and Belgium 1924 has even beaten the 1923 record. The most practical assurance of steady progress which can be given to the world would be a prompt return of a substantial part of the world to a gold basis."

[2] "The solid basis of an actual physical scarcity, of wide general acceptability and serviceableness, these circumstances underlie the universal use of specie and make it certain that for as long a time as we can consider in present economic arrangements, gold and silver, and mainly gold, will be the basis of the world's circulating medium. Gold is not a perfect monetary medium, but it is the best which the fallibility of human nature and the present degree of civilisation enable us to devise" (Taussig, *Principles of Economics*, 1911, vol. i. p. 326).

[3] "Opinion in America is looking in the same direction, and there is no doubt that some form of co-operation could be arranged or assistance given in the New York market if it were thought necessary. This attitude is not the outcome of philanthropy. It is dictated by two motives of self-interest. On the one hand, American opinion regards the restoration of the pound as one of the key moves in the stabilisation of European conditions and hence in the restoration of her chief market. On the other, the wisest Americans realise that if the world does not resume the gold standard, the American monetary and banking system will be in danger of being broken down if it is flooded with the whole of the world's gold available as currency. Her power of absorption is not unlimited, and her responsible financiers will be greatly relieved when the golden flood is more evenly distributed" (the *Economist*, December 6, 1924).

the management of credit money by bodies controlled by an enlightened public opinion — these alone can guarantee the growth and prosperity of post-war Europe. It is not " managed " currency that we condemn, but a " managed " currency that does not stand on a gold basis ; and the gold that will mostly lie in the banks will not by that simple fact cease to render the services that it performs in actual circulation. It is short-sighted to speak of the " useless " and " unproductive " gold which, because it is not yielding any interest, is said to cease to be of advantage to the country. If to-day one of the greatest dangers to national prosperity arises from a depreciation of currency, the gold lying in the vaults of the banks as a reserve performs a far greater service than gold otherwise employed.

Finally, whilst we plead for credit control on a gold basis by a Central Bank, we are not blind to the imperfections of a credit machinery which in practice may often work in combination with industrial trusts controlling prices—with the result that the nation as a whole may have to pay not only for the cost of the commodity produced, but also for the cost of maintaining and improving the means of further production and for the cost of maintaining in working order the banking organisation that provides the credit. A system that perhaps permanently impoverishes the many to serve the sordid interests of the few, frustrating by its credit control the production which, better manipulated, could satisfy the reasonable needs of all, and that devotes itself to the consolidation of monopolies by which the masses can be enslaved, instead of meeting the claim of all to a proper share of a common inheritance, might well be characterised as bordering on the insane. Where money values become the underlying realities of life, the substance of things hoped for, the evidence of things not seen, the inflation of prices means business gain, and for declining prices the remedy is sabotage and liquidation. Even on a gold basis, credit control in the interests of big business

may work both inflation and deflation according to the rhythmic movements of trade, to the loss of primary producers and wage-earners. But whilst we are prepared to recognise these difficulties, we also recognise that an effective gold standard limits to a definite extent credit manipulation by banks, and thus safeguards the general interest of the producer and the consumer. It affords a rough-and-ready method of measuring the limits within which credit can safely expand, and a banking organisation subject to the control of depositors and investors may adjust its volume to the needs of production and promote by its operations the general wellbeing of the community.

CHAPTER IX

MEASUREMENT OF VARIATIONS IN THE VALUE OF MONEY

Value of Money

The expression "Value of Money" is used in various senses. In the first place, it is used to denote the rate of interest, the price of the use or extended loan of purchasing power; it is also used to denote the rate of discount, the price of the temporary use of purchasing power. It is in this latter sense that money is said to be cheap or dear in the market from day to day. Some economists would speak of the "price of money", and not of the "value of money", when they have in view the rate of interest or the rate of discount. The expression is sometimes used to indicate the value of the monetary unit of one country as measured in terms of the monetary unit of another country, as when we speak of the value of the rupee in terms of the dollar. This is the rate of foreign exchange. Lastly, the expression "the value of money" may be used to denote the value of a unit legally defined by weight, or otherwise, of the commodity used as money in terms of all other commodities. In other words, the value of money is its purchasing power in terms of other commodities. The exchange value of a commodity (quite apart from its utility or intrinsic value) is the quantity or amount of other goods for which it will exchange. In our times the amount of every commodity which can be exchanged for definite amounts of other commodities is determined by the price or quantity of the money material for which it will exchange. The money material, as legally defined, is the common

denominator which registers the exchange values of all other commodities. The commodity chosen as the standard has value in itself, otherwise it would not have come into use as a common denominator at all. Money as a standard cannot strictly be regarded as a "measure of values" except in the sense that a given quantity of the money material can exchange for a definite quantity of all other commodities that can be exchanged, and thus enables us to ascertain the exchange relations between those other commodities. The value of money, then, means its purchasing power, or the amount of commodities in general which will be given in exchange for a unit of money. When the prices of commodities are low, money has a high purchasing power; when prices are high, money has a low purchasing power. If the prices of all commodities as measured in terms of the monetary unit fell or rose uniformly, there would be no difficulty in ascertaining the value of money from time to time. If prices are doubled, the purchasing power of money is halved. But in the actual economic world prices of commodities do not undergo rigidly uniform movements, and the reasons are obvious. The exchange value of every commodity in terms of money is subject to the conditions of demand and supply affecting the commodity; and these conditions are different in the case of different commodities, so that in one and the same period of time some commodities may rise in price owing to shortage of supply or excessive demand, while others may fall in price. But all commodities are subject in their prices to another set of conditions which are not peculiar to each commodity taken separately, but govern all commodities uniformly, and these conditions affect the money material itself. The general level of prices is only another name for the value of money: to say that the value of money has risen at any time is to say that the general level of prices has fallen, and *vice versa*.[1]

[1] The problem of explaining the general level of prices is one of arriving at the adjustment between two terms of a ratio (the standard

Measurement of the Value of Money: its Importance

There are some economists who scout the idea of measuring the general level of prices on the ground that it is impossible to measure the variations of one commodity in terms of another, if the variations of both commodities depend upon causes entirely independent of one another. It is true that our standard of values is itself liable to variations, but if these variations themselves can be reduced to a law the standard will serve the purpose of measuring variations of other commodities as well as if it were itself absolutely stable. It is also true that in determining the movements of prices we often get confused between the registration of such movements and questions about the causes that bring about the movements. We must never lose sight of the fact that a statistical determination of the trend of

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on the one side and the goods on the other) each of which is influenced by supply and demand (Laughlin, *Money and Prices*, p. 85). It has been said that the general level of prices is never independent of particular prices, that there can be no such thing as a general level or average of prices which is not the resultant of a number of particular prices, each arrived at by individual buyers and sellers: "The causes of price changes must be sought in the forces settling particular prices" (Laughlin, p. 82). Now there may be some need for special emphasis on the goods side of the ratio when we have to examine the causal laws underlying the quantity theory of money and have to point out the weaknesses of that theory. But an emphasis of this kind is misleading if it leads us to question altogether the possibility of price movements due to changes in the standard, as contrasted with price movements affecting commodities other than the standard, price movements due to mechanical and chemical improvements, increased mobility of labour and capital, opening up of fertile tracts and rich deposits, etc. In fact the standard is one commodity amongst others, and on account of its peculiar importance changes affecting demand and supply of the standard may have greater social reactions than changes affecting demand and supply of any other commodity. Prof. Fisher goes so far as to maintain that individual prices of commodities presuppose a price level. It would be safer to maintain that particular prices or actual quotations are the bases from which all averages or price levels are computed.

prices over short or long periods is not a statement of the cause of the changes.

The measurement of variations in prices with the help of index numbers is of great importance to our social life. It is desirable to have a correct idea of the extent of the variations in the purchasing power of money, to fix the value of deferred payments, and to correct the hardships to debtors or creditors, to wage-earners, or to those in receipt of fixed rents and incomes, which often arise from such variations in price levels. In view of the fact that governments and private corporations in our own times are often committed to expenditure in distant places, measurements of price levels in different countries have more than a purely academic interest. Comparisons in the purchasing power of money at different periods of time throw considerable light on the economic condition of different classes, and enable us to form a fairly correct idea of a rise or fall in the standard of comfort.[1] They also afford a measure of the extent to which trade and industry may be injuriously affected by variations in the price level, and may enable us to correct the injurious consequences to some extent by credit control.

Index Numbers

The usual method of measuring variations in the purchasing power of money is by the use of index numbers. "An index number is a number which represents the price of a chosen commodity, or group of commodities, or the average of closely consecutive prices of those commodities, at a selected date, which is used as a standard wherewith we may compare the prices of the

[1] "If goods and labour are priced in the same standard, a means is at hand to determine accurately the changes in the real wages of labour; since the actual quotations of money wages paid are of little purpose without a means of comparison with what the wages will buy" (Laughlin, *Principles of Money*, p. 147).

same article at later dates." [1] Starting from some base, the number 100 is used to represent either the average of a given year or that of several years, and the higher or lower quotations in subsequent years can be expressed by the relations they bear to 100, which is the base. The following table may serve as an illustration :

	Prices in Rupees.		
	1900.	1910.	1920.
Rice, per maund . . .	3 0 0	3 8 0	5 0 0
Wheat, per maund . . .	3 12 0	3 0 0	4 0 0
Sugar, per pound . . .	0 2 6	0 3 6	0 4 0
Milk, per pint . . .	0 1 6	0 1 6	0 2 0
Pulse, per maund . . .	2 0 0	2 0 0	4 0 0
Gold, per tola . . .	27 0 0	24 0 0	26 0 0
Rs.	36 0 0	32 13 0	39 6 0
Average . . Rs.	6 0 0	5 7 0	6 9 0
Basic year . . .	100	90·6	109·3

In 1900 100 units will purchase the six commodities given in our list. In 1910 90·6 units will be sufficient to purchase the same commodities; in other words, there is a fall in the general level of prices, or a rise in the purchasing power of money. In 1920 we require 109 units to purchase the same amount of commodities; that is, there is a rise in the general level of prices, or a fall in the purchasing power of money.

METHODS OF COMPUTING AVERAGES

The accuracy of index numbers depends amongst other things upon the kind of average used in computing the base. Different writers have used different averages, including the arithmetical, the geometrical, the harmonic, and the medium.[2] One method of computing an average

[1] Kinley, *Money*, p. 228.

[2] Using the arithmetical average means adding the separate prices of a number of articles, or a number of prices of any article on different dates, and dividing by that number. The geometrical average involves

may be good for one purpose but unsatisfactory if the purpose is different. Thus if a large number of articles were low-priced goods and were shown to be falling in value whilst a very few valuable commodities were subject to a remarkable rise in price, the significance of the trend of prices might be more accurately expressed by the harmonic than by the arithmetical or geometrical average, by the number which stands nearer to the smaller than to the larger amounts in the quotations. The choice between the different types of averages must then depend largely upon the nature of the inquiry. If the problem before us is that of determining the relative quantities of commodities that a given amount of gold can purchase, the arithmetical average will be far from unsatisfactory, as it will enable us to know the total amount of gold which is equal in value to the sum of all the same quantities of goods at the different periods. Jevons has advocated the use of the geometric mean,[1]

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multiplication of the prices and finding that root of the product which is indicated by the number of the prices. The harmonic average is the reciprocal of the arithmetical average of the series of prices. The medium is that term or price of the series of articles which has as many prices above it as below it. Thus, taking Rs. 5, 6, 8, 9, and 11 as the prices of a commodity on different days, the arithmetical average would be 7·8, the geometrical average 7·5, the harmonic 7·2, and the medium 8. See also Fisher, *Purchasing Power of Money*, p. 349.

[1] The price of cocoa has nearly doubled since 1845–50. It has increased by 100 per cent, so that its variation is now expressed by the number 200. Cloves, on the other hand, have fallen 50 per cent and are now at 50. The arithmetical mean of these ratios would be 125. The average rise of cocoa and cloves would then appear to be 25 per cent. But this is totally erroneous. The geometric mean of the ratios expressed by the numbers 200 and 50 is 100. On the average of cocoa and cloves there has been no alteration of price whatever. In other words, the price of one is doubled, of the other halved; one is multiplied by two, one divided by two—on the average, then, the prices of these articles remain as they were instead of rising 25 per cent (Jevons, *Investigations in Currency and Finance*, p. 23). It has been pointed out in criticism of this view that if any one makes two investments of Rs. 100 each, on one of which he realises 200 per cent and on the other only 50 per cent, according to Mr. Jevons' reasoning the investor would gain nothing at all. By the same reasoning, if 100 commodities

perhaps on the ground that variations of prices are variations of ratios and that the proper method of averaging the ratios is the geometric. Mr. Walsh, in an elaborate study of the whole question of averages, also favours the use of the geometric mean in the measurement of variations of prices in the actual market.[1] It would appear safe to point out that the use of the geometric mean will not always allow us accurately to measure the changes from time to time in the purchasing power of money in terms of commodities, more especially when we take into account not merely the quantities by weight of commodities, but the satisfactions to be obtained with the same sum of money.[2]

Weighted Index Numbers

In inquiries into the stability of the purchasing power of money between one period and another, that is into the variations of the standard for deferred payments, it has been pointed out that the assignment of equal importance in a list of prices to articles like wheat and pepper, cloth and motor-cars, which vary so remarkably in the amount of money laid out on them, would be very misleading. It has therefore been thought desirable to introduce a coefficient of quantity in making up the

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doubled in price the effect would be offset by one single commodity declining to 1/100 of its standard price (Padan, "Prices and Index Numbers", *Journal of Political Economy*, March 1900).

[1] *The Measurement of General Exchange Value*, 1901.

[2] If, for example, at one period I can buy with Rs. 100 20 maunds of sugar, and with another Rs. 100 20 maunds of cocoa, and at another period the price of sugar is doubled and that of cocoa halved, it may be said that I can buy with the same total of Rs. 200 20 maunds of cocoa and 15 maunds of sugar, or 10 maunds of cocoa and 17½ maunds of sugar, or 13 maunds of sugar and 28 maunds of cocoa. In the last case I may be getting roughly the same weight of the two commodities with the same amount of money, but the satisfaction that I may be obtaining may be altogether different in each of these three cases; and if I resolve, as before, to buy 20 maunds of sugar, I may have nothing left with which to buy cocoa at all.

index number, in order to give to different commodities the weights which conform to their relative importance in the normal consumption of the masses, or in the quantities produced, or in the relative amounts exported or imported. Some commodities enter more into consumption than others: bread, for example, more than silk. If a simple average is taken, a rise in the price of bread might be cancelled by a corresponding fall in the price of silk, thus leaving the index number stationary, notwithstanding the fact that bread is consumed in much larger quantities than silk.[1] Taking a single

[1] Let us assume at a given time, 1900, the price of bread to be 2 annas per loaf, and silk to be Rs. 4 per yard. In 1920 the price of bread rises to 3 annas, and that of silk falls to Rs. 2 per yard. Assuming 1900 as the basic year, we have

In 1900.		In 1920.	
Bread 2 as.	100	Bread 3 as.	150
Silk 4 Rs.	100	Silk 2 Rs.	50
	200		200
Average	100	Average	100

Taking a weighted average, let us assume that bread and silk are consumed in proportions of 12 to 1. Then

In 1900.		In 1920.	
Bread (12 units)	1200	Bread (12 units)	1800
Silk	100	Silk	50
	1300		1850
Average of 13 units	100	Average of 13 units	142·3

142·3 is the weighted index number for bread and silk.

This is a very simple illustration of what is known as the budget method. It was employed by Falkner in the tables of American wholesale prices, and consists in assigning a coefficient to different articles in proportion to their importance in the budgets of expenditure of families in moderate circumstances. Such a method may be useful in certain cases—*e.g.* if we wish to know if any particular class in the community is better or worse off in consequence of changes in prices. Food, for example, forms a large part—say 40 to 50 per cent—of the total expenditure of working families. A rise in the price of food measured by its importance in the budget might cause their cost of living to rise. Amongst the well-to-do classes a rise in the price of food would be of less importance and might easily be offset by a fall in the price of other things (see quotation from an article by Prof. Taussig in the *Yale Review*, Nov. 1893, in Laughlin's *Principles of Money*, pp. 160-161).

commodity like wheat, the average price will vary according as we include all the quantities sold at different prices. If 5 bushels are sold at Rs. 3 per bushel, and 20 bushels at Rs. 2.12.0, the average price is not correctly expressed by averaging one bushel at Rs. 3 and one at Rs. 2.12.0. The weighted average will be Rs. 2.12.9 instead of Rs. 2.14.0 :

5×3		$= 15$ Rs.
20×2.12		$= 55$ Rs.
25	2.12.9	70 Rs.

So again if more wheat is sold in October than in March, the October prices will have more weight than the March prices in determining the average price for the year.

In computing weighted averages, different coefficients of quantity are often employed. In some tables of American wholesale prices, the coefficient of quantity is proportional to the expenditure on each article in the family budgets of a particular class.[1] Inglis Palgrave varies the coefficient in proportion to the relative importance of commodities in exports and imports, or in proportion to the quantity of national expenditure on different commodities. So also Soetbeer and Sauerbeck weight the articles in their tables according to their relative annual consumption. These last methods of computing the average assume that the relative importance of the commodities remains unchanged over different periods of time; moreover, they do not enable us to take account of the fact that the purchasing power of money differs for classes having a different order of consumption, and that changes in prices affect them unequally. With regard to very many articles, statistics of total expenditure are not available. Finally, the relative quantities of different commodities consumed frequently change as between one period and another. Thus it is not surprising if, in view of the theoretical doubts and statistical difficulties, we find the attempt

[1] See footnote on the preceding page.

to arrive at weighted averages abandoned in favour of the simpler method of assigning equal relative importance to all the items, especially if care is taken to include as many articles of importance, like corn and cotton, as possible.[1]

Number and Selection of Articles

The number of articles to be chosen for the table of prices is mainly a question of convenience, provided the number is large enough to be fairly representative, and provided that the articles are those of the widest demand.[2] In arriving at conclusions about variations in price level based on averages, it is more profitable to have a fairly large number of commodities than to make accurate calculations as to the proper weights to be attached to each article. Soetbeer's unweighted averages are found to give practical results as good as the results of weighted averages ; and it is also found that there is a remarkable coincidence between the results based on unweighted index numbers and those based on numbers weighted for a certain purpose.[3]

In the construction of an index number which is intended to serve as a standard for deferred payments, we must take into account a large variety of consumable goods and services, including wages.[4] In an index number which serves as a basis for deferred payments for wage-earners themselves, however, wages have been excluded, as a wage-earner does not judge his purchasing

[1] The index numbers of the *Economist*, of Jevons, of Soetbeer and Sauerbeck, are based on unweighted averages. Even a mathematician like Edgeworth does not consider weighting of much importance, and Giffen remarks : " The articles as to which records of prices are obtainable being themselves only a portion of the whole, nearly as good a final result may apparently be arrived at by a selection without bias according to no better principle than accessibility of record as by a careful attention to weighting " (*Report of the British Association*, 1888, p. 184).

[2] Kinley, *Money*, p. 233.

[3] See diagram, Laughlin, p. 221.

[4] Irving Fisher, *Purchasing Power of Money*, ch. x.

power on the basis of how much labour he can buy.[1] Sauerbeck's list, which gives us an unweighted arithmetical average, includes 37 articles, but some of them are introduced more than once, so that the total reaches 56 items. The London *Economist* index number is based upon an average of 22 articles; the prices of these for six years, 1845–50, constitute the base. Soetbeer's tables begin with 1847, and his list includes 114 articles. He grouped these articles into 8 classes, and his data were obtained from the Hamburg Bureau of Trade Statistics. The index number of the Department of Statistics of the Government of India is based upon 39 articles, 28 exported and 11 imported.

In the next place, it is important to know whether wholesale or retail prices are to be used in the making up of index numbers. If the purpose is simply to indicate the change in the general level of prices, wholesale prices may be safely used. But if our object is to ascertain changes in the economic conditions of any one class of society, retail prices may be a better guide. Retail prices are, however, not only higher as embodying services rendered to these commodities on different occasions; they are often arbitrary and linger on even when there is a fall in wholesale prices. Wholesale prices are more uniform and more sensitive.

From the point of view of the purchasing power of money, the use of index numbers may be recognised with certain qualifications. The purchasing power of money cannot be said to be the same over two periods, if a given amount of money purchases the same total quantity of different commodities but in different proportions in the two periods. Changes in relative prices take place from time to time, and these involve changes in the relative proportion of satisfactions which a given quantity of money will obtain. A rise of 1 per cent in the price of bread or rice may be much more important than a

[1] Edgeworth's articles on "Index Numbers", Palgrave's *Dictionary of Political Economy*.

fall of 50 per cent in the price of pepper or silk. Index numbers based on an unweighted arithmetical average will not enable us to trace such changes. Finally, we must always remember that the use of index numbers, weighted or unweighted, is simply confined to the indication of changes in price level and must never be confounded with questions connected with the causes that bring about the changes. We must guard against assuming that if the prices of commodities are regulated by the amount of money offered for them, index numbers would show how far articles make an increased or decreased demand upon the money supply.

CHAPTER X

THE VALUE OF MONEY AND THE QUANTITY THEORY

Causes that determine the Value of Money

The value of money, or the purchasing power of money as measured by changes in the price level, is the result of two series of causes—causes operating on and affecting the supply and demand of the money commodity, and causes operating on and affecting the supply and demand of commodities. The problem of explaining the price level, as we have already indicated, is one of determining the adjustment between two terms of a ratio (gold or substitutes for gold on the one side, and commodities on the other), each of which is liable to changes following upon shiftings of supply and demand. Now there are a large number of economists who believe that they offer a complete and adequate explanation of changes in price levels, if they draw attention to what they consider to be the main causes that affect one side of the ratio, namely, the standard of values or gold.

We may briefly indicate three different theories formulated from this point of view, which claim to give an adequate account of price movements by a consideration of conditions that affect the value of the money commodity alone. The modern theory of supply and demand states that when the marginal supply and demand prices are equal, the amount supplied and the amount demanded will be equal. This theory is a theory of prices that presupposes or assumes a fixed value of money ; and it cannot, therefore, be employed to explain

changes in the value of money (or the general level of prices). If demand is defined as quantity demanded, then the quantity demanded will vary with the price, giving us a demand curve. Similarly, there is a supply schedule giving us a supply curve of a like nature. These curves are expressed in money, and a change in the value of them will affect both of them proportionately. But the theory assumes that supply and demand are independent, and must therefore treat changes in the value of money as non-existent.

Modern theories of supply and demand are, then, inadequate for solving the problem of the value of money. Mill maintains, in discussing the theory, that the demand for money is not the amount of money demanded, but the quantity of goods offered against money, and defines the supply of money as quantity multiplied by rapidity of circulation. It may be pointed out that quantity of goods to be exchanged is not a true quantity at all, but a collection of incomparables like eggs, gallons of wine and milk, tons of cotton, dozens of cattle, etc.; and secondly, that increase in the quantity of one of these items may actually diminish the supply of money.[1] Restricting the meaning of the expression "value of money" to the price paid for short-term loanable money in the money market, it is correct to maintain that the price is determined by demand and supply. But the fundamental problem that we are here considering cannot be solved by the formulæ of supply and demand.

The cost theory of the value of money assumes that the purchasing power of money in terms of commodities depends upon the cost of production of the monetary

[1] Cf. Anderson, *Value of Money*, p. 60. An increase of cotton supply in America may lessen its value so that it may sell for less money, and as America is a large exporter of cotton this may turn the balance against America, leading to export of specie, or in other words to a reduction in the supply of money. An increase of demand for money in Mill's sense would drive money away. We shall return to an examination of Mill's theory when discussing the quantity theory of money.

commodity, which is in turn a money cost. But even leaving aside the vicious circle, it has been rightly pointed out that in the case of a commodity like gold, whose total stock is so enormous compared to the annual production, the cost of production can only affect the value very slowly and feebly. As in the earlier theory, so in this theory which makes the value of money depend on the marginal cost of production, we presuppose fixity in the value of our money unit, and we cannot use the theory for explaining the value of money itself. Undoubtedly the production of gold, like all other industries, is ultimately governed by some sort of equilibrium, which at one time attracts and at other times repels labour and capital. But it has comparatively little value as a theory that can account for all changes in the price level.

Finally, the marginal utility theory of the value of money has found supporters, amongst others in the Austrian, Wieser, and in Kinley and Davenport in America. Wieser maintains that money is not to be treated as a commodity, that its value is bound up with the money service, and that this depends on goods as well as money. Money has no marginal utility of its own, but a subjective exchange value derived from the marginal utility of the commodity purchased with the money unit. This subjective exchange value of money is the cause of its " public economic value ". The personal value of money changes with the volume of one's personal income, with the intensity of one's need for money, and with market prices. The personal value of money depends on the relation between an individual's money income and his real income in terms of commodities. The " public economic value " of money (general level of prices) depends on the money income of the community as a whole and its real income. Money income is not like real income, dependent on quantity.

The value of money, in other words, does not depend on its own marginal utility, but on the marginal utility

of the goods which are exchanged for it. But these depend on prices, and prices depend in turn on the value of money itself.[1]

More definite even than Wieser is David Kinley, who explains the value of money by its utility as a commodity in the first instance, and by its utility as money in the second instance. Kinley maintains that money has utility as money; it facilitates exchange and transfers commodities from people who do not use them to those who do, and increases to this extent the utility of commodities. The utility of money is the additional utility that comes into existence or is added on to commodities by virtue of its use as contrasted with a state of simple barter. The marginal utility of money is determined not merely by its marginal utility for making exchanges and for other purposes, but by its marginal utility in effecting exchanges and that of other means of effecting exchanges, as well as by its marginal utility and that of the goods it exchanges for.[2]

The marginal utility theory, in so far as it makes marginal utility the cause of value, involves a vicious circle. The value of the goods that a man desires depends not merely upon the intensity of his desires—a beggar may desire a palatial flat in a big city ever so intensely without affecting its value—but also upon the value of his possessions. This is to explain value not by marginal utility alone, but by value itself. Or, speaking in terms of prices, the price which an individual is willing to pay for a commodity depends on his income—which rests on prices—and on the prices he has to pay for other goods he also wants. His offer for a horse depends on considerations of the wages of grooms, the price of its food, of harnesses, of the kind of carriage he requires, still more on the price of his own food, theatre tickets, house-rent, and so on. In other words, the market controls the price which the individual is willing to pay, instead of

[1] See Anderson, *Value of Money*, pp. 80 and following.

[2] Kinley, *Money* (1913), p. 145.

the individual controlling the market.[1] "Marginal utility is not a cause of market prices, but rather, marginal utilities and market prices are alike resultants, effects, of more fundamental factors." "In most of the efforts to apply the utility theory to money, the circle becomes so obvious that one marvels that able theorists should for a moment fail to see it."

The Quantity Theory

We pass on now to the consideration of a theory widely accepted to-day by such representative writers as Nicholson, Irving Fisher, Taussig, and Kemmerer. Whereas the earlier theories to which we have referred lay stress on the qualitative character of the substance used as money,[2] either its cost of production or its marginal utility, the quantitative theory lays stress on the quantity of the units that effect exchanges of commodities, on the idea that the general level of prices depends ultimately on the quantity of the money in circulation. It assumes that price level is a ratio between the number of units of money and the number of units of commodities to be exchanged, and that these two numbers are independent of each other.[3] The average price is a simple function of the quantities of goods and of money respectively, such that an increase in the quantity of money will increase the average price if goods remain unchanged in amount, or an increase in goods will lead to a fall in price per unit, money being assumed to remain unchanged in quantity. As for rapidity of circulation, which affects both money and

[1] See Anderson, *Value of Money*, pp. 111-113 (1917).

[2] For Wieser, of course, money is not a commodity like other commodities. Anything can be used as money—as a medium of exchange—and it has a velocity in circulation which is not present in commodities.

[3] The statement of a quantity theory of prices assumes two independent variables—total money or total purchasing power on the one hand, total supply of goods or total volume of transactions on the other (Taussig, *Principles*, 1911, i. p. 432).

goods, it is thought of as a constant, so that the original formula remains unaffected. At the root of the quantity theory is the view that the substance of which money is made has no bearing on its value, and that it is the number and not the quality of the money units that counts.[1]

J. S. Mill gives us a fairly complete theory of prices, and his views may be taken as fairly representative of the quantity theory of the value of money. "Money is a commodity, and its value is determined like that of other commodities, temporarily by demand and supply, permanently and on the average by cost of production." [2] "The supply of money is all the money in circulation at the time; the demand for money again consists of all the goods offered for sale. As the whole of the goods in the market compose the demand for money, so the whole of the money constitutes the demand for goods." [3] "The value of money, other things being the same, varies inversely as its quantity." "The amount of goods and of transactions being the same, the value of money is inversely as its quantity multiplied by what is called the rapidity of circulation." Mill makes the assumption that the only demand for gold is a monetary demand and that the only medium of exchange that circulates is the standard money. He goes on to recognise that

[1] "The quantity theory asserts that (provided velocity of circulation and volume of trade are unchanged) if we increase the *number* of dollars, prices will be increased in the same proportion. It is the number, and not the weight, that is essential. . . . It is a fact which differentiates money from all other goods and explains the peculiar manner in which its purchasing power is related to other goods. Sugar, for instance, has a specific desirability dependent on its quantity in pounds. Money has no such quality. The value of sugar depends on its *actual quantity*. If the quantity of sugar is changed from 1,000,000 lb. to 1,000,000 hundredweight, it does not follow that a hundredweight will have the value previously possessed by a pound. But if money in circulation is changed from 1,000,000 units of one weight to 1,000,000 units of another weight, the value of each unit will remain unchanged" (Irving Fisher, *Purchasing Power of Money*, pp. 31-32).

[2] *Principles of Pol. Econ.* Bk. III. ch. vii.

[3] *Ibid.* Bk. III. ch. viii. sec. 2.

credit acts as purchasing power, and holds that the supply of goods brought to market is compared with an offer of purchasing power through which prices are fixed. There are, however, other passages,[1] where Mill seems to imply that the quantity theory of money can only apply to the temporary fluctuations of market prices, and that the "natural" rate of prices is determined by the general principles of value which operate in determining exchange of any two commodities. Gold in the long run would adjust its value to commodities in such a way that the cost of production of gold tends to equal the cost of production of the article against which it exchanges.[2]

J. S. Nicholson has restated the quantity theory in simple terms. He assumes a hypothetical market with the following conditions: (1) No exchanges are to be made unless money (the equivalent being counters of a certain size made of dodo-bones) actually passes from hand to hand. In other words, there is to be no credit or barter. (2) All the money is to be in circulation, as the money has no value apart from its use as a medium of exchange. (3) Let us suppose there are ten traders, each with one kind of commodity and no money, and one trader with all the money (100 pieces) and no commodities. The price under these conditions will be 10 pieces for each

[1] "It is hardly necessary to say that the permanent value of money —the natural and average prices of commodities—are not in question here. These are determined by the cost of producing or of obtaining the precious metals. An ounce of gold or silver will in the long run exchange for as much of every other commodity as can be produced or imported at the same cost with itself.

"It is not, however, with ultimate or average, but with immediate and temporary prices that we are now concerned. These, as we have seen, may deviate very widely from the standard of cost of production. Among other causes of fluctuation, one we have found to be the quantity of money in circulation. Other things being the same, an increase of the money in circulation raises prices, a diminution lowers them" (*Principles of Pol. Econ.* Bk. III. ch. xii. sec. 1).

[2] "The value of money then conforms permanently and in a state of freedom (and with no seignorage) almost immediately to the value of the metal of which it is made" (*Ibid.* Bk. III. ch. ix. sec. 2).

article, every article being assumed to be of equal value. If the amount of money is increased to 1000, the price will be 100 for each article. The value of money thus varies inversely with the quantity. Rapidity of circulation has the same effect as an increase in the quantity of money.[1] So also Professor Taussig: Instead of saying that the general range of prices depends (other things being equal) on the quantity of specie, we must say that it depends on the total quantity of money means, or on the available total purchasing power in terms of money. In proportion as this total purchasing power becomes greater or less, prices will rise or fall—other things, such as the flow of commodities for sale into the market, being still assumed to be the same.[2]

[1] J. S. Nicholson, *Money and Monetary Problems*, pp. 64-66, 71-73. Nicholson, however, does not seem to be quite clear as to what he means by "money". "Money", he says, "is not simply a commodity like other commodities, with its value dependent merely on the value of its material." His discussion of bank notes shows that he includes all media of exchange in "money". But he rules out all deposit currency. Any interpretation of money which includes cheques is fatal to the quantity theory. "Gold is the wind of commerce and the tide of trade, and its abundance or scarcity raises or lowers general prices just as the wind or tide raises or lowers the speed of vessels." Metallic money is the necessary foundation of credit superstructure, and gold imposes real limits on the inflation of prices through the influence of credit (see *Elements of Political Economy*, 1903, pp. 278-279). Speaking, however, of the fall of prices, 1873–93, he observes, "We can hardly say that the effective cause of the fall is to be found in the contraction of credit due to the amount of gold being insufficient to support a greater superstructure of representative money". Does not the quantity theory break down altogether if with increasing production of gold and no restriction of credit prices continue to fall?

[2] Cf. "That the general range of prices depends on the quantity of money, and that an increase in quantity will bring about a general rise in prices, has become one of the commonplaces of economic theory. In this simple form of statement 'money' means what we usually denote by that term—coin, Government notes, bank notes. Five hundred years ago, even a hundred years ago, when almost all purchases were made with actual coin or notes, the proposition in all essentials was true. But the enormous developement of credit in modern times compels a modification. . . .

"The true way to state the conditions on which in our day the general range of prices depends is to compare the quantity of commodities

Nicholson is prepared to include bank notes in the volume of money, and sees a typical illustration of the quantity theory in the case of inconvertible paper, but would exclude other forms of credit or representative money. Taussig, on the other hand, extends the quantity theory so as to include in the volume of money all forms of credit—cheques, deposits, etc. But whilst Taussig thus extends the theory into a theory of the total volume of purchasing power, he admits that the connection between the total purchasing power and the quantity of money becomes very loose at any given time.[1] He points out that the extent of the superstructure of credit built upon the foundation of a given supply of cash (meaning, by cash, specie and all legal tender paper) is affected by (1) direct necessity, which compels every banker to keep some cash in hand; (2) the force of custom, as in the case of the Bank of England; (3) direct regulation by law, as in the United States, where a minimum is laid down; (4) the need of cash for everyday transactions; and (5) the temper of the business community, which influences the volume of deposits. Taussig appears almost to give up the quantity theory in despair when he acknowledges that, "where bank media, whether in the form of deposits or notes, are an important part of total purchasing power, the connection between general prices and the quantity of 'money' is irregular and uncertain". In other words, the total purchasing power includes elements of such a shifting character, dependent on such a variety of causes, that it loses a considerable part of its value as an explanatory phenomenon.

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offered for sale with the total volume of *purchasing power in terms of money*. In this volume of purchasing power the largest item consists in our day not of actual money, but of credit in various forms. . . . At any one time and for considerable lengths of time the general range of prices with a given volume of transactions depends not on the quantity of money simply, but on the volume of credit used as purchasing power" (*The Silver Situation in the United States*, pp. 73-75 (1893)).

[1] *Principles of Economics*, 1911, i. p. 432.

A Few Assumptions of the Quantity Theory

We may here briefly consider a few of the assumptions on which the quantity theory rests. Nicholson points out that the medium of exchange has no intrinsic value in his illustration. Why should any one accept the counters at all in exchange? It is a vicious circle to argue that every trader will accept them. As a matter of fact, if the dodo-bones circulate, it is because there is a mutual understanding amongst the traders to take them as representative money, as representing a standard of values, or as tokens. Money has amongst others two functions, that of serving as a standard of values and that of a medium of exchange. The standard must at any rate have some value in itself if it is to measure other things that have value; you cannot measure values by a commodity that has no value. Similarly, if barter is to give place to a money economy with a medium of exchange, people will not part with commodities except in exchange for a commodity that has value, or for something representative of that (money) commodity. Thus nothing can function as money unless it has a value independent of its functions as money.[1] This value need not exclusively be centred in a physical commodity. There are people to-day who would, like Mr. J. P. Morgan in his testimony before the Pujo Committee, maintain that "gold is money, and nothing else"; but the value of money to an individual is the reflection of its social value, and paper, originally valued because it is convertible into coins, and these again into objects of value,

[1] There are representative exponents of the metallist or commodity theory, like Prof. Laughlin, who, while they recognise that the commodity of which money consists has value of its own, deny that the money employment has any direct effect in increasing the value of money. It has been suggested, in criticism of this view, that money has value as money, that exchange is a productive process, that money as an instrument of exchange creates values: and that discount and the rate on call loans may be taken to be measures of the value of this money service.

may be regarded hereafter as possessing a value of its own.[1]

Secondly, the quantity theory assumes that all exchanges must be made through money or through money and credit instruments. Barter is definitely excluded.[2] It is not difficult to show, however, that barter plays an important part in the money market to-day. It has even been said that money economy has made barter easier rather than harder. Foreign trade is carried on through the bill of exchange, which is not money in the strict sense ; and where bills of exchange are used for the purposes of internal trade they may often change hands several times before they are discounted. A large amount of ordinary trade in every country is carried on by book entries, bills of exchange, clearing-house arrangements. The recognition of barter in the modern money market completely dislocates the theory of proportion between the amount of money and the general level of prices.[3]

[1] In fact all those who, like Fisher and Keynes, urge the uselessness of gold assume—and wrongly assume—that the secondary and derivative value of paper money to-day *has* become substantial and independent of its presuppositions.

[2] Cf. Fisher, "As long as there were any preference at all for the use of money, resort to barter would be reluctantly made and as a temporary expedient only". "Practically, in the world of to-day, even such temporary resort to barter is trifling. The convenience of exchange by money is so much greater than the convenience of barter, that the price adjustment would be made almost at once. If barter needs to be seriously considered as a relief from money stringency, we shall be doing it full justice if we picture it as a safety-valve, working against a resistance so great as almost never to come into operation, and then only for brief transition intervals" (*Purchasing Power of Money*, pp. 156, 160).

[3] Cf. Kinley, "The credit exchanges may be increased as the value of money rises. That is to say, there may be a relative increase in the amount of credit paper used in payments. For the increase in the value of money makes possible a larger business on the same reserve. Doubtless a rise in the value of money would cause some diminution of the amount used as a reserve, and the remainder so used would support a volume of credit larger in proportion to the whole volume of payments" (*Money*, p. 161).

CHAPTER XI

THE " EQUATION OF EXCHANGE " AND IRVING FISHER

In Irving Fisher's *Purchasing Power of Money* we have the most uncompromising exposition of the quantity theory to be found in recent economic literature.[1] The quantity theory asserts that the price level varies directly as the quantity of money in circulation, that if we increase the number of dollars, prices will be increased in the same proportion ; that money alone of all goods possesses this fundamental peculiarity, that it has no power to satisfy human wants except a *power to purchase* things which do have such power.[2] " The study of the purchasing power of money is identical with the study of price levels." [3] It is somewhat difficult to follow Fisher in his distinction between individual prices from which the general level of prices is derived as an average, and the price level. He asserts that the general price level is independent of, and causally prior to, the particular prices of which it is an average.[4] The average can be nothing if it is not a summary of results ; and there can be nothing more in it than in the particular prices from which it is derived.[5]

[1] See footnote, p. 85.

[2] *Purchasing Power of Money*, pp. 29, 31, 32.

[3] *Ibid.* p. 14.

[4] *Ibid.* pp. 175-180.

[5] Anderson, in his *Value of Money*, makes an elaborate attempt to distinguish between the " absolute value " of money, which he takes to mean the value as determined by conditions peculiar to the money commodity, and the relative value of money, which is the reciprocal of the price level. There is undoubtedly great force in the distinction;

Starting with the accepted view that the level of prices varies directly with the quantity of money in circulation, provided that the velocity of circulation of that money and the volume of trade are not changed, Fisher goes on to the discussion of the equation of exchange, which makes the quantity theory more clear. The equation is a statement of the total transactions effected in a certain period in a given community ; it is the sum of the equations involved in all individual exchanges in a year. In each sale and purchase the money and goods exchanged are *ipso facto* equivalent, and in the total of exchanges for a year the total money paid is equal in value to the total value of the goods bought. The equation thus has a money side and a goods side. The money side is the product of the quantity of money, multiplied by its rapidity of circulation. The goods include all wealth, property, and services, all objects the transfer of which involves the actual transfer of money. The goods side is made up of the products of quantities of goods exchanged, multiplied by their respective prices. If we call the amount of money M, and the velocity of circulation V, and similarly if the average price of any particular commodity like bread be designated p, and the total quantity of that commodity purchased by Q, the equation of exchange may be expressed as follows :

$$MV = pQ + p^1Q^1 + p^2Q^2 + p^3Q^3 + \ . \ . \ .$$

Using Σ as a symbol of summation, we have

$$MV = \Sigma pQ = PT,$$

but changes in the absolute value can only be measured in the same way as changes in the relative value—namely by changes in the price level. Assuming with Anderson that cost of production, supply and demand, and other price theories presuppose something fundamental, namely changes in the value of money due to causes exclusively governing the money commodity, how can these changes be ascertained except through their reflections in prices ? Anderson admits this much himself when he observes that the price level will be different if the value of money is changing through causes other than those that affect the value of commodities in general.

the p's and the Q's relating to the entire community in any one year. The equation may be further simplified by rewriting the right-hand side as PT, where P is a weighted average of all the p's, and T is the sum of all the Q's. P represents in one magnitude the level of price, and T represents in one magnitude the volume of trade.[1]

The equation of exchange is expressed by Fisher in a somewhat more complex manner in order to bring it closer to the actual world of prices. The formula $MV = PT$ does not take into account the influence of credit and the possibility of a resort to barter. He therefore gives us a revised formula which includes credit:

$$MV + M'V' = PT.$$

M consists of all the media of exchange in circulation which are generally acceptable (including bank notes).[2] It excludes money in bank reserves and Government

[1] T is the sum of all the Q's. But the various Q's are measured in different units. How can one sum up pounds of sugar, loaves of bread, tons of coal, etc. ? "If we add together these tons, pounds, bushels, etc., and call this grand total so many 'units' of commodity, we shall have a very arbitrary summation. It will make a difference, for instance, whether we measure coal by tons or hundredweights. The system becomes less arbitrary if we use, as the unit for measuring any goods, not the unit in which it is commonly sold, but the amount which constitutes a 'dollar's worth' at some particular year called the base year. Then every price, in the base year, is one dollar, and therefore the average of all prices in that year is also one dollar. For any other year the average price (*i.e.* the average of the prices of the newly chosen units which in the base year were worth a dollar) will be the index number representing the price level, while the number of such units will be the volume of trade" (*Purchasing Power of Money*, p. 196). In Fisher's theory, as in the quantity theory generally held, the volume of trade is one of the causes that determine the level of prices (see *ibid.* ch. viii.). But we are now told that T is the sum total of Q's, which can only be obtained by the use of a common unit which is a price—a dollar's worth !

[2] A bank note is money because it is generally acceptable in exchange, while a cheque is only acceptable by the consent of the payee. Nicholson, on the other hand, limits money to coins, and includes bank notes and Government paper money in credit instruments.

treasuries. M′ consists of deposits transferable by cheque.[1] Fisher assumes that there is a normal ratio of bank deposits (M′) to the quantity of money (M), and the inclusion of deposits does not disturb the quantity relation between money and prices.

Finally, Fisher summarises his theory by asserting that the various factors represented in the equation of exchange do not stand on the same causal footing. Prices are the passive element, and their general level must conform to the other factors.[2] An increase in the quantity of money tends to increase deposits (M′) proportionally, and the increase in these too tends to increase prices proportionally. An increase in deposits (M′) compared with money tends likewise to displace coin and to raise world prices. An increase in velocities tends to produce similar effects. An increase in the volume of trade tends not only to decrease prices, but also to increase velocities and deposits, and thus to neutralise partly or wholly the decrease in prices.

Fisher acknowledges, however, that during periods of transition the relation between money (M) and deposits (M′) is by no means rigid. In such periods an increase in M produces effects, not only on the P's, but on all the magnitudes of the equation of exchange; it not only increases M′ in its normal ratio to M, but often

[1] It is also difficult to understand why other forms of credit instruments like book credits and bills of exchange should not be included in M′. Bank credits, says Fisher, have no direct effect on prices, as they merely postpone and do not dispense with the use of money and cheques. But it may be said that all credit instruments which involve a time element merely postpone the use of money. All credit instruments alike have an indirect effect on prices in so far as they increase the velocity of money; and if the formula $MV + M'V' = PT$ is more useful than the simple formula $MV = PT$ then we might as well have a more elaborate formula:

$$MV + M'V' + M'' V'' + M''' V''' + OV'''' = PT,$$

where M″ will stand for book credits, and M‴ for bills of exchange, and O for all other media of exchange.

[2] "The price level is the effect and cannot be the cause of change in the other factors" (*Purchasing Power of Money*, p. 182).

temporarily beyond that ratio, and quickens V and V' temporarily, as also the Q's.[1]

The equation of exchange as formulated by Fisher and others is in itself a truism, a statement of fact. It is only when it is used to support a causal connection between the quantity of money and the price level that it lays itself open to criticism, and it is regrettable that those who defend the causal theory should mix up the equation with it. If there are six factors in an equation, any one or more of them may be taken as causes or effects of the rest, and the equation will remain unaffected under any of these causal hypotheses.

Examination of Professor Fisher's Views

(1) The causation theory involved in the equation of exchange, that the quantity of money governs the price level, depends on the assumption that M', the volume of bank deposits, bears a pretty constant ratio to M. Now M is the money in circulation. This money in circulation is held by bank depositors who may keep a certain ratio

[1] *Purchasing Power of Money*, p. 159.

Mr. Keynes in his *Tract on Monetary Reform* gives us still another formula of the equation of exchange:

$$n = p(k + rk').$$

n is the total holding of cash, p the level of prices or the price of each consumption unit, k the number of such units that can be bought with cash, k' the volume of commodities or consumption units which can be bought with bank deposits; r represents the proportion of cash kept by the banks. Mr. Keynes, like Fisher, argues that so long as k, k', and r remain unchanged, n and p will rise and fall together. There is thus no difference between the two formulæ; cash for Keynes includes bank notes, as it does for Fisher. As with Fisher so with Keynes, the amount of k and k' depends partly on the wealth of the community, partly on its habits. But Keynes admits what Fisher does not, that a sudden increase in the output may react on the value of r instead of leaving it constant. So also Keynes admits that changes in p will not always be exactly proportional to changes in n.

In Gustav Cassel we have yet another exponent of the quantity theory, though he does not formulate an equation of exchange. See *Money and Foreign Exchange after 1914*, pp. 26-32 and 52-54.

between their cash transactions and their cheque transactions; but the money in circulation is also held by large numbers of people who have no bank accounts. Fisher assumes that the whole of M tends to keep a definite ratio to M′; it is clear, however, that it is a sum of money not part of M, and another unknown fraction of M, that tend to keep a constant ratio to M′. In the next place, it is not safe to assume that banks keep fixed ratios between deposits and reserves, nor even that individuals keep fixed ratios between the cash on hand and their balances in the bank. The ratio of money held by the banks to deposits is subject to wide variations.[1] So also it seems too wide an assumption to speak of a fixed ratio between the cash on hand and bank balances in the case of individuals and corporations. The choice between legal tender and bank balances is determined, as Professor Pigou observes, by custom and convenience, and varies from class to class, according to the amount of income and nature of occupations. Finally, the comparative use of currency and bank balances may be affected by causes of a general kind that have no connection with the proportion itself.[2]

Stating Fisher's contention in a general way, it

[1] For the United States from 1890–1911, taking yearly averages, we have a variation in the ratio of reserves to deposits of over 73 per cent of the minimum ratio. The ratio was 26 per cent in 1894 and 15 per cent in 1906. The juxtaposition of these extreme variations shows how inaccurate is the assumption that the deposit currency may be treated as a substantially constant multiple of the quantity of money in banks (Anderson, *Value of Money*, pp. 178-179). So also J. M. Keynes points out that "the ratios of gold to liabilities vary very extremely from one country to another without always being explicable by reference to the varying circumstances of these countries. . . . The contingencies against which a gold reserve is held are necessarily so vague that the problem of assessing the proper ratio must be within wide limits indeterminate. It is natural, therefore, that bankers who must act one way or the other should often fall back on mere usage or accept that amount of gold as sufficient which, if they are chiefly passive, the tides of gold bring them. At any rate the management of gold reserves is not yet a science in most countries" ("The Prospects of Money", *Economic Journal*, December 1914).

[2] Pigou, *Essays in Applied Economics*, pp. 183-184.

amounts to this—that deposit money varies directly and proportionately with gold and is in fact determined by it. Admitting, and readily admitting, that gold has in gold-standard countries in some way put a limit on the expansion of credit, we cannot argue to any fixity of ratio or quantitative relation between the amount of gold and the amount of deposits.[1] As has been correctly pointed out, the basis of credit is goods; and the expansion of credit may often be traced to an increase of large and profitable business enterprise, rather than to an increase in the stocks of gold. It may even be urged that a pressure of demand for credit may become a potent factor in determining the supply of gold, rather than the supply of gold determine the amount and extent of the credit superstructure. Statistics of bank deposits show that in most countries during the twenty years preceding 1895, when the annual production of gold was fairly stationary, bank deposits increased as rapidly as during the fifteen years following 1895.[2]

(2) The quantity theory assumes that the volume of trade is independent of the quantity of money and credit instruments. Fisher does admit that increase in the volume of trade has some effect in modifying the habits of the community with regard to the proportion of cheque and cash transactions, and tends to increase M′ relatively to M. But except in this indirect manner, Fisher contends, it is still true that the volume of trade, like the velocity of the circulation of money, is independent of the quantity of money. "An inflation of the currency cannot increase the product of farms and factories, nor

[1] Nicholson, following Bagehot, points out how the proportion of the reserve to liabilities is determined by a number of shifting conditions in the mind of the banker—including not merely the amount of the liabilities, but also the time when they become due, the form in which they become due, the intensity of the demand, that is, whether the creditors are likely to be influenced by the same or by counteracting causes as regards withdrawals and deposits (*Elements of Pol. Econ.* p. 306).

[2] Layton, *Introd. to the Study of Prices*, pp. 136-138.

the speed of freight trains and ships. The stream of business depends on natural resources and technical conditions, not on the quantity of money. The whole machinery of production, transportation, and sale is a matter of physical capacities and technique, none of which depend on the quantity of money." [1]

It is not difficult to point out that a view of this kind is irreconcilable with the broad facts of economic history. The effects on trade and industry of gold discoveries in America after the voyage of Columbus were enormous. They facilitated saving and accumulation of capital, on which ultimately depends the growth of industry. And the explanation is sufficiently simple. In a country with potential resources, any addition to currency and credit to a certain limit stimulates production, and leads to an increase in the number of commodities which men desire.[2] An increase of gold in any country is in one sense equivalent to an increase of capital, if the gold is not bought by the export of an equivalent amount of commodities; and an increase of capital ultimately involves more exchanges and therefore greater production.

The quantity theory seems to lose sight of the distinction between the volume of production and the volume of trade. It is only in connection with the volume of production in the stricter sense that it would be true to maintain that it is limited by technical and physical factors, and that money does not influence it. But for trade and commerce money is of primary importance. Now the total volume of trade in a broad sense, including production, in the United States of America for 1909 is given by Fisher at $387,000,000,000. In 1904, according to the census figures of production, the total annual production for the United States did not exceed $400,000,000, including agricultural products, manufactures, and mining products. Even raising this

[1] *Purchasing Power of Money*, p. 155.

[2] See Hartley Withers, *Meaning of Money*, p. 18.

figure to $1,000,000,000 for 1909, the surprising revelation that these figures make is that the actual production is an insignificant part of the total volume of trade; that the greater bulk of this trade is made up of speculation which is not limited by physical capacities and technique. Production, as it is carried on to-day, is carried on in the expectation of sale; it has even been urged that the cost of marketing is at least equal to "real cost of production",[1] occasionally only slightly below, and often far above it. It is the very function of money and credit as instruments of exchange to bring about a fluid market, to effect rapid readjustments, and to make prices stable. But the quantity theory of money assumes a normal period and static conditions. When these conditions are realised, money has ceased to function in one sense; it has no work to do such as it has in dynamic conditions, when price fluctuations are to be smoothed out and uncertainties to be guarded against by cover and hedging. If money has to discharge its proper functions, it presupposes friction and fluctuations, and therefore periods of transition and cycles of trade expansion and depression; and in such periods there is the closest possible relationship between the volume of money and credit and the volume of trade.

(3) The velocity of circulation of money and of deposits must also be independent of the quantity of money and deposits. In the quantity theory the velocity may be compared to a channel through which M and M′ run on to influence the price level. Velocity of circulation is defined by Fisher as the average number of coins which pass through one man's hands, divided by the average amount held by him. "The velocity of circulation depends on technical conditions and bears no discoverable relation to the quantity of money in circulation. Velocity is the average rate of 'turnover', and depends on countless individual rates of turnover. These depend on individual habits. Each person regulates his turnover

[1] Dibblee, *The Laws of Supply and Demand*, p. 62.

to suit his convenience. . . . In the long run the average rate of turnover, or what amounts to the same thing, the average time money remains in the same hands, will be very closely determined. It will depend on density of population, commercial customs, rapidity of transport, and other technical conditions, but not on the quantity of money and deposits nor on the price level."[1] Fisher assumes that if money and deposits are doubled, prices would be doubled, leaving velocities unaffected.

Here again there are obvious considerations which point to a different relationship as between increase or decrease in the quantity of money, and increase or decrease in velocities. Most people have a tendency to save, and if there is a sudden increase in the quantity of money without any change in price level, a considerable amount of money might be hoarded or go into savings, which means a reduction in velocity. If this money saved went into the banks, the banks might increase the ratio of their reserves to liabilities rather than increase the volume of credit or deposits. So also density of population increases trade, and this may offset the effect of increasing velocity on rising prices. But Fisher contends that the concentration of population in cities has been an important factor in raising prices in the United States.[2]

Briefly, the velocity of circulation of money may be said to vary with the volume of trade and prices, and these concomitant variations may be due to far-reaching causes affecting producers and consumers alike. One obvious cause that determines both the volume of trade and the velocity of circulation is business confidence such as is manifested in the beginning of trade cycles.[3]

[1] *Purchasing Power of Money*, pp. 152-153.

[2] *Ibid.* p. 88.

[3] "The history of paper money abounds in instances of sudden changes within the country itself in the value of paper currency, caused by reports unfavourable to the country's credit. The value of the currency was lowered in these cases by a doubt as to whether the government would be permanently stable and would be in a position to honour its

It has been said that money and its representatives circulate more easily and rapidly when, as in a time of growing prosperity and increasing population, people spend with greater freedom instead of hoarding. In an undeveloped country or in an agricultural tract, the sluggishness of circulation and the absence of an elaborate credit organisation may require a greater amount of money for a given price level than in an industrial centre or in an advanced community. Want of rapidity of circulation is thus a phrase very often employed to mean an ill-regulated system of banking or a system of banking that suffers in efficiency, through ignorance and conservative customs or through distrust, and causes may frequently be at work affecting rapidity of circulation quite independently of the quantity of money, and on the other hand reacting on the quantity.[1]

(4) Fisher contends that the quantity theory as a causal theory holds good not merely of a hypothetical market with no credit, but of the actual world under normal conditions. But during periods of transition, by which he means the periodic phenomena of trade cycles, the relation between money (M) and deposits (M′) is by no means rigid, and the proportion between the quantity of money and the price level is not strictly maintained. So likewise in the transition period, prices are not wholly passive, but react on the other factors in the equation of exchange. To be brief, the causal theory about the

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drafts. . . . It is not easy to see how, on the theory of the quantity law, such a report could affect very rapidly the magnitudes on which the value of the note is supposed to depend, viz. the quantity of business to be transacted and the amount of the currency. Nor is it easy to see why we should suppose that the frequency with which the notes pass from hand to hand is independently fixed. On the other hand, the quantity of business done by the notes as distinct from the quantity of business done altogether and the rapidity of circulation of the notes may obviously be affected by sinister rumours. Two of the quantities, then, supposed to determine the value of the unit of circulation are themselves liable to be determined by it" (Wicksteed, *Common Sense of Political Economy*, p. 623).

[1] See Pierson, *Principles of Economics*, vol. i. pp. 398-399 (1913).

relation between the quantity of money and the price level does not hold good of periods of transition. A period of transition is defined as a period of rising or falling prices ; it is a period in which the factors in the equation of exchange are continually seeking normal adjustment. Such a period, which we call a business cycle, extends over a number of years and recurs at regular intervals. Prices and other factors are constantly adjusting themselves before what Fisher calls normal equilibrium is reached. The normal period, then, would appear to be, if not hypothetical, one of which the economist may catch only occasional glimpses during a number of years. Fisher himself seems to recognise this when he observes that " periods of transition are the rule and those of equilibrium the exception ", and " the mechanism of exchange is almost always in a dynamic rather than a static condition ".[1] He goes further, and admits that the strictly proportional effect on prices of an increase in M is only the *normal* [2] or ultimate effect after transition periods are over. " The proposition that prices vary with money holds true only in comparing two imaginary periods for each of which prices are stationary or are moving alike upward or downward and at the same rate." So that it does appear that the quantity theory, in so far as it asserts a causal connection between the quantity of money and the price level, is a hypothetical statement of static conditions which can never hold true of a dynamic world of rising and falling prices. If, on the other hand, the quantity theory, like Boyle's Law, is only a statement of a proportion or statistical correspondence between money and price [3]—in other words, if it is to be treated as a simple equation of exchange—it falls far short of asserting that causal dependence of prices on the quantity of money which it

[1] *Purchasing Power of Money*, p. 71.

[2] We have never seen the word " normal " put to such an extraordinary use as here.

[3] See *Purchasing Power of Money*, p. 296.

is Fisher's business to defend. Finally, a causal theory presupposes a dynamic world of events in the order of time, and becomes almost meaningless if it is to be applied to an ideal world of stable equilibrium round which price movements fluctuate.

We cannot, then, accept the causal sequence which the quantity theory seeks to establish under the guise of an equation of exchange. The assumptions that it makes do not hold good of the actual world of prices. Its best exponents have confessed that it does not give a satisfactory account of movements in price level over short periods of time. Even as a theory for the explanation of price movements in the long run, it breaks down in view of the interaction between the various factors that enter into the situation. It is too general to give us any insight into the causes of the dynamic movements in price level in which we are all immediately interested.

Value of the Quantity Theory

Yet while we recognise the weaknesses of the quantity theory, we must not be led to reject it altogether. It is true that the assumptions under which the purchasing power of the monetary unit diminishes in exact proportion to an increase in its quantity, never hold good of our actual markets, and that a large number of other factors besides the quantity of money play a part in determining price movements over short as well as long periods. These other factors, moreover, are constantly shifting and difficult to measure, and exert a greater influence than the quantity factor on the trend of prices. It still remains true to assert that the quantity of money is one cause amongst others whose importance may sometimes be overlooked. Thus proposals to prevent a rise in the level of prices by curbing the expansion of currency and bank credit are often opposed on the ground that any restriction of the volume of money would restrict production. Now it is true that when employment and

business activity are below the maximum, rising prices with increase in the volume of credit may stimulate production and reduce unemployment. But a point is soon reached when competition in business may result in higher prices and wages, and in further demands for credit, though production does not increase. With every one commanding higher wages and spending more money, a temptation offers itself, as it did to the belligerent Powers during the war, to increase the volume of money and credit, bringing about a further phenomenal rise in the price level. The history of the last few years bears ample testimony to the play of the economic forces that brought about soaring prices, ending in chaos in some portions of the European continent. Production soon reached its maximum, and much of it was directed to the manufacture of commodities that ended in smoke and fire. Wage-earners went on spending more, and the banks were urged to supply more and more credit for private expenditure and for the "essential" industries. The increased purchasing power thrown into the market resulted in a higher price level.

But if the quantity theory has thus its element of truth, it is partly due to the larger meaning we attach to the term "money". As society grows and develops its methods of trading and exchange, the meaning of "money" undergoes radical alteration; the "efficiency" of a given amount of money as a medium of exchange to-day is much greater than it was in the past. Among the factors that determine the price level are the amount of cash and the amount of bank deposits, and these are now increasingly recognised as factors that can be controlled by banking organisation.[1] The working of the Federal

[1] Cf. Keynes: "The moral of this discussion is that the price level is not mysterious, but is governed by a few, definite, analysable influences. Two of these, n and r, are under the direct control (or ought to be) of the central banking authorities. The third, namely k and k', is not directly controllable, and depends on the mood of the public and the business world. The business of stabilising the price level, not merely over long periods but so as also to avoid cyclical fluctuations, consists

Reserve system in the United States has definitely demonstrated the possibility of preventing undesirable movements in price level, by the exercise of an effective control over the use and extension of credit.[1] The body economic, like the human body, is built upon the co-ordinated functions of many organs; it is not difficult to weaken the body by tampering with one of these organs; if the disease is properly diagnosed, it may be possible to treat the organ. But no single prescription can by itself keep the balance and health of the economic organism. The quantity theory draws attention to one of the organs essential to the proper working of our price-ridden world, and it may enable an enlightened public opinion, working through a banking organisation like that of the Federal Reserve system, to safeguard the economic life of the nation by a control of credit and currency.

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partly in exercising a stabilising influence over k and k', and, in so far as this fails or is impracticable, in deliberately varying n and r so as to *counterbalance* the movement of k and k'" (*Tract on Monetary Reform*, pp. 84-85).

[1] "We have to-day the greatest gold stock in our history or in the history of any country—about $4,500,000,000. We have a price level which is about 50 per cent above the pre-war figures and which corresponds roughly to the prevailing level in Great Britain and in several other countries. We have a volume of deposit credits which I have stated in round numbers as about $37,000,000,000, or larger than perhaps at any previous time. Credit and money both far surpass in volume amounts available when prices were at their peak in 1920. Prices themselves remain at about 60 per cent of their figure of that year" (H. Parker Willis, *Proceedings of the Academy of Political Science*, Columbia University, Jan. 1925, pp. 116-117).

CHAPTER XII

THE VALUE OF MONEY AND THE PRICE LEVEL

OUR discussion has led us to a few general conclusions concerning the value of money as measured by changes in the general level of prices. The price of every commodity is measured by the quantity of a given standard for which it will exchange. A change in prices may be due to changes in the conditions affecting the supply of commodities, and on the other hand to changes in the demand for and supply of the money commodity. Such changes are measured by the help of index numbers of various kinds.

Taking the money side of the ratio of exchange, we have in the first instance the causes affecting the supply of money. The quantity of money will be dependent on the output of the mines, on the discovery of fresh gold deposits, on changes in the alternative uses of the money commodity. If by money we mean, as to-day, not only gold but paper money and credit devices generally, including bank deposits, then the quantity will be dependent on the volume of trade, on psychological conditions such as business confidence, and on the faith or reliance of the business world and of the public in general in the ultimate convertibility of credit instruments into cash. The quantity of deposit money will also depend on the efficacy of an extended banking organisation, and on the habits and customs of the people.

In the case of other commodities, the quantity depends partly on the cost of production or reproduction. In

the case of gold, the fact that it performs its services through an indefinite number of exchanges, that it does not perish in being used, that therefore the total supply is so enormously large as to make the annual additions a negligible quantity, results in the generally accepted principle that the cost of production has very little influence in determining the value of the commodity as a whole.[1] A large addition to the supply of gold in any particular year will normally pass through the banks into the reserves or into circulation, without affecting prices, assuming that the growing volume of trade admits of such absorption. If, however, no more gold is needed for the reserves or the media of exchange, the gold will go into the arts, where the increased supply may bring about a fall in its purchasing power. The ultimate result of such a fall in value may be to diminish the profitableness of mining, and may check further investments in gold-mining as a business, if it does not affect the mines actually on the margin. But long before the actual adjustments have time to effect themselves, the sensitive conditions of the money market may bring about the adjustments without affecting the supply, by operation of the Bank rate or otherwise.

[1] Compare Kinley (*Money*, pp. 164-165), who goes much further than we do in the view that cost of production has no relation to the value of gold. "In the first place, until a very recent time, the production of gold has not been, properly speaking, economic. That is, it has not been carried on as a business for profit. From the earliest times gold has had for men a peculiar fascination, which has led them to endure and, indeed, to court all hardships and dangers in order to procure it. The fascination of prospecting for gold, the desire to get rich quickly, has been at the bottom of nearly all the uneconomic production of the metal from the earliest times. Men have seen and have been attracted by the gold accumulated by the few who have been successful in their search for it, and have constantly forgotten the losses, the hardships, and the sacrifices of life and property, suffered by the much larger number who have been unsuccessful. Where one has succeeded, probably hundreds have failed in their efforts to secure a sufficient amount of the precious metal to offset their labour in seeking for it. Considering the gold possessed by the world, as a whole, therefore, every ounce of it has cost many times its purchasing power."

The question has often been asked in our times: Is a downward trend of prices to be expected in the coming years through a lack of monetary gold ?[1] The total stock used for currency purposes is estimated at about $10,000,000,000, the balance being hoarded or used for the industrial arts.

The following table gives us statistics of the world production and consumption of gold in the period 1915–1923, and the world's total stock of gold.

In millions of dollars.*

	1915.	1916.	1917.	1918.	1919.	1920.	1921.	1922.	1923.
World production	469	454	420	384	366	337	330	319	360
World consumption in industrial arts (Europe and America) . .	85	90	80	85	115	110	60	75	..
India (hoarded) .	8·5	25.5	100	·5	148	17·5	4·5	133	..
China (hoarded) .	8·5	13	13	2	57·5	19·5	11	5	..
Consumed in arts and Orient .	85	128·5	193	87·5	320·5	108	53·5	203	..
Available for money	384	325·5	227	296·5	45·5	229	276·5	116	..
World's stock of gold money .	8445	8770	8999	9280	9325	9580	9825	9950	..

* Taken from the *Proceedings of the Academy of Political Science*, New York, Jan. 1925, pp. 158 and following.

Mr. Joseph Kitchin, who can speak with authority on world gold production, estimates that the annual production for 1924–27 will be at the rate of $385,000,000, and that for the years 1927–30 it will decline to about $370,000,000. He does not expect the actual annual production to vary more than 5 per cent from the estimate. So also the Harvard Committee on Economic Research expresses the view that an annual supply of $150,000,000 for the purposes of currency will be sufficient to prevent a decline of gold prices during the present decade.[2]

[1] This is a different apprehension from that of Mr. Keynes, who fears the quantities of this useless metal thrown on the market by the adoption of more scientific currencies by the world will bring a phenomenal fall in its purchasing power.

[2] See "Future Price Trends", by J. O. Downey (*Proceedings of the Academy of Political Science*, New York, Jan. 1925). It has been

Even assuming that the annual production falls off to some extent, the history of the last few years has drawn attention to another source of supply which exercises a steadying influence on the price level, namely, the existence of hoards. The net increases in the gold reserves of some of the European countries and the United States during the period 1913–24 can only be accounted for on the assumption that in times of great and unusual need nations can draw upon these private hoards.

CENTRAL GOLD RESERVES

In millions of dollars

Date end of Year.	United States.	United Kingdom.	France.	Italy.	Germany.	Spain.	Japan.	Netherlands.
1913	691·5	170·3	678·8	288·1	278·7	92·6	65·0	60·7
1914	827·7	428·3	799·4	299·7	498·7	110·8	64·1	83·6
1915	1312·3	389·3	967·9	293·2	582·5	167·7	68·2	172·5
1916	1442·2	402·9	652·8	255·9	600·4	242·0	113·4	236·4
1917	1739·8	422·4	639·6	238·9	573·4	380·8	230·0	280·6
1918	2245·7	523·7	663·9	234·1	538·9	430·0	225·8	277·0
1919	2097·7	583·0	694·8	231·6	259·4	472·1	349·9	256·2
1920	2222·9	763·1	685·5	235·5	260·1	474·2	551·8	255·7
1921	3021·3	763·3	690·2	243·6	237·0	485·0	611·2	243·6
1922	3909·7	751·4	708·3	250·1	239·4	487·3	605·7	233·9
1923	4226·4	754·3	709·5	249·0	111·2	487·9	602·2	233·9
May 1924	4468·4	755·3	710·0	250·5	105·3	488·9	598·7	213·6

Turning in the next place to the causes affecting the demands for gold, the demand is in the first instance for non-monetary purposes. These non-monetary uses of the precious metals account for the preference which mankind has shown for their use as money. The demand includes a demand for gold by dentists, surgeons, and manufacturers, its use in innumerable forms of watches, ornaments, and jewellery, its use in decorating the edges of books and the domes and interiors of big architectural

estimated that from the total annual supply of roughly $350,000,000, the net amount available for monetary purposes after deducting gold for the Orient and other non-monetary purposes will be in excess of $150,000,000 a year.

enterprises. Secondly, every country that uses gold for monetary purposes requires a certain stock of it every year for securing the convertibility of the various media of exchange. The amount of gold in actual circulation in any country will depend on the habits of the people, the stage of economic development the country has reached, and the extent to which banking organisation has created facilities for the use of media of exchange other than the precious metal.

The demand for money in a more comprehensive sense, including deposits—in other words, the demand for purchasing power—depends on the volume of trade and business, on the conditions or terms on which such money is available, and ultimately on the volume of the physical goods or utilities which such purchasing power renders exchangeable.

Hitherto we have been dealing with the conditions that affect the money side of the ratio of exchanges. When we direct our attention to the side of commodities in general, every commodity has its own variations in price due to causes affecting its supply and demand. It has been observed that any serious changes in price during short periods of time in commodities " must always be referred to causes affecting the expenses of production ", or to causes touching their demand and supply, " quite irrespective of those operating on gold ".[1] Laughlin, who claims that this view gives a correct interpretation of fluctuations in price level over short periods of time, seems, however, to lose sight of two important considerations. In the first place, the causes that operate on the *money* side of the ratio of exchange are not, and cannot be, identified with those that operate on gold. The price level is determined amongst other things, not simply by the quantity of the precious metal, but by the quantity of other media of exchange, including book entries, that the metallic basis can support. Secondly, if the cost of production is a dominant factor

[1] Laughlin, *Principles of Money*, pp. 350-351.

in the determination of prices of commodities, that cost presupposes and is calculated on a definite price level, and changes with every change in the price level. It would not, therefore, be safe to assert that price fluctuations over short periods of time are due entirely to causes affecting the commodities side, and not to causes affecting the money side.

The supply of commodities is dependent upon the costs of production, which in turn involve a definite price level. The demand for commodities depends on causes affecting the distribution of wealth, on changes in men's conception of the relative values of different kinds of utilities, and on the amount of money or suspended purchasing power that each individual possesses.

Thus changes in price level constitute a normal feature of economic life. A society with an absolutely stable level of prices is a hypothetical assumption, useful for understanding the trend of actual price movements, but never literally true of the concrete economic world of prices. These changes are the result of a number of interacting factors, amongst which the quantity of purchasing power in the shape of gold and credit plays a dominant part. With more goods to be exchanged, the volume of the media of exchange must expand ; and an expansion of credit in turn stimulates production by giving an upward trend to prices. In a country with a well-organised banking system, where a credit organisation is fully developed, and people are accustomed to economise the use of the precious metals to the fullest, the evils of the alternating periods of trade expansion and depression are found to be intimately related to the volume of the media of exchange and purchasing power for short periods created by the banks ; and a wise management and control of the volume of credit may minimise, if not entirely remove, those evils incidental to trade cycles. There are even to-day economists who believe that the only thing which it is necessary for the State to do is to assure the permanence of the standard, and remove all

shadow of doubt as to the immediate convertibility of the media of exchange into that standard, and that the expansion and contraction of the media of exchange can be with confidence left to take care of themselves. The story of currency management during the last ten years both in the United States and Great Britain has, however, made it clear that with a gold standard, if it is possible to give greater relative stability to the price level, it is not by leaving credit expansion and contraction to take care of themselves, nor even by an automatic and mechanical regulation of the Bank rate, but by a comprehensive series of measures which involve a social control over the use of credit, exercised in the general interests of the country on sound principles of banking.

CHAPTER XIII

CURRENCY SYSTEMS

IF we examine the operation of a currency system in any civilised country, we find that the actual media of exchange are complex, and we also find that the best media are those which circulate easily. The proper method of approaching the subject is from the point of view of circulation.

LEGAL TENDER MONEY : TOKEN MONEY

It is best to begin with a few preliminary definitions. The currency of every country includes legal tender money and money that is not legal tender. Legal tender money is that money whose offer is sufficient to discharge obligations. A legal tender law prevents uncertainty in contracts, and protects ignorant creditors from being imposed upon with spurious money. It does not prevent people from settling transactions by other means. Under a legal tender law, the standard money is usually unlimited legal tender, and its mint value is identical with its market value. Thus in England sovereigns, half-sovereigns, and Bank of England notes are unlimited legal tender (with the exception that the last are not legal tender on the part of the Bank of England itself) ; whereas cheques, bills of exchange, etc., are not legal tender.

A subsidiary or token coin is one whose face value is greater than its intrinsic or real value. Token money

is used for the convenience it affords for small transactions and for the economy that it effects in the use of the precious metals. Token coins circulate at their face value, because their supply is limited to the money work they are expected to perform. In the circulation of token money we have a typical illustration of the quantity theory of money. There is no free coinage, and the coin does not contain the stuff it professes on its face to contain. It is argued by some economists that token money circulates at its face value because it is legal tender only to a limited extent, but this has no bearing on the question. It is limitation of supply that enables the token coin to circulate at its face value. The rupee in India circulates at its face value though it is legal tender to an unlimited extent.

The primary cause of the circulation of money, whether standard money or token money, is the receiver's belief that others will take it from him in turn. The extent to which money will circulate depends on the nature of the confidence which induces acceptability, and it may vary from a small group, like the primitive tribe, to a nation or an empire.

GRESHAM'S LAW

Briefly stated, Gresham's law tells us that "bad money drives out good money". This law is incorrectly attributed to Sir Thomas Gresham, the founder of the Royal Exchange and financial counsellor to Queen Elizabeth. It had already been propounded by early thinkers in the fourteenth century. (1) When coins of the same denomination circulating in a country differ in weight or fineness, the better ones will serve not only for ordinary payments, as do the inferior coins, but have an alternative use for foreign payments, in which case they are exported, or for making more valuable articles in the arts, in which case they are melted down. (2) So also when coins made of two different metals circulate

side by side as full legal tender money, as in a bimetallic system, and the market value of one metal in terms of the other is different from the legally fixed value, the tendency will be for the coins with a smaller market value as bullion to drive out of circulation the coins with a higher value as bullion. (3) Similarly, when inconvertible paper money is circulating side by side with standard metallic money, and both are unlimited legal tender, the paper money will tend to drive out the full value coins.

The statement that bad money drives out good money seems paradoxical; ordinarily men would prefer to keep what is good and to reject what is bad. In the case of money they seem to keep the bad and reject the good. But the paradox disappears when we remember that the owner of money is a seller who sells the better goods because they can fetch him more, while he keeps the inferior goods for the purposes of payment.

(*a*) If Gresham's law is to come into operation it is necessary that the aggregate of the good and bad coins, or money in circulation, should be in excess of the country's need for the metallic or paper media of exchange. Every country requires at a given time a definite quantity of circulating media of exchange for commercial transactions large and small, and if the total quantity of the good and bad money does not exceed this limit, the good and bad money will continue to circulate side by side. This is the first limitation on Gresham's law.

(*b*) Secondly, the force of habit may very often defeat the operation of Gresham's law. The coins in circulation are liable to wear and tear through use; and very often coins lose in weight to an appreciable extent without driving out the "good" or freshly minted coins from circulation. It is only when the loss in weight becomes so great as to be at once noticed, that it may bring Gresham's law into operation; and every country provides for the contingency by regular withdrawal of such "bad" coins and replacement by freshly minted ones. We have a striking illustration of the influence of

custom in the history of California during the Civil War. The people of California would not use the greenbacks issued by the Government, and continued to use gold whilst the rest of the United States was using paper money.

Gresham's law is sometimes stated in a more generalised form : " When a community in which competition is free and intelligent has a choice of means of payment, it will use the least expensive which will serve its purpose under existing circumstances."

Organisation of a Modern Currency System

The best currency is that which is most easily current or acceptable. The fundamental object of the currency organisation of a country is to provide the most convenient and multifarious kinds of media of exchange, so as to suit all kinds of transactions large and small, and all kinds of payments involved in such transactions. The monetary system should be so organised that it is divided into sub-multiple and multiple units enabling people to discharge all debts of different denominations. The currency organisation must be adaptable, elastic, and flexible and must supply a variety of forms of currency to meet a variety of needs. There are large payments running into millions of pounds on the one hand ; there are small payments varying from a penny to a few pounds. To meet these various kinds of needs, our modern currency systems have to be composite, making use of all kinds of media of exchange. The currency requirements of a country, moreover, differ according to the stage of economic and industrial development it has reached. A country like Great Britain, accustomed to the use of credit instruments of all kinds, will require less of metallic money than a country like India, where banking facilities are not adequate. A wealthy country with a larger per capita income will need large quantities of full legal tender money, whilst on the other hand a country like

India, with a smaller national dividend, will need a larger quantity of token money. The details of currency organisation in any country have to be worked out with special reference to the needs of the country and the habits of the people.

The currency organisation of every civilised country makes provision for—

(*a*) metallic money, both standard and token coins ;

(*b*) convertible paper money and deposit certificates ;

(*c*) credit instruments of all kinds, cheques, drafts, bills of exchange, promissory notes, etc.

Of these the first two are universally current in the country, whilst credit instruments have a limited circulation, though the volume of transactions settled by credit instruments may be infinitely greater than that of transactions settled by metallic and paper money. It is not necessary that all metallic money should consist of one metal ; all that is necessary is that the standard coins should be of one metal, and that all other coins and media of exchange should be ultimately convertible into standard coin.

Types of Systems of Currency

Every country has evolved a system of currency under its own peculiar local conditions, though the fundamental principles underlying the currency systems of all civilised countries are the same. Through a long series of trials and errors, the civilised countries of the world have evolved one main type of currency, though they had developed distinct types at different stages of their economic evolution, and though even to-day they combine modifications of all kinds suited to local conditions with the main type.

The most important of these types of current interest are :

1. Monometallism, or the single metallic standard. This standard has for all practical purposes come

to mean the gold standard, because with the exception of China, which has still a silver monometallism, the whole world is in a sense on a gold basis.

2. Bimetallism, or the double standard. This standard is only of historical importance. It is now obsolete and is not in operation in any country.
3. The Gold-Exchange Standard. This is a variation of bimetallism and is in operation in a few dependencies. The most important country in which it is in operation is India.
4. Convertible paper money, both paper money issued by banks, and by Government.
5. Inconvertible paper money issued by banks or by Government. The last two are associated with one of the three types of currency systems mentioned above, and their nature and working depend upon the particular type with which they are associated.

The Gold Standard

Under a gold standard, coins of only one metal function as standard money; all values, in other words, are measured in terms of gold, and gold coins alone are full legal tender and thus capable of discharging all debts. It is not necessary that coins of only one metal should be current, or even that the whole currency should be metallic. Under a gold standard we have in actual circulation subsidiary or token coins, paper money, and cheques. If the banking organisation is adequate, the amount of metallic money required in a country may be very small. All that is essential for the proper working of the system is that all the substitutes used for standard money should be convertible at the will of the holder into the standard coin. Under a gold monometallism, there is an open mint for the free coinage of gold, and the mint value of the coin is identical with the market

value. The weight and fineness of the coins are defined by law, and the public can get bullion changed into coin either free of charge or at a nominal fixed rate. If there is any superfluity of currency, the coins can be melted down. There is, under the gold standard, an automatic device for the expansion and contraction of currency. The flow of gold outward and inward is unhampered: in other words there is a free and open market for gold. Foreign exchanges under the gold standard adjust themselves, because the mint par is fixed, and the fluctuations in the rates of exchange as between gold standard countries are confined only to the specie points. A favourable or adverse balance of trade is adjusted by the operation of the Bank rate, and in the last resort by the shipment of specie to and fro.

This was the pre-war currency system in England. It was the system that the Cunliffe Committee recommended for early restoration, and which has now been restored after an interval of about ten years.[1] Under this system the local currency generally consists of standard coins together with convertible paper money, either Government notes or bank notes. As the metal is coined freely, the metallic money responds quickly to international influences of demand and supply; for the mint and market values are identical. The volume of money comes to be regulated by its demand and supply. Under an effective gold standard, we have a system of currency that is elastic, adjusted automatically to the volume of trade, and for all practical purposes international.

This metallic money is combined with convertible

[1] The Cunliffe Committee observe, describing the pre-war English currency system: "Under these arrangements this country was provided with a complete and effective gold standard. The essence of such a standard is that notes must always stand at absolute parity with gold coins of equivalent face value, and that both notes and gold coins stand at absolute parity with gold bullion. When these conditions are fulfilled, the foreign exchange rates with all countries possessing an effective gold standard are maintained at or within the gold specie points." Para. 7.

paper money. As the paper money is convertible into standard coins, there is no danger of over-issue either by Government or by banks. In a civilised country the standard coins, notes, and credit instruments generally, co-operate efficiently to meet the requirements of trade and commerce. The most important requisite of a good system of money is that it should be sufficiently elastic to meet the demands of trade and commerce without delay ; and the co-operation of these various constituents in the way described above results in making the currency organisation automatic, securing an equilibrium between the volume of money and the money work to be done.[1]

BIMETALLISM

Under a bimetallic system of currency, coins of two metals circulate freely side by side. Both kinds of coins are full legal tender ; either or both may be employed to an unlimited extent to discharge debts. There is a free and open mint for the coinage of the two metals, and a fixed legal ratio of exchange. This is the vulnerable point of the system. The successful working of the bimetallic system depends on the maintenance of the coincidence between the market ratio and the legal ratio of exchange between the two metals. So long as the two coincide, coins of both the metals will continue to circulate side by side. A slight variation between the market and the legal ratio will throw the system out of gear ; for the moment such a variation occurs, Gresham's law will come into operation ; the coins of the depreciated metal will remain in circulation, while the coins of the appreciated metal will disappear from circulation, as there is an alternative use for them.

The bimetallists point to the great fluctuations in prices since the abandonment of bimetallism in Europe

[1] Mr. McKenna as Chairman of the Midland Bank, in January 1925, described the essentials and advantages of the gold standard. See above, p. 58, footnote 3.

in the seventies of the last century. They also charge monometallism with making international trade hazardous on account of the impossibility of establishing a fixed par of exchange between gold-using and silver-using countries. As a remedy the bimetallists rely on what is known as the compensatory action of the double standard. Supposing, for example, that the mint rate of exchange between gold and silver was 1 to 16, and that a change in the market for bullion, due to a fall in the value of silver, made the market ratio of exchange 1 to 18. It will be profitable to sell gold coins as bullion, and the gold coins will be melted or exported to buy silver bullion and take it to the mint for coinage. One result of this will be a large increase in the demand for silver for monetary purposes, and a decrease in the use of gold. Thus a change will be brought about which will counteract the fall in the market value of silver and bring the market ratio back to the legal ratio. The compensatory action of the double standard presupposes an international agreement for the adoption of bimetallism. Moreover, there may be forces at work which, instead of correcting the discrepancies between the market and legal ratio, may accentuate the discrepancies. With growing prosperity a country may acquire a partiality for the dearer metal. We are familiar to-day with the preference of the banking world for gold. The use of gold in payment of international balances would not be affected by the adoption of a bimetallic arrangement between the nations. Finally, it has been pointed out that the real effect of bimetallism would be to introduce an alternative standard, now of one metal, now of the other. No ratio established by law would be long maintained, and the metal which became relatively cheap in the market would become the real standard, the other being used as bullion.[1]

The reason why serious attempts were made during the last quarter of the nineteenth century to arrive at some international agreement on a bimetallic basis was

[1] *Money and Banking*, by W. A. Scott (1921), p. 333.

the belief generally entertained that bimetallism would conduce to stability in the general level of prices. It was thought that if both the metals were used concurrently as standard metals, there would be smaller variations in supply and demand, and that the failure of one metal to meet the increasing monetary requirements of the civilised world would be made up by the supply of the other metal. This argument found considerable support during the period 1873–96, when there was a fall in the general level of prices. It was urged that the fall was due to the deficiency in the supply of gold for monetary purposes, and that if bimetallism were adopted by the joint use of silver and gold for monetary purposes, prices would be kept more steady. During the years that followed there was an unusual increase in the production of gold, and the argument in favour of bimetallism lost much of its force. By the end of the nineteenth century all the civilised countries of the world had become confirmed converts to gold monometallism, and bimetallism was ruled out once for all. Silver was discarded as a standard metal by all the civilised countries and relegated to a secondary and subsidiary position.

Bimetallism may be regarded as an attempt to prevent fluctuations in the general level of prices. Now, though bimetallism may act as a check upon fluctuations, it cannot entirely prevent them. Supposing, for example, the production of silver to increase 25 per cent under the bimetallic system, all that can be claimed is that the demand for silver for monetary purposes would be increased and that for gold decreased to whatever degree might be necessary to prevent a change in the ratio; but this would not mean a 25 per cent change on both sides, which is what would be required to restore the former ratio of demand to supply. Very likely there would be a $12\frac{1}{2}$ per cent increase in the monetary demand for silver, and a corresponding decrease in that for gold. In this case both metals would have experienced a considerable fall in value, though not so great a fall as silver

would have experienced had there been no counteracting agency. It is difficult to decide between fluctuations small and continuous, but spread over a large range of years, and great fluctuations of a less frequent character.[1]

Monetary Problems at the End of the Nineteenth Century

After 1870 the European countries demonetised silver. The gold price of silver fluctuated violently. A number of international monetary conferences were held with a view to fixing the ratio between gold and silver. The fluctuations in the gold price of silver led to the dislocation of foreign exchanges between the gold-standard and silver-standard countries. When one country after another adopted the gold standard, silver lost its value for monetary purposes and came to be regarded as a commodity whose value, like the value of other commodities, depended on the forces of supply and demand. The closure of the mints to the free coinage of silver by the members of the Latin Monetary Union, and the increased production of silver, led to a marked fall in the gold price of silver, dislocating foreign trade and hampering the movements of capital from the gold-standard to the silver-standard countries. The difficulties were of a twofold character :

[1] Under bimetallism " the fluctuations would, probably, be of smaller range, but of greater frequency. It is claimed, however, that frequent small changes would be less detrimental to business than a smaller number of changes of considerable magnitude. This claim is of very doubtful validity. For the period of a large volume of debts, and of by far the greater number of productive and mercantile transactions, is short—too short to be seriously affected by a change of much magnitude in the purchasing power of money. The time necessary for such a change would overlap a series of periods of debt and of manufacturing and trade activity. To increase the number of fluctuations of the price level would be to introduce some, or many, within the debt periods and the cycles of production and trade. Business would be exposed to more uncertainty by such procedure. . . . Moreover, even if frequent small changes were less harmful than occasional large ones, it is questionable whether the condition of greater frequency and less degree could be permanent" (Kinley, *Money*, pp. 303-4).

(*a*) those involved in maintaining stability in the internal level of prices in each country, and (*b*) those involved in maintaining stability in the exchanges between the countries with different standards.

The failure of the international monetary conferences was followed by the adoption of gold monometallism by very many of the States of the world. India, which had a silver monometallic currency, suffered heavily during the period of fluctuations in the gold price of silver. In 1893 the mints in India were closed to the free coinage of silver with a view to the ultimate adoption of a gold standard. But after 1899, instead of adopting a gold standard, as the Fowler Committee had definitely recommended, her rulers drifted into a currency system which was called the Gold-Exchange Standard.

THE GOLD-EXCHANGE STANDARD

We shall have occasion at a later stage to examine and develop in detail the theory of the Gold-Exchange Standard. We shall here be satisfied with indicating the essentials necessary for the working of the Gold-Exchange Standard.

(*a*) It may be said to be an extension of the bank note system to token coins. The token coin (the rupee in India) is in effect a metallic bank note, whose maintenance at gold par is subject to the rules of sound banking. It has been said that the Gold-Exchange Standard has an advantage over the bank note in undeveloped countries, in so far as it conforms to the prejudice in favour of " hard money ". The token coin is full legal tender, and its currency at face value is maintained by limitation of output.

(*b*) It is essentially a managed currency, and the token coin is maintained at its face value by means of two funds—a fund consisting of gold maintained abroad to meet foreign obligations, and a fund consisting of token coins to meet favourable balances. Gold is not

available for internal circulation, but in theory it is available for meeting foreign obligations.

(*c*) It assumes the selling of foreign exchange by the Government—the supply of sterling bills in India and the sale of rupee bills in London by the Secretary of State.

Briefly the Gold-Exchange Standard aims at securing to the country all the benefits of an effective gold standard, without the use of gold for the purposes of internal circulation. It effects, or claims to effect, the largest possible economy of gold by making it available for meeting foreign obligations, and substituting token coinage for the purposes of internal use.

CHAPTER XIV

PAPER MONEY

We have so far described three kinds of metallic currency—gold monometallism, bimetallism, and the Gold-Exchange Standard. An enormous amount of money work in every civilised country is performed by paper money, and paper money plays a far greater part in the monetary organisation of a civilised country than metallic currency. But the circulation of paper money ultimately depends on its convertibility into metallic currency, and it is necessary to consider the principles underlying the issue of paper money.

Paper money may be regarded as a form of token money and performs the functions of money as well as gold, in some cases better than gold. Notes are more convenient for keeping and for payment of large sums than gold or silver. They can be more easily stored and carried ; each is identifiable by its date and number.[1]

Paper money is of three kinds :

(*a*) Representative paper money. This consists of notes or certificates which are mere receipts showing that as much bullion as is stated on the note or certificate is kept in the treasury office or bank.

(*b*) Fiduciary paper money—convertible or inconvertible. This kind of paper money consists of promissory notes, notes promising to pay the bearer on demand a specified sum of metallic money. It is a promise to pay, not directly backed by specie, but by the faith that the

[1] Edwin Cannan, *Money*, pp. 40-42.

promisor can inspire. Though part of the issue of Bank of England notes is fiduciary, nobody impugns the Bank's credit on that account. British Treasury notes may also be regarded as fiduciary paper money. The gold backing is small, but the notes are regarded as convertible.

(*c*) Fiat or conventional paper money—inconvertible. Fiat money consists of notes of various denominations. In form they are of the nature of promissory notes, but they are inconvertible. They acquire their value simply because of the fiat of Government or a bank authorised and backed by Government. It is a means sometimes adopted by a Government to pay its debts. In spite of the absence of a commodity backing, it has been pointed out that paper currencies in some States have performed the services of good money inside the country, with careful control and limitation.

All kinds of paper money are full legal tender and they are issued either by the Government or by a bank or banks.

Convertible Paper Money

Convertible paper money consists of notes issued by the Government or corporate bodies and convertible into standard money at the will of the holder. The advantages of the use of convertible paper are obvious. There is an economy of the precious metals. By the use of paper money the precious metals are released for nation-building purposes. Thus there is a saving of capital. If expanding commerce calls for more money work to be done than the volume of metallic money in actual circulation can cope with, it can be done by means of a more extended use of paper money. This can be more conveniently handled, and its destruction causes no loss of wealth to the community.

Convertible paper money may be issued either by the Government or by a bank or banks. The controversy as to the rival claims of Government and banks assumed a serious turn in the first half of the nineteenth century.

To-day we find that almost all advanced countries are in favour of allowing banks to issue notes. The main objection to the Government's keeping to itself the right of issuing notes is that the Government is not in such intimate touch with the business community as a bank, and therefore is not in a position to regulate the volume of issue to suit and meet the requirements of the business community. In the case of the Government, there is also the danger and temptation of over-issuing convertible paper money. A bank is better fitted as an institution for issuing convertible notes, because it can regulate the issue by the discount rate.

If paper money is issued by the Government it is of the nature of a promissory note payable to bearer on demand. If it is a bank note, it is issued by a bank promising to pay a specified amount. These bank notes get into circulation in two ways. A customer may deposit money in the bank and may receive bank notes, or he may give to his banker his promissory note or a bill of exchange and receive a bank note. The number of bank notes depends partly on the amount of promissory notes and bills of exchange offered to the bank ; and the number of promissory notes and bills of exchange depends on the volume of business. A bank is thus better fitted to regulate the note issue, because it is in touch with the requirements of the community. It is this peculiar power of banks to adjust the supply of bank notes to the demand that we characterise as the elasticity of the issue of bank notes.

Regulation of Convertible Note Issue

If the Government issues notes, it does so under the provisions of an Act regulating the issue of notes, and regulating also the fiduciary and metallic portions of the paper currency reserve. But if banks are empowered to regulate the issue of paper money, the question arises whether the issue of notes should be regarded as part

of the ordinary banking business, and the banks left to themselves, or whether the banks should be controlled by law in this particular business. Economists in the earlier days were divided into two schools on this question —one supporting the banking principle of note regulation, the other supporting the currency principle.

(*a*) The banking principle. Those who maintained this principle regarded the issue of notes as part of the ordinary business of a bank. There is no danger of over-issue of notes, so long as they are convertible. Convertibility is an adequate guarantee against over-issue and the resulting depreciation of notes.

(*b*) The currency principle. Those who advocated this view pointed out that notes issued by a bank vary independently of the volume of gold and silver which the issue replaces. Paper money put into circulation leads to inflation and an additional demand for more issue. Convertibility is not a sufficient guarantee against inflation. The advocates of the currency principle therefore insisted upon the regulation of note issue.

Both these principles embody important elements of truth, and it is interesting to notice that the first rules theory, whilst the second rules the practice of note issue in all civilised countries. The Bank of England and the Imperial Bank of Germany follow the second principle, while the Bank of France follows the first. But the general banking opinion favours the banking principle.

The fundamental question that must be settled is : Can a bank issue notes in excess of demand ? Now, issuing notes is the same process as that of extending or selling credit. An increased demand for currency is a consequence of large and increasing business ; and to speak of currency being issued in excess of demand is to mistake effect for cause. We do not suggest that the issue of notes should not be subject to regulation. It is quite possible for a bank to accentuate speculative tendencies by a low discount rate and easing the money market. Again, all men do not always insist upon

convertibility. All notes are not simultaneously presented for conversion. A bank may, with the best intentions, issue notes in quantities in excess of the legitimate demands of trade, and subject the community to the evils of depreciation.

Measures of various kinds have been suggested and adopted for guarding against this evil. (1) Some of them seek to act directly on the issue by fixing a limit to the amount that a bank may issue. Such measures are open to the objection that they make the currency inelastic, and dissociate the issue of notes from that close correspondence with the needs of business and trade which is so essential to economic development. Such measures involve the currency principle in disguise. (2) Others seek to regulate the reserve. Though the soundness of the banking principle has been generally recognised, it has been thought necessary to have some control over the issue of notes, and this control is exercised either by regulating the maximum reserve or by regulating the reserve itself. In the case of regulating the maximum reserve, it is not difficult to fix the amount in proportion to the volume of paper money. The regulation of the reserve, which includes not merely specie, but bonds, stock, and commercial paper, may be effected in various ways :

(*a*) Minimum reserve method. Under this method the law requires a fixed amount of specie on hand at all times. This is a defective system. The purpose of such a reserve is twofold—to protect the bank against a possible danger of failure to redeem its obligations, and to afford relief to people who deposit money in banks, in case of expanding business. Now, if the bank is to keep the reserve at a certain minimum, these purposes are defeated in the case of an emergency or crisis.

(*b*) Proportional reserve method. This method of regulation insists on the bank's keeping a reserve which shall bear a definite proportion to the note issue. In practice the proportional reserve virtually becomes the minimum reserve, and is open to the same objections.

(*c*) Simple deposit method. This method involves keeping a stock of specie equal to the whole amount of the note issue. This is a safe method, but it is not economical. The notes thus issued are equivalent to warehouse receipts or deposit certificates, and do not possess the advantages of bank money.

(*d*) Partial deposit method. This method allows the issue of a certain proportion of the notes against stocks and bonds, but guards all further issue by the deposit of specie. This method is adopted by the Bank of England. Its advantage lies in the fact that, as the amount of outstanding notes increases, the specie also increases proportionately; but, on the other hand, it makes the note issue inelastic.

(*e*) Bond deposit method. Under this method a bank is not required to keep the reserve in specie, but to build up a reserve of stocks and bonds, of gilt-edged securities. The objection to this method of regulation is that the stocks and bonds do not secure convertibility, and that the issue of notes becomes inelastic, because the volume of these notes depends not upon the requirements of commerce but upon the value of the bonds.

(*f*) Notes to be issued on the general assets of the bank. This method makes note issue elastic, but affords no provision for ensuring the convertibility of the notes. Wherever this method is adopted, the precaution is taken to make the notes a first lien on the assets.

The brief review of these methods makes it sufficiently evident that each one of them has its own shortcomings. It passes the wit of man to devise an ideal method of reserve against note issue, which would ensure convertibility, make the issue elastic, and at the same time guard against redundancy. Any method of regulation of note issue must serve two purposes: (1) it must secure to the country the utmost possible economy of the precious metals; (2) it must avoid the danger of inflation through over-issue and, on the other hand, the possibility of undue contraction and deflation. If a single method cannot

achieve these objects, possibly a combination of some of them might be more successful.

Inconvertible Paper Money

Inconvertible paper money consists of notes which are not convertible into the standard coin on demand. Paper money may be inconvertible from the date of issue, or convertible paper money may be turned into inconvertible paper money owing to the insolvency of the issuer. Such paper money may be issued by the Government or by a bank. Fiat money and inconvertible paper money may sometimes be regarded as exchangeable terms. Sometimes, however, the term fiat money is restricted to metallic money which is full legal tender, but whose face value is greater than its intrinsic value. We may distinguish between the two by using the expressions "soft fiat money" and "hard fiat money", indicating inconvertible paper money by the first, and metallic money by the second expression. The essential character of fiat money lies in the fact that its value is artificial, and depends on the declaration of Government. Government assigns an arbitrary value by its fiat to a piece of paper or to a quantity of bullion, and invests it with full legal tender power. Paper money of this kind performs all the functions of money except that of a store of value.

Inconvertible paper money suffers from the one great disadvantage that its value is precarious. The value of such paper depends on the fiat of the Government, while the value of standard metallic money depends on the conditions of demand and supply. The value of metallic money, though it varies in the long run, is on the whole steadier than the value of fiat money. The circulation of fiat money is restricted to the particular country in which it is issued; it cannot function in international transactions. This restriction of circulation reacts on the value of fiat money. Gold and silver have an inter-

national market, but fiat money is not exportable, and goes on accumulating, even if it is not over-issued, thus affecting its value in the long run.

Some economists argue that these disadvantages of inconvertible paper money can be obviated, if all civilised countries agree to confer legal tender quality on the money by an international agreement. The quantity of this money should be fixed in advance for each nation in view of its requirements and the size of its population. It is urged that under these circumstances inconvertible paper money will not be subject to variation in value, more especially if the volume of this money is regulated on a scientific basis. It is difficult to imagine, however, that an international agreement could be arrived at on such a basis ; we have only to remember the greed and anxiety for strengthening the gold reserves manifested all the world over since the outbreak of the war. We may safely reject the scheme as beyond the realm of practical politics. Even an advocate of monetary reform like Mr. Keynes contemplates the building up of gold reserves for foreign liabilities.

But though paper money may not be a good substitute for metallic money, it is not inherently bad money, if the difficulties of over-issue are avoided. A depreciated currency creates high prices, with uncertainty in business and speculation. These dangers of over-issue can be avoided by a far-sighted policy of credit control, by a careful observation of the symptoms of the money market. A premium on gold, a rise in the rate of exchange, a rise in the general level of prices, are all signs of approaching disaster which may warn the banker and arm him against it.

There is just one more question which we may briefly notice—Is paper money wealth ? Does it create wealth ? In the first place, it must be remembered that wealth cannot be created out of nothing ; but it can also be maintained that paper money can increase the wealth of a nation to a certain extent. Adam Smith was the

first to attempt an explanation of the way in which paper money may add to the wealth of a country. Metallic money in actual circulation is unproductive capital, and the substitution of paper money allows the application of metallic money to productive purposes. Adam Smith pointed out that doing away with metallic money was like doing away with roads if we could travel by air. All the land now used for roads would then be available for cultivation. Though this may be true, it is a half-truth at the best. What if the metallic money displaced by paper is melted down and hoarded or turned into ornaments ? The element of truth in Smith's view is just this, that the metal which is released by paper money will be available as capital for productive purposes at home, or for the purchase of technique and equipment abroad, or for investment abroad. If the total money work to be done in any country is greater than the volume of metallic money can perform, paper money which does the rest of the work may be said to increase wealth by stimulating production. The fiscal advantages of the use of paper money by the State are obvious. When a Government falls short of means it can resort to the issue of paper money, and pay its way without being obliged to pay interest. Of course, there is also the danger of a spendthrift Government's yielding to the temptation to over-issue—a danger so conspicuously illustrated by the practice of some of the belligerent States during and after the war.

CHAPTER XV

CREDIT AND PRICES

Credit and Credit Instruments

In modern economic organisation credit plays a predominant part in the settlement of transactions. To give credit means to give time for payment. A credit transaction is an exchange transaction in which one person parts with goods on condition of receiving a return for them in the future. There is no element of credit in a gift or in transactions in which goods are sold and payment made for them on the spot. It is only when payment is to be made at some future date that credit appears. All loans are credit transactions in this sense. The reason for calling such transactions credit transactions is that all such transactions imply trust or confidence. Every credit instrument assumes an obligation on the part of some person to pay to another a specified sum. The fulfilment of the obligation depends on the ability and willingness of the person to pay his debt, and on the machinery for compelling payment in case of default. Ability to pay depends upon the amount and saleability of the wealth in a man's possession at the time his debt falls due. Willingness to pay is equally important as a factor in credit. The amount of credit a man will obtain depends partly on the belief which he inspires in the lender about his readiness to pay.

In the business world credit is expressed in terms of money, like all other commodities. But we must not forget the fact that, when a man gets credit or borrows

money, what is borrowed is not money but goods or control over goods. If a borrower obtains credit, he gets purchasing power, hence a demand for credit is fundamentally a demand for goods. A credit transaction may be the result of the confidence on the part of the lender in getting back his money from the borrower, in which case it is personal credit ; or credit may be given on the deposit of securities, in which case it is secured credit.

Credit instruments are written documents which record transactions and make possible the effective use of credit. One form of credit instrument is that of book credit, a statement of a series of transactions in a book in which a man is debited with what he gets and credited with what he parts with, and the balance represents what he owes or what the person with whom he is dealing owes him.

A promissory note is an unconditional written promise to pay on demand or at a fixed future date a stated sum of money to another person.

A bank note is a promissory note by which a bank promises payment on demand of a certain specified sum of money. The confidence which a bank inspires makes a bank note as universally acceptable as a standard coin. Governments may similarly issue promises to pay on demand, as in the case of the Government of India currency notes and the " greenbacks " of the United States of America.

A bill of exchange is an unconditional order addressed by one person called the drawer to another called the drawee, requiring him to pay a third person called the payee a sum specified in the bill. Though a bill of exchange may be payable on demand (sight bills), it is usual to allow a designated period of time to elapse before the date of maturity (time bills). The drawee may be asked to indicate his willingness to pay the bill by writing his name across its face, in which case he is called the acceptor ; a bill may pass through several

hands before the date of maturity. The stronger the credit of the first acceptor, the more readily does the bill pass from hand to hand, serving as a substitute for metallic money. If the bill is drawn upon a merchant and represents goods shipped and consigned to him, it is called a trade bill—a cotton bill or a grain bill, according to the nature of the commodity involved. When a bill represents a loan it is called a finance bill. A bill drawn by one banker upon another is commonly known as a draft.

A cheque is an order on a banker for a sum of money payable on demand. It resembles a bill of exchange in so far as it is a negotiable instrument, an order on the part of the drawer addressed to a bank which is a debtor.[1]

The Functions of Credit

The person who obtains credit may secure thereby an immediate gratification of his wants, or may use it as capital in industrial and commercial enterprise. In all advanced countries a large proportion of the capital employed in industry and commerce is obtained by means of credit. As the result of the lengthening of the process of production by the introduction of highly specialised machinery and the division of the detailed methods of manufacturing, credit has naturally come to play a larger and larger part in the economic organisation of modern society.

From the standpoint of the nation, credit makes possible a more complete utilisation of human and natural resources, stimulates large-scale production, and increases the efficiency of labour and capital. The talents and aptitudes of the individuals belonging to any

[1] Bonds, shares, and stocks are promises to pay made by a corporation or joint-stock company, sometimes secured by mortgage of the property or assets of the company. Similarly Governments and municipalities borrow money by the issue of loans and debentures of various kinds, at definite rates of interest, redeemable at a definite future date.

one community differ widely, and credit effects the transfer of the wealth and natural resources of a country into the hands of those who can make the best use of them. It economises the use of metallic money, which in any case would be insufficient in quantity to meet the growing requirements of trade and industry. Finally, the use of credit reduces fluctuations in the general level of prices and stabilises trade. An over-issue of credit may promote unwise investment and lead to unhealthy speculation, may favour extravagance and subject a country to a financial crisis. But so great are the advantages resulting from a wise use of credit that some have gone to the length of suggesting that credit creates capital. All that can be safely asserted is that credit facilitates the economic devices which lead to the creation of capital, and increases enormously the efficiency of capital.

Credit and Prices

In discussing the supply side of the exchange equation, we saw that the machinery for supplying the necessary purchasing power is of a heterogeneous character. It includes not only metallic currency, but all other substitutes used for effecting payments. The nature and extent of the effect of the volume of metallic and representative money can be definitely ascertained, but credit currency brings in complications whose effects cannot be precisely evaluated. Deposit currency is an unknown factor, for its use, size, and influence depend upon the reserve of the banks and other factors. But there can be no hesitation in admitting that the extensive use of credit instruments as a medium of exchange exercises an appreciable and important influence over the trend of prices. We may regard credit instruments as additions to the demand for goods and services, which in their turn will affect prices, or we may regard them as additions to the existing media of exchange. There are two schools of thought holding somewhat different views about the

relation of credit to prices. One school maintains that normally credit has no effect on prices, for credit demands as a whole cancel themselves ; in other words, sales and purchases effected through the use of credit instruments balance each other, and leave the money supply unaffected. Credit leads a compartmental life and as such has no effect on price level. The other school maintains a diametrically opposite view. It holds that if credit is demand for goods and services, it is also a demand for money, and thus affects the price level. Those who of late have advocated a policy of controlling the purchasing power of a country by regulating credit, endorse this view of the relation of credit to prices.

It is urged that credit given for productive purposes does not affect prices, because on the one hand there is an increase in the volume of purchasing power to the extent to which credit is given ; on the other hand, goods to the same extent are produced and put on the market. The increase in the volume of purchasing power is counterbalanced by a corresponding increase in the supply of goods. But it is impossible to find at any given time this exact coincidence of demand and supply. Most of the credit supply is given on a basis of future payments when goods are sold. At the time credit is given there are no corresponding goods on the market. When credit is given, purchasing power is increased to that extent, but the producer may miscalculate the possible demand and commit mistakes, and produce more than is required. If the demand does not correspond to the expectation, or if there is a change in fashion in the interval, the original purchasing power is not cancelled, and may affect prices.[1]

[1] It is sometimes urged that book credits do not affect prices, because they do not create instruments which can circulate as media of exchange. Book credit enables the buyer to purchase without the use of currency, and to that extent adds to purchasing power. Cf. Lavington, *The English Capital Market*, p. 39 : " It may be objected that this system of trade credit (book debts) does nothing but postpone payment, that it merely defers the use of currency and consequently adds nothing to

It has been rightly observed that a portion of the immaterial capital of each country consists in the normal level of credit, or what is the same thing, "in the normal level of confidence on the part of capitalists in the ability and business integrity of those who bid for the use of their capital. The yield of this immaterial capital is expressed partly in the form of the lower gold reserves which the country needs to hold against its paper currency, partly in the more effective application of the resources of which it disposes." [1] The level of credit depends partly on national temperament, partly on the stability of social and political institutions, partly on the extent to which a community is accustomed to the use of banking facilities. Judged by all these criteria, as we shall see later on in our discussion of Indian banking institutions and the Indian currency organisation, India is found lagging infinitely behind in the development of credit resources, as compared with a country like England or the United States of America. Illiteracy, absence of banking facilities, lack of confidence in the currency policy of the rulers, which we shall find to be a policy of drift and opportunism, all combined are responsible for the low productivity, agricultural and industrial, of a country so rich in its potential resources of land and minerals and men.

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the average volume of purchasing power. This would be only partially true if the total volume of book debts were always about the same; for although in that case the creation of new book debts would proceed concurrently with the extinction of old book debts by the use of currency, it would still be true that the average volume of purchasing power had been increased by the mere fact that payment was deferred. The average volume of these deferred payments would still constitute a net addition to the total stock of purchasing power, for corresponding to it would be an average volume of goods purchased without the use of currency. The significance of book debts, however, lies less in the addition which they make to the average volume of purchasing power than in the ease with which they are expanded and contracted, and in the fact that these variations are free from any control on the part of the market organisations whose business it is to regulate the supply of purchasing power."

[1] Lavington, *The English Capital Market*, p. 17.

CHAPTER XVI

MONEY AND FOREIGN EXCHANGES

THE problem of foreign exchanges is the problem of the causes or conditions that determine the relative value of the monetary unit of one country in terms of the monetary unit of another country. It is an expression of the valuation of the purchasing power of the unit of currency of one country in terms of that of another. If all the countries of the world had a common currency—a monetary unit of the same metal, quality, and weight—the problem of foreign exchanges would not present any difficulty. But different countries have monetary units of different weights and fineness, either of one metal or of different metals. In pre-war days, when the currencies of all the civilised countries were on a gold basis, the rates of foreign exchange, or the relative value of the currency of one country in terms of the currency of another country, depended upon the amount of gold contained in the monetary units of the two countries, and the cost of freight and insurance for remitting metal from one country to the other.[1] The whole of foreign

[1] Thus, taking the mint par of exchange as between England and France, it could be determined as follows:

The sovereign = 7·98805 grammes of gold $\frac{11}{12}$ fine,
= 7·32238 ,, of pure gold.
The French napoleon (20 francs) = 6·45161 ,, of gold $\frac{9}{10}$ fine,
= 5·80645 ,, of pure gold.

Therefore a sovereign $= \frac{7{\cdot}32238 \times 20}{5{\cdot}80645}$ francs = 25·2215 francs.

Between gold-standard and silver-standard countries the relative

trade to-day between any two countries is practically settled by the media of bills of exchange and telegraphic transfers.

In examining the conditions that determine equilibrium in the exchanges between two countries on a gold basis, it is necessary, in the first instance, to distinguish between exchange equilibrium and trade equilibrium. Professor Cassel has pointed out that it is possible to have an exchange equilibrium without a trade equilibrium, and he considers this a surface phenomenon.[1] Professor Pigou, on the other hand, considers exchange equilibrium as of fundamental importance. When we have an exchange equilibrium between two countries, there is no disparity between the relative prices and the rates of exchange in those countries. Professor Cassel holds that an exchange equilibrium is possible under conditions in which nobody can get any profit by diverting produce from one country to another. When this condition is realised, when the difference between the profit on foreign sale and sale at home disappears, we have an exchange equilibrium. This depends, however, on equi-

market values of the two metals serve as the basis of commercial transactions instead of the par of exchange.

The rates of exchange between two countries are based upon the mint par of exchange, if one exists, and fluctuate between points above and below this figure, determined by adding or subtracting the expense of shipping the currency acceptable in the country in question. In gold-standard countries these are called the gold points. The actual rates of exchange between any two countries are determined by the relation between the demand and supply of foreign bills, and this by the trade and credit relations of the two countries. In New York, for example, bills on London are constantly being drawn against goods exported and on account of foreign investments in American enterprises, and these bills are in demand to meet American indebtedness to foreigners for imports of foreign merchandise, etc. If the amount of London bills offered exceeds that demanded, sterling exchange will be below par, and in the opposite conditions it will be above par. If the competition forces the rate to the gold points, bankers will find it profitable to ship gold, and these shipments will affect bank reserves, the bank rate, the volume of loans, prices, and investments in the two countries.

[1] *Monetary Problems of the World*, p. 38.

librium between the rates of return to capital invested in both the countries, between the rates of wages to labour, on equal accessibility of raw materials, and a number of other conditions difficult to realise.

Confining ourselves to Professor Pigou's standpoint, when one country trades with another, this trade consists in commodities which regularly flow from one country to another, and commodities which do not flow regularly but only under certain conditions. In the case of the former class of commodities, it is necessary for an exchange equilibrium that the units of money which one country obtains by the sale of a commodity to another country must be equal to its price within the country itself. In the case of the other class of commodities, to secure an equilibrium the value of the unit in one country must not fall below the value of the unit in the other country, beyond certain limits. In other words, the quantity of gold contained in the monetary unit of one country should have the same purchasing power in terms of commodities in both the countries, the limits of variation being represented by the cost of shipping gold from one country to the other. We have thus an equilibrium of exchanges with the mint par.

Professor Cassel explains this equilibrium of exchanges in terms of purchasing power parities. Under normal conditions, with freedom of import and export and an effective gold standard, the rates of exchange correspond to the purchasing power parities. That is, a block of goods in one country, representing a particular value in the monetary unit of that country, will buy a similar block of goods in another country, allowance being made for freight charges, etc. Now, if the block of goods is expressed in terms of sterling, the same amount when converted into dollars will give in exchange a sufficient amount of dollars to buy a similar block of goods in America. The exchange rate between pound and dollar will correspond to the purchasing power parity. In other words, the internal and external purchasing power

of a country's currency is the same under these conditions. The exchange rate between England and America is arrived at by the price in dollars of a particular quantity of goods, divided by the price in pounds sterling of the same quantity of goods, and this ratio gives us the purchasing power parity. The rate of exchange and the purchasing power parity tend to be equal. If they are not equal, we infer that there is a disturbing force operating till the equilibrium is again restored. If there are obstacles to the trade between two countries, the exchange equilibrium will be different from the purchasing power parity. Mr. J. M. Keynes accepts this theory with qualifications. "If . . . changes are taking place in the equation of exchange between the services and products of one country and those of another, either on account of movements of capital, or reparation payments, or changes in the relative efficiency of labour, or changes in the urgency of the world's demand for that country's special products, or the like, then the equilibrium point between purchasing power parity and the rate of exchange may be modified permanently." [1] The purchasing power parity theory in the abstract is a truism; in its application it has to be hedged round with so many qualifications as to be rendered almost useless. Again, in determining purchasing power parity Professor Cassel makes use of general index numbers, including the prices of commodities that do not enter into the foreign trade between two countries. This involves the assumption that the prices of commodities that do not enter into international trade move in exactly the same direction as the prices of commodities that do so enter — an assumption that needs justification before it can be accepted.

Thus the exchange equilibrium position need not correspond to the purchasing power parity. The normal rates of exchange between two countries on a gold basis will be confined in their movements to the limits indicated

[1] *A Tract on Monetary Reform*, p. 97.

by the specie points, and within these limits we can use the purchasing power parity to measure changes in the rates of exchange and exchange equilibrium. But greater complications arise when, as during recent years on the Continent, the countries trading with one another are on a basis of inconvertible paper money. At first one may be tempted to say that any cause which tends to alter the ratio of exchange of commodities between two countries on the basis of inconvertible paper, alters correspondingly the exchange equilibrium between the monetary units of those countries. But in actual practice, alteration in the ratio of exchange of goods does not exactly correspond with the alteration of the relative efficiency of the monetary units of the two countries. Changes in the prices of commodities lead to changes in the exchange equilibrium, and the purchasing power parity theory will apply to that extent. "The essence of the purchasing power parity theory, considered as an explanation of exchanges, is to be found in its regarding internal purchasing power as being in the long run the more fundamental determinant of a currency's foreign exchange value, internal purchasing power in its turn being fixed by the monetary policies of the authorities, whether inflationist or deflationist. . . . Thus, provided no persisting change is taking place in the basic economic relations between two countries, and provided the internal purchasing power of the currency has in each country settled down to equilibrium in relation to the currency policy of the authorities, then a modification in a rate of exchange between the currency of the two countries must correspond in the long run to modifications in their comparative internal purchasing powers. Subject to these provisos, comparative internal purchasing power does take the place of the old gold parity as furnishing the point about which the short-period fluctuations of the exchanges swing." [1]

[1] *Manchester Guardian Commercial*, Reconstruction Number, "Europe," Sec. I.

The Bank Rate and the Exchanges

A movement of the exchanges against a country means that the gold export point is being approached, if not passed. To prevent the flow of gold abroad, the Bank rate may be raised. A rise in the Bank rate discourages the borrowing of money and discounting of bills, whilst it encourages the transfer of credits from abroad and attracts money to the banks, reducing to that extent the demand for commodities. The contraction of credit, which means diminishing the demand for money at home and increasing the effective supply, tends to bring about a fall in prices, and causes the foreign exchanges to move back to the equilibrium point or the mint par.

Raising the Bank rate in recent years has not had the usual effect, as the export of gold was forbidden by most countries during and after the war, and as there is an enormous demand for money for purposes of reparation payment and reconstruction. It has also been pointed out that using the Bank rate means entrusting the vitally important function of regulating the monetary circulation of the country to a private profit-making institution; and that if the use of the Bank rate is intended to secure stabilisation of prices and foreign exchanges, such an object cannot be effectively achieved so long as the marketing of staple commodities, which enter into the general index number of prices, is carried on under competitive conditions.

The Problem of Stabilisation of Exchanges

The greatest obstacle to the recovery of European trade to-day has been said to be the instability of the foreign exchanges. The root of this instability in the exchanges is the instability of internal purchasing power, due to the inability of some of the European countries to balance their budgets and the consequent resort to further issues of paper money. The Financial Commission

of the Genoa Conference advocated a policy of devaluation with the value of the monetary unit fixed at a new gold parity. Very many of the belligerent countries are unable to restore an effective gold standard. The Financial Commission therefore recommended a policy of regulating the volume of credit and currency through the co-operation of the Central Banks of the world, not with reference to any fixed amount of one commodity, such as gold, but with reference to the total volume of all commodities bought and sold, as indicated by the general level of prices, statistics of trade and production, and general economic conditions.

We have already criticised in an earlier chapter the possibilities of credit control divorced from a gold basis. Credit control can be more successfully exercised on a gold basis than on a basis of index numbers. The paramount economic problem of all countries in the world to-day is the stabilisation on a gold basis of the purchasing power of monetary units in home markets. This is the first and the most essential step towards restoring and fostering foreign trade. It is of far greater importance than a return to pre-war values. The restoration and revival of international trade depend on stabilisation of the internal level of prices in each country, and such stabilisation can be brought about only by a restoration of the gold standard. If the amount of gold available for such purposes is limited, modern credit devices have taught us to effect the utmost possible economy of the precious metals consistent with ultimate convertibility. The fantastic changes in the value of the mark, the franc, and the krone, have made some people unreasonably sceptical about the possibility of using these units of value for the purposes of exchange. If the purchasing power over commodities of any one of these units could be stabilised, even at its present level, it would serve the purposes of foreign trade exactly as well as it would at any other level. The one thing essential for stabilising the foreign exchanges is that the rates should remain

stable sufficiently long to inspire confidence in their stability. No amount of international agreement on a basis of credit control divorced from gold will ever succeed so well as a policy of stabilising internal prices in each country. "A fairly constant and entirely satisfactory rate between any two countries becomes established as soon as each country stabilises the purchasing power of its own money, whatever that may be, in its own markets."[1]

[1] Foster and Catchings, *Money* (1924), p. 144.

CHAPTER XVII

BANKING

Functions and Types—The Place of Banking in Economic Organisation

In any attempt at understanding the place of banking in modern economic life it is necessary to observe that banking institutions have changed in character very much since their origin. The early banks of the Middle Ages seem to have originated in connection with the business of exchange of money or coins. In every country, and more especially in countries that had international connections, a variety of coins of different metals circulated side by side, coined by private agencies both within the country and outside the country. The banker's business was to keep on hand considerable quantities of coins of all kinds and to offer them in exchange to customers. With the lapse of time they became custodians of the money of their clients, issuing receipts redeemable on demand. To-day money-changing has fallen into the background, whilst other functions have emerged out of the shifting conditions of economic life.

The two marked features of the economic and industrial life of our times are indirect large-scale production and commerce. Production of goods has become an extended and prolonged process, with specialisation carried as far as it can go. Between the purchase of raw materials and the final delivery of goods a long interval of time has to elapse—and so also between production, exchange, and consumption of goods. Medieval production was

based on individual efforts : the individual or a small group of craftsmen carried on their productive activities with the help of their own tools and small capital. Modern production, being on a large scale, requires the use of money or capital to supply the tools which are no longer the property of the workmen, and the employment of credit to bridge over the time element. The capital of our joint-stock and limited companies, our trusts and combines, runs into millions ; and it is impossible for private individuals, however wealthy, to finance modern industrial and manufacturing concerns. Banking institutions provide credit, bridge over the time element, and link together the specialised processes of production and exchange. It is not too much to assert that, without banking, production, exchange, and consumption on the present scale would not be possible. Banking constitutes the very life-blood of an advanced economic society.[1]

Functions of Banking

The services rendered by a modern bank to society are many and various. The most important and yet the simplest service it renders to the community is that of receiving deposits from the public. In every country there are persons whose incomes are large enough to admit of savings, there are others who are eager to provide for a rainy day, and there are still others who pinch themselves and save in order to provide for their families. All these actual or potential savings require a place where they can be safely kept and at the same time earn interest. This need is met by a bank which receives deposits and pays a moderate rate of interest. Deposits may be received on current account, whereby the banker incurs the obligation to pay legal tender on demand, or on deposit account, when the money is deposited

[1] " The banker is the universal arbiter of the world's economy " (Walter Leaf, in an opening speech at the meeting of the Finance Committee of the International Chamber of Commerce, June 1921).

with a banker for a fixed period, short or long, and earns interest at the current rate. Thus a bank attracts the scattered savings of a society to a common centre by offering safety for such savings and a reasonable rate of interest. It mobilises almost automatically the surplus savings of society. All the small streams of savings of a people flow into a single reservoir in order that the waters thus collected may be redistributed into more fruitful and profitable channels.

A bank lends out money to those who require it. The development of economic life in our times has led to the rise of a class of men who possess ability, business enterprise, imagination, and a spirit of adventure, but who want capital and credit to bring their abilities into play for the purposes of production. It is the banker who provides the necessary capital and credit. Thus a bank acts as a medium for transferring capital from those who possess it but do not know how to use it, or have not the time to use it, to those who require it but do not possess it, to the advantage of all concerned, depositors, bankers, and borrowers alike. The banker acts as an intermediary between voluntary lenders and borrowers. He increases the productive capacity of a country by receiving money which would otherwise be hoarded and lying idle, and lending it for the carrying on of productive enterprises.[1] The bank lends money against security at a relatively high rate of interest. The loan usually takes the form of permission to draw cheques through a current account up to the amount lent. The borrower becomes indebted to the bank in order that for his own purposes he may use the promise of the bank as the equivalent of cash to himself.

Buying, selling, and discounting bills of exchange constitutes an important part of a banker's business. The holder of a bill payable at a future date may sell

[1] Investment and industrial banking have during the last fifty years so grown in importance that to-day they may be regarded as indispensable to the development of commerce and industry.

it or " discount " it at a bank which will give him its present value calculated at the current market rate. The bank can resell the bill at any time, or keep it till it matures. When a bank buys a bill, it is converting cash into credit, making an advance and receiving interest on it. When it sells or rediscounts a bill, it is converting its credit into cash again.

By dealing in bills, selling drafts or orders, and issuing letters of credit, a bank facilitates the transmission of money from one place to another or from one country to another; it thus helps the movement of commodities, and therefore the development of trade and commerce, both internal and international.

A banker also acts in various ways as an agent for his customers and other banks. He recovers and collects interest and dividends on stocks and shares, buys and sells stocks and shares on behalf of his clients, keeps his client's valuables in safe custody, acts as trustee and executor, and performs similar services, charging a commission for such services.

By bringing into existence credit instruments of all kinds, such as cheques, bills of exchange, and bank notes, a bank economises the use of the precious metals to the utmost, releasing them for productive purposes. By means of banks, savings are stimulated and concentrated for national purposes. Banks promote habits of thrift, and afford to customers through the use of cheques, records of payments and receipts which cannot be disputed. Keeping an account gives a social status of some kind to the holder. A banker often serves as a reliable adviser to his clients in the matter of investments. A prospective investor has neither the time, nor the will, nor the intelligence to examine the genuineness and soundness of new or already established concerns. A bank by its weekly circulars and bulletins can give guidance and advice of a reliable character, and direct the savings of the community into proper channels.

The credit instruments of various kinds which banks

can create may be regarded as bank currency; and one great advantage of such currency to the country is that it can be made elastic, adjusted almost automatically to the varying needs of commerce. The amount of credit instruments which the banks can create depends primarily on the needs and demands of their customers. They are created by the processes of discount and deposit, and enter into circulation when customers pay out the notes received, or draw on their credit balances by transferring them to others by the use of cheques. So long as the banks can go on discounting their customers' bills all over the country, they can increase the volume of bank currency, enabling it to come into circulation in all places and at all times where it is needed. Just as banks can expand the volume of credit, so they can contract it when necessary by allowing bills to mature and not discounting fresh bills, and by raising the rate of discount.

Types of Banking

We have already indicated how banks sustain production and facilitate the exchange and consumption of wealth. Now the process of production is different from the processes of exchange and consumption. As these processes are different, they require different types of banking. The process of production involves a relatively greater length of time than those of exchange and consumption. We have accordingly (1) industrial or investment banking, which serves the process of production, and (2) commercial or exchange banking, which fosters trade and commerce.

Commercial banks help in the movements of goods and in the processes of exchange, and make use of short-term credits in carrying on their business. Investment banks are an essential part of the machinery by which the scattered resources of the society are collected and applied to the production of commodities. Industrial banks help in the building up of enterprise, whilst

commercial banks help in the transportation of goods. Merchants and traders are usually both debtors and creditors, and it is necessary that they should meet their obligations as they fall due at the stipulated time. But it rarely happens that debts owed and debts owing exactly correspond at any one time; and the great service that commercial banks render to their customers is to enable them to turn some of their future claims into present money. An investment bank, on the other hand, serves as an intermediary between persons who are desirous of investing and persons who want capital for industrial enterprise.

In the national economy of every country both these types of banking are necessary, one for helping and stimulating production, the other for distributing this production.

The credit which a bank lends or extends to its customers may be either commercial credit or industrial credit. The former is generally used by those engaged in commerce and trade, who require money for short periods for the movement of goods from producers to consumers. This credit runs for a short period and takes the form of either promissory notes, cheques, or drafts. Industrial credit is used by joint-stock companies, corporations, and other bodies engaged in productive concerns. This credit is a long-term credit, because the repayment of loans for productive purposes may take years. Such credit is given in the form of stocks and bonds. Both these kinds of bank credit are made possible on the basis of the subscribed capital of the banks, which are usually joint-stock concerns; but in the case of commercial banks the creation of credit is helped by the funds derived from deposits by private individuals or public bodies. On the strength of these funds the bank lends money to borrowers to a considerably greater extent than that indicated by its resources. Sound banking consists in extending the use of credit to the limit of safety. The banker knows too well that the credit he gives or the

liabilities that he undertakes are much greater than he is able to meet at any particular moment in case of a rush. But he also knows that all persons having claims on the bank do not demand their money at one time under normal conditions. Hence he has to use his discretion in judging the probable demand for cash; and he will go on lending, provided he is able to meet such demand. Credit is confidence, it is a psychological phenomenon, and the nature and size of the credit superstructure in any country will depend upon the stage of banking development it has reached, upon the habits of the people, upon confidence in the stability of political institutions, and upon the national temperament.[1] In a community where banking habits are developed, the use of deposits is so extensive that a banker thinks it unnecessary to have cash in readiness for the payment of more than a small proportion at any given moment. But in a period of financial alarm, withdrawals may be made earlier and more frequently, and a large provision of cash may be needed. The kind of business carried on by depositors may subject one bank to heavier occasional demands than other banks, and a city bank may be liable to heavier calls from depositors than a branch in a rural area. In general, for every bank there is some line below which its provision of cash cannot safely fall. This provision of cash includes metallic money and legal-tender notes, and is known as the reserve.

[1] "The Irish are constantly alternating between the extremes of confidence and distrust. At one time they will avail themselves in a most inconsiderate manner of any facility of credit. At another, and immediately as credit is in any degree checked, they fall into a total want of confidence. In Scotland a sound public opinion respecting the currencies operates rather more efficiently than any Bank Restriction Act in economising the use of gold. A person who asks for gold in payment of a note acts in the eyes of the community in a most unpatriotic manner and contrary to the interest of the country. In Ireland the great body of the peasantry have upon the slightest rumour a desire to possess themselves of gold in preference to paper" (Leon Levi, *History of British Commerce*, quoted by Lavington, *The English Capital Market*, p. 17).

Cash Reserves

The proportion of the reserve to total liabilities is sometimes regulated by law. In the United States, before the passing of the Federal Reserve Act of 1913, banks in country towns were required to keep a reserve of 15 per cent of their deposits, of which at least two-fifths were to be in cash in their own vaults, and the remainder at their option on deposit with approved national banks in the reserve cities. Banks in these cities were required to keep a reserve of 25 per cent of their deposits, of which one-half had to be in cash in their own vaults, and the remainder to be on deposit with approved national banks in the so-called central reserve cities. Banks in these cities had to keep 25 per cent of their deposits in cash in their own vaults.

One objection that has been taken to such legislative restriction is the difficulty of classifying banks according to their real needs for cash. When banks are arbitrarily classified, either the limit set by law will be so low as to afford no real protection, or it will be in some cases so high as to interfere seriously with the elasticity of bank currency. Where the law compels the bank to stop discounting when the cash reserve falls below the fixed limit, the reserves are made practically useless at the time when they are most needed. In a crisis, banks should be able to accommodate merchants and business men to the greatest possible extent, and this they could do by discounting bills and other securities to a larger extent than in normal times. When the law prevents the banks from doing so, the evils of a crisis are seriously aggravated.

Commercial and Industrial Credit

Governments, like banks, can create credit by raising loans for productive or unproductive purposes. Such credit takes the form of promissory notes redeemable at a definite date. Bank credit may be given for developing

and financing industrial concerns, or it may be short-term credit given to merchants and traders for financing the transport of commodities. In the case of industrial credit, as the loans given are for long terms, the banks make such advances on the strength of their share capital or on the strength of long-term deposits which they may be able to attract. We have in the case of German banking a typical illustration of the successful working of industrial banks. The banks in Germany are associated with the concerns to which they lend money, and thus direct and control economic production. "If we survey the world generally and the mass of economic literature we shall find that opinion is unanimous, except perhaps in this country (England), that the proper and primary business of a banking system is to finance industry and trade."[1] This is recognised in all industrially advanced countries. It is almost impossible for a country to carry on its productive activity without the help of industrial banks. Not that commercial banks are less important in so far as they give credit to those who are engaged in the exchange and distribution of goods. Both kinds of credit are indispensable, and we find them existing in all industrialised countries with the exception of England.

Characteristics of English Banking

There are no industrial banks as such in England. The English banking business is confined to commercial and financial transactions, to discount and short loans. In England, bankers practically confine themselves to acting as mediators between those who want money for

[1] Foxwell, *Papers on Current Finance*, p. 103.

"Many of these (German enterprises) have been nursed from their earliest beginnings by the banks, and largely owe their success to guidance received from them" (*Ibid.* p. 117).

"Not only have the banks promoted most of the industrial joint-stock companies and retained part of their capital, but their managing directors remain members of the boards of these companies and draw personally large incomes for their services in this capacity" (*Economist*, October 21, 1911).

short periods and those who desire to deposit money for short periods. English banking is financial banking, and owing to the peculiar position of London, the clearing-house of the world, it requires large amounts of short loans and equally large amounts of liquid assets.[1] When we remember that the five big banks of London are all commercial and mercantile banks, financing English as well as international trade, we can well appreciate the warnings of some of the English economists against the investments of England abroad. The average annual investments of Great Britain abroad in the years preceding the war were estimated at over £100,000,000, and this process of investment abroad has not slackened appreciably. It has been urged by some economists that this peculiar feature of the English banking system—the absence of industrial banking—has been a handicap to English industrial development. Thus Professor Foxwell, speaking about the English banking system, observes: "Thus our own industries go a-begging or are driven to the tender mercies of the company promoters, while we lend large sums through foreign banks, on terms which deprive our industrials and merchants of trade. The radical fault of our system lies in the fact that our financial, as distinguished from our banking, institutions are out of touch with our industries, with the natural consequence that these industries, or the majority of them, are defective in their organisation and equipment."[2] Mr. Keynes emphatically asserts that England is investing much more abroad than she ought, and urges that, to relieve unemployment in Great Britain, she should invest at home instead of abroad, as there is considerable scope for investment within the country.[3]

[1] "The preference for financial banking is intelligible enough. It may conceivably be necessary for banks of the peculiar English type" (Foxwell, *Papers on Current Finance*, p. 112).

[2] *Ibid.* pp. 111, 134.

[3] One may well hesitate to accept Mr. Keynes' view. England is highly industrialised, and the reason why she invests abroad is that she has already employed as much capital at home as is possible, and that it is the surplus capital which seeks investment abroad.

The question may be raised: If England has had no industrial banking, how has it been possible for her to reach the present stage of her highly developed industrial and economic life? The explanation may perhaps be found in the fact that England was a pioneer in the Industrial Revolution, and that she was in a position to accumulate capital for a number of years while she was alone in the field, and this capital was available to her for further industrial development. Her industrial and economic apparatus was gradually adjusted to modern technology, and the capital that she requires for modern industrial organisation and equipment was supplied without difficulty by individuals through joint-stock companies. Owing to this initial advantage and earlier start, and owing to her being the home of modern industrial technology, she was in a position to adjust her productive apparatus to modern conditions conveniently without the help of industrial banking. Other countries, like Germany and Japan, found themselves faced with a different economic environment. These countries had no accumulated capital, which is so indispensable for industrial organisation and equipment. They had to adjust their industrial apparatus within as short a period of time as possible. Hence they needed a well-organised system of industrial banking.[1] If England has had no industrial banking, it was because the need for it was not felt and the same work was done in other ways.[2] It may be that in the coming years,

[1] "In Germany the vigour and enterprise of her business men, together with the comparative poverty of the country, have made the market primarily a domestic organisation. The success with which her available resources have been applied to the development of industry and trade seems to have been largely due to an exceptionally efficient system of intelligence organised by the banks. This system has given them an intimate knowledge of business men and their undertakings at home and abroad, by means of which the 'credit' of these business men becomes an effective means of obtaining the capital required to give scope to their energies" (Lavington, *The English Capital Market*, p. 18).

[2] "While all these conditions were favourable to the growth of deposit banks, it would seem that the industrial need for capital was

with other countries highly developed in industrial organisation, England too will require the help of industrial banking, as she will no longer enjoy the accidental advantages she has hitherto possessed.[1]

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not of such a nature as to call for special machinery for its satisfaction. In England the transition of industry to its modern form was more gradual than in Germany; and after 1862 the demand for long-period capital to which it gave rise was satisfied in part by the legal facilities granted to joint-stock companies. But it seems reasonable to suppose that during the whole period the greater part of the demand was met from the rapidly accumulating wealth of manufacturers themselves and of the parties with whom they were in close business contact. No doubt many other influences played their part in determining the form of the English banks; but those seem to explain in a great measure the character of the main body of the English system as a group of banks of deposit and issue, simple in function and homogeneous in type" (*Ibid.* p. 127).

[1] During the war a Committee appointed by the Board of Trade in England to investigate the question of financial facilities for trade, pointed out that existing banking institutions left little undone in the way of providing sound financial facilities in the past, and could not be said to have starved home industries. The Committee, however, believed there was "ample room for an institution which, while not interfering unduly with the ordinary business done by the British joint-stock banks, by colonial banks, and by British foreign banks and banking houses, would be able to assert British interests in a manner that is not possible under existing conditions. Such an institution might in many ways be beneficial to the development of British industry and manufactures. It might in certain cases, after careful examination, agree to make advances for the extension of existing manufacturing plant, or perhaps for the amalgamation or co-ordination of certain works so as to reduce the cost of production. It would assist these works to obtain orders abroad and give them reasonable financial facilities for executing these orders." A concrete scheme was subsequently put forward for a new type of bank fortified with a Government charter, working with a large capital, but not taking deposits at call or short notice. The bank would not open current accounts except for actual traders using its facilities. It was to have a foreign exchange department where special facilities might be afforded for dealing with bills in foreign currency. The bank was to give longer credits than ordinary banks, and to supplement the business done on a less adventurous basis than banks which attract deposits. The traditions of English banking have not, however, hitherto reconciled the country to the idea of an industrial bank.

Principles of Sound Banking

For a bank, as for other joint-stock companies, it is necessary that capital should be provided at the outset. The larger the business which a bank can carry on with a given amount of capital, the larger will be the field from which profits can be earned. The capital provided by intending shareholders must be paid in money or in legal tender of the country. It is not necessary that the whole capital should be subscribed at the outset, but the law in some countries requires that a definite proportion — say one-half — shall be paid in before the bank can commence operations. The initial position of a bank starting business with a capital of Rs. 1,00,000 will be represented by the following statement :

Liabilities.		Assets.	
Capital . . .	Rs. 1,00,000	Specie . . .	Rs. 1,00,000

The capital appears as a liability because the bank is accountable to its shareholders for the amounts they have paid in. The idle cash of the bank has to be converted into some kind of interest-earning security, and the bank makes use of its credit for affording to purchasers and dealers the means of using, by anticipations, funds which are receivable by them in the future. For this purpose the bank discounts bills. The time for which bills have to run varies with the custom of the trade, but is in most cases sufficiently short to ensure early repayment to the bank. It is not difficult for a banker to arrange by the purchase of bills of different dates of maturity to provide for a steady flow of cash from day to day. This enables the banker to reduce the amount of his credit at any time, as prudence may require.

But a banker often finds it desirable to invest a part of his resources in securities. The principle that he has in view in selecting these securities is that they should be readily saleable and should not be subject to violent

fluctuations in price. He prefers, therefore, gilt-edged securities to the shares and stocks of joint-stock companies. If he lends money on real estate, it is only as collateral security, as the conversion of the mortgage into cash by sale is not always easy. Land and landed property are not only subject to violent changes in price, but are at times unsaleable.

The results of the process of dealing in bills will be readily intelligible if we tabulate it in a statement of accounts as below.

LIABILITIES.		ASSETS.	
Capital . . .	Rs. 1,00,000	Loans . . .	Rs. 1,00,000
Undivided profits .	1,500	Real estate, furniture, etc. . .	20,000
Deposits . . .	98,500	Specie . . .	80,000
	Rs. 2,00,000		Rs. 2,00,000

The loans represent the securities which at a future date will be converted into cash. The deposits represent the aggregate of the sums which the bank holds itself liable to pay on demand. The interest deducted in advance, which the bank at the proper time has to pay to the shareholders, also appears as a liability. The bank can go on safely increasing its loans, or its purchase of bills and other securities, till it reaches a limit in the form of a minimum reserve beyond which it would not be prudent to go under the circumstances.

Specie, or bank notes which are currency, alone forms the real reserve of a bank. But the reserve may be greatly strengthened by the judicious selection of securities. If the securities held are readily saleable, they afford the means of replenishing the reserve in case of need. The natural method of securing the apportionment of resources between a bank's securities and reserve is by increasing or diminishing the loans, in other words, the purchases of securities made from day to day. If the bank stops discounting at any time, the succession of maturing bills will strengthen its reserve ; if it continues

discounting to the extent of the cash it receives from time to time, it may keep the strength of the reserve unaltered.

If we now take the statement of the Imperial Bank of India for the purposes of illustration, say for the week ending 22nd May 1925, we shall be able to analyse the various items without difficulty.

	This Week. In Lakhs of Rs.	Last Week. In Lakhs of Rs.
LIABILITIES		
Subscribed capital	1,125	1,125
Capital paid up	562·50	562·50
Reserve	467·50	467·50
Public deposits	2,606·74	2,574·88
Other deposits	6,721·88	6,859·16
Loans against securities	..	..
Sundries	181·45	181·65
ASSETS		
Government securities	1,405·24	1,400·12
Other authorised securities	122·10	122·10
Loans	2,954·28	2,513·68
Cash credits	3,514·65	3,671·68
Inland bills discounted and purchased	1,044·58	1,095·12
Foreign bills discounted and purchased	27·18	32·33
Dead stock	76·96	76·85
Balances with other banks	14·74	26·74
Cash	2,150·32	2,028·65

The public deposits of the Imperial Bank represent the Government balances with the Bank. Other deposits represent the Bank's liabilities to private individuals. The reserve is built up out of the profits of the bank and serves to strengthen the resources on which the bank extends its credit. The Imperial Bank refrains from dealings in foreign bills except to a very limited amount. The percentage of the cash to the total liabilities is 21·50 during the week, but it can strengthen the reserve to the extent of another 10 per cent and over, allowing bills to mature and refraining from further purchase or discount.

Bank Notes

Besides deposit accounts banks are permitted to make use of bank notes. These are promises of the bank to pay specified sums to the bearer on demand. They circulate from hand to hand and are issued in such denominations as are convenient. In many respects bank notes and deposits on current account resemble each other. Both represent liabilities of the bank to pay on demand. Both are used for making advances to customers. Both serve as means of payment and are part of the media of exchange. The bank note is payable to bearer and is issued in fixed denominations, whereas a cheque by which a deposit may be drawn upon is an order to pay, drawn for any amount and presented to the bank for payment or acceptance. In earlier days the bank note played a larger part in the settlement of transactions than cheques. To-day, however, with the development of banking habits, cheques have continually gained over bank notes, and settle far more transactions than bank notes.[1]

[1] For a full discussion of bank notes see Chapter XIV.

CHAPTER XVIII

CENTRALISED AND DECENTRALISED BANKING

CENTRALISED BANKING—BANKING IN ENGLAND

IT is noteworthy that during the nineteenth century the evolution of banking took two forms, centralised banking and decentralised banking — the single reserve system and the multiple reserve system. It is also interesting to notice that the banking organisation of a country is largely a reflection of its political organisation. We have centralised banking organisations in England and on the Continent, where the form of Government is mostly unitary. On the other hand, in the United States of America, with a federal form of Government, we have a typical decentralised banking system.

The English banking system may be taken as a typical illustration of a highly developed centralised system of banking. It has a pyramidal shape, with the Bank of England at the apex and the mass of depositors at the base, a widely ramified organisation of branch banking completing the figure.

1. The governing body of the Bank of England consists of a Board of Directors of 24 members, a Governor, and a Deputy Governor. The Governor holds office for two years and is regularly succeeded by the Deputy Governor. The Bank of England in the first place acts as banker to the British Government, a function which gives it prestige and brings it into touch with the officials of the Treasury. The public deposits average about 10 to 20 per cent of the total. The Government's

account with the Bank presents problems of its own. The deposits increase during the tax-collecting season and regularly decrease during the remainder of the year. Large drafts have to be met when interest on the public debt falls due ; and when Government deficits occur, as they do at regular intervals, they are met by loans from the Bank or through the issue of Treasury Bills.

2. In the second place, the Bank of England acts as banker to the joint-stock and private banks. It is a bankers' bank. The joint-stock and private banks keep their accounts with the Bank of England, and the credit balances on these accounts constitute an important element in their reserves. They keep on hand only such amounts of cash as are necessary to meet daily needs, leaving the rest of their reserves with the Bank of England, considering such balances as equivalent to cash in hand. The provincial banks as well as the Scotch and Irish banks follow a similar policy, using as their agent, and keeping their reserves with, if not the Bank of England, some London joint-stock bank. The Bank of England thus holds the reserves of the entire country. It has been estimated that the regular balances of the joint-stock and other banks with the Bank of England amounted to £20,000,000 and over before the war. The Bank of England thus carries a heavy responsibility as a bankers' bank. The liabilities of the Bank of England, which are regarded as cash by the rest of the banking community, compel the Bank to maintain a proportion of cash to liabilities which is fully twice as high as that of the other banks. This proportion rarely falls below 33 per cent, and ranges generally between 40 and 50 per cent. The amount of the bankers' balances is not separately stated. It is included in the other deposits in the Bank of England returns. It has been pointed out that the system by which the other banks treat their balances at the Bank of England as cash, leads to the existence of a vast amount of " cash " in England which, as a matter of fact, consists of paper securities or promises to pay.

On the other hand, if the other banks kept their cash reserves themselves, the country would be deprived of the advantages of the single reserve system, and the elasticity of currency which it secures.

3. Thirdly, the Bank of England has a practical monopoly of note issue,[1] a privilege which has lost its former importance on account of the change in banking habits which has largely displaced the bank note by the cheque for ordinary payments. The right of issuing notes is regulated by the Bank Charter Act of 1844, passed at a time when the memories of the disasters that had arisen through the reckless issue of notes by private banks were still fresh in the minds of men. By the Act of 1844 the Bank of England was required to separate the Issue Department from the Banking Department, leaving the Directors of the Bank free to carry on banking business in the latter department unhampered by any legislative restriction. The Act allowed the Bank a fiduciary issue up to £14,000,000 against the Government debt of £11,000,000 and other securities ; all issues over and above this amount were to be secured by a deposit of an equivalent value of gold and silver in the Bank's vaults, the deposit of silver being limited in amount to one-fourth of the gold in reserve. On a country bank's ceasing to issue notes, the Bank of England could increase the fiduciary issue by two-thirds of the lapsed note issue. No further banks were to be established with the right of note issue. With the help of the lapsing process, the Bank's fiduciary issue has been raised to £18,450,000. So far as the Act of 1844 is concerned, it makes the currency system entirely inelastic. The difficulty has been overcome in practice by the increased use of cheques, the issue of which is not limited by any law. An over-issue of cheques is in many ways as dangerous as an over-issue of notes. The method usually adopted in times of a crisis is to suspend the Act and so

[1] On the outbreak of the war, currency notes (Treasury notes) for £1 and 10 shillings were issued as legal tender by the Government.

to give the Bank the right to issue notes unsecured by gold. Thus the Bank Charter Act was suspended on the outbreak of the war, though no advantage of this concession was taken by the Bank owing to the issue of Treasury notes. It has been urged that as Bank of England notes are chiefly used by the other banks as till-money or part of the legal tender cash they keep to meet demands, even the present amount of the fiduciary issue may be regarded as unsafe.

4. As a bankers' bank, the Bank of England is in a position to provide emergency currency with ease, as credit with the Bank of England is regarded by the community as cash. This cash at the Bank of England in the hands of the other banks can be multiplied as rapidly as the Bank of England is prepared to make advances. Every bank in England has among its assets "cash at call or short notice", which consists of loans made by the banks to the discount houses. In a time of pressure such loans can be called in at once; the discount houses usually repay the banks by borrowing from the Bank of England and transferring the credit to the banks, whose "cash" at the Bank of England is thus increased. This increase in book entries is treated by the other bankers as cash, on the basis of which they increase their own advances to customers. Thus the Bank of England can at any time create book credits which are regarded as cash by the English banking world, and therefore as the basis for further credit. The extent to which the Bank of England can create this credit is left to its own discretion, but any additional credit that it thus creates is indicated by a diminution of the proportion of cash reserve to liabilities in the Bank's weekly returns.

5. The Bank of England has not only to keep an adequate supply of cash reserve for sudden emergencies in the shape of an internal demand for gold, but it has also to be prepared to meet demands for gold from abroad, based on credits given to foreigners by English banks. The Bank of England maintains its reserve by

the use of the Bank rate, raising it at times so as to make it effective. It has been said that the business of credit-making has been so quickly extended in our own times that the money market is frequently able to ignore the Bank rate, with the help of the other banks, so long as they continue to make advances at low rates. The Bank of England is thus often obliged, in order to make its rate effective, to borrow funds in the market and to diminish to that extent the " cash " at the Bank of England of the other banks.

The Private Banks—Accepting Houses and Discount Houses

The functions of private banks cannot be easily differentiated from those of the joint-stock banks. Their business is essentially the same, but the private banks are usually owned by a few partners, who generally conduct the business for themselves, whilst the joint-stock banks are managed by salaried officials on behalf of shareholders. Some of the oldest private bankers have served certain great families for generations, and owe their prestige to this fact. Like the joint-stock banks, they depend upon their balances with the Bank of England, loans at call, and rediscount of bills, for the satisfaction of their need for cash.

The function of the London accepting houses is to a certain extent subordinate to the judgement of the banks, who decide as to whose paper is most readily negotiable. The Bank of England is, however, the final arbiter, since the paper of an accepting house questioned by the other banks can be negotiated at the Bank of England through a discount house. The business of acceptance has been undertaken by the banks themselves in our times.

The bill brokers and discount houses deal chiefly with merchants who have bills to negotiate, and with foreign banks. The extensive imports of British merchants create an enormous volume of trade bills on London

which, when they reach the London market through the London offices of foreign banks, are bought by the bill brokers and discount houses. These discount houses use for the purpose funds largely lent to them by the banks at call or on short notice. The funds thus lent by the banks are regarded as " cash at call ", as the bankers believe that they can be called in at any moment. Besides the money that they borrow from bankers, the discount houses have also large sums placed on deposit with them by other lenders. There are only about twenty of these discount houses in London, including three joint-stock companies.

DECENTRALISED BANKING—THE FEDERAL RESERVE SYSTEM

The serious defects which were found to affect the working of the banking organisation in the United States of America led to the passing of the Federal Reserve Act of December 1913, which now governs the working of banks in that country. These defects may be briefly summarised: unhealthy competition between State banks, national banks, and trust companies led to unsafe transactions and to higher rates of interest on deposits than the banks should have paid; the distinction between commercial and investment operations was not clearly understood; the Secretary of the Treasury had no fixed policy in depositing surplus Government funds in national banks, with the result that the uncertainty thus created fostered speculation; and each national bank was required to keep locked up in its vaults money to the amount of 6 to 25 per cent of its deposits, and a balance with banks in reserve and central reserve cities sufficient to bring the total to 15 per cent in the case of country banks and 25 per cent of deposits in the case of reserve city banks. Finally, there was a lack of elasticity in the currency.

The Federal Reserve Act of 1913 authorised the establishment of not more than 12 and not less than 7

Federal Reserve Banks in as many cities, the United States to be divided into as many districts as there are banks established, one of the cities selected being located in each district. The national banks in each of these districts are to subscribe to the capital stock of the Federal Reserve Bank located in it an amount equal to 6 per cent of their capital and surplus. The subscribing banks are called " member banks ". The administrative machinery for these banks is a Federal Reserve Board consisting of the Secretary of the Treasury and the controller of the currency *ex officio* and five other persons appointed by the President of the United States. The Board has supervisory powers over the Federal Reserve Banks and controlling powers in such matters as note issues, rates of discount, rediscounting between the Federal Reserve Banks, etc.

Section 14 of the Act confers upon the Federal Reserve Banks the following powers :

(*a*) Under rules prescribed by the Federal Reserve Board, to purchase and sell in the open market cable transfers and bankers' acceptances and bills of exchange of the kind and maturities by this Act made eligible for rediscount.

(*b*) To buy and sell bonds and notes of the United States, and bills, notes, revenue bonds, etc., with a maturity from date of purchase of not exceeding six months, issued in anticipation of the collection of taxes, or in anticipation of the receipt of assured revenues by any state, district, or municipality in the United States.

(*c*) To purchase from member banks and to sell with or without their endorsement bills of exchange arising out of commercial transactions.

(*d*) To establish from time to time, subject to review of the Federal Reserve Board, rates of discount for each class of paper.

It will be noticed that cable transfers, bankers' acceptances, and bills of exchange are the only forms of commercial paper in which the Federal Reserve Banks are

permitted to deal. Promissory notes, so widely used in credit transactions, are not included; so also the only securities in which the Federal Reserve Banks are permitted to deal are those of public bodies issued in anticipation of collection of taxes or revenues, and maturing within six months from the date of purchase.

Further, the paper eligible for rediscount is defined in the regulations as bills " the proceeds of which have been used or are to be used in producing, purchasing, carrying, or marketing goods ". It does not include bills, the proceeds of which have been used or are to be used " for permanent or fixed investments of any kind, such as land, buildings, machinery ", or " for investments of a merely speculative character ". All rediscounted bills must bear the endorsement of the member bank which presents them.

The Federal Reserve Act changed both the amount and the composition of the reserves of national banks. After three years from the date of the establishment of the system, these reserves must consist of cash in the vaults and balances with the Federal Reserve Banks in the following proportions.

For Central Reserve banks, six-eighteenths cash and seven-eighteenths balances, and the remainder in either form at the option of the banks. For reserve city banks, five-fifteenths cash, six-fifteenths balances, and the remainder in either form at the option of the bank; and for other banks four-twelfths cash, five-twelfths balances, and the remainder in either form at the option of the bank.

An important function of the Federal Reserve Banks is the right to issue notes. They are permitted to issue two kinds of notes—Federal Reserve notes and notes resembling existing national bank notes. Federal Reserve notes may be issued if rediscounted commercial paper to the amount of the issue applied for be placed in the custody of the local Federal Reserve Agent, and if a gold reserve of not less than 40 per cent of the amount

issued be maintained. These notes are redeemable on demand in gold at the Treasury Department in Washington, and in gold or lawful money at any Federal Reserve Bank. Every Federal Reserve Bank is required to keep with the Treasurer of the United States a fund in gold sufficient to enable him to redeem its notes when presented for that purpose.

Each Federal Reserve Bank is authorised to buy Government bonds and may be compelled to buy the bonds national banks have on deposit with the controller of the currency as security for their note issues. In case such purchases are made by any Federal Reserve Bank, it may deposit such bonds as are endowed with the circulation privilege with the controller of the currency, and receive in exchange and issue notes of essentially the same character as national bank notes.

Section 15 of the Act authorises the Secretary of the Treasury to deposit at his discretion with Federal Reserve Banks " the moneys held in the general fund of the Treasury except the 5 per centum fund for the redemption of outstanding national bank notes, and the funds provided in this Act for the redemption of Federal Reserve notes " and the " Revenues of the Government ", and " to make disbursements by cheques drawn against such deposits ".

Briefly, each Federal Reserve Bank is intended to be a Central Bank for the section of the country which it is to serve. It has all the responsibilities and most of the powers of the Central Banks of the European countries. The Federal Reserve Banks receive deposits from the Government and from member banks only, and ordinarily they lend to member banks only. They provide an elastic currency, issuing notes secured by their commercial assets, and they are empowered to undertake the business of collecting and clearing cheques throughout the entire country, thus providing an effective organisation for making settlements between banks in different places.

Under the plan of organisation of the Federal Reserve Banks, the dangers of concentrating economic power

and credit control in the hands of the Government, which a Central Bank would have involved, were avoided. Purely banking matters, such as the granting of loans, were left to boards selected by the bankers whose funds provided the resources ; on the other hand, such supervision and control as might be considered advisable were entrusted to a Board appointed mainly by the President of the United States.[1]

Industrial and Investment Banks

Commercial banks furnish credit for short periods for carrying on trade and commerce ; they may indirectly promote the flotation of industrial concerns by extending credit, and they often supply working capital for short periods to industrial concerns.[2] Investment banks, on the other hand, as we have already indicated, act as intermediaries in transferring funds from voluntary lenders to *bona fide* borrowers for long periods and for productive purposes. Savings banks similarly mobilise the scattered savings of a community and loan them to those who require funds for the development of industries, generally to Government or corporations on their securities. Investment banks receive deposits for long periods, paying interest, and reinvest these funds at a higher rate of interest. They place in the hands of prospective investors securities of public bodies or joint-stock companies ; some of their clients are the savings banks themselves.

The chief function of investment banks is that of marketing stocks and bonds, and this work is done with

[1] See Phillips, *Readings in Money and Banking*, chap. xxxi.

[2] There is always a temptation on the part of commercial banks to become involved in investment banking. They often hold stocks as collateral security when personal credit is not sufficient ; time loans given by commercial banks are also often used for the purposes of underwriting or speculation. Investment securities are not as liquid as commercial paper, and commercial banking often defeats its own purpose by dealing too largely in stocks which fluctuate in price and are often not immediately saleable.

the help of various institutions—houses of first purchase, underwriters, and houses of distribution. The house of first purchase buys up the whole issue of stocks and bonds in order to sell at a profit. It employs underwriters who in their turn resort to the house of distribution. By the activities of the latter, the stocks and bonds pass into the hands of individual investors. The houses of distribution include insurance companies, banks, savings banks, trustees of charity funds, and syndicates.

With regard to purchasing new stocks, the investment bank carefully examines the proposition with a view to judging about its soundness. It rejects or is reluctant to entertain propositions from companies which are not known to it, or propositions about which it does not possess special knowledge. If the bank is satisfied about the soundness of the proposition, it refers it to a committee of its own experts for a further report, and finally settles the transaction.

The bank further advises its clients through its weekly bulletins and circulars about different classes of investments. It supplies information to prospective investors, and sells stocks and bonds to them. Lastly, investment banks carry on banking functions, lending money to prospective investors and keeping money on deposit on their behalf.

Savings Banks

Looked at from the standpoint of organisation and control, we have various types of savings banks. We have the philanthropic savings banks, the co-operative savings banks, and the stocks savings banks. The philanthropic or trustee savings banks are an attempt on the part of the well-to-do to improve the condition of the poorer classes. All the earnings of the bank, after allowing for expenses and apportionment to surplus fund, are divided among depositors in the form of interest. They are managed by a body of trustees who do not share the earnings. The investments are carefully

restricted, and the trustees are not responsible for losses. The deposits are more or less permanent, and, to safeguard the banks from unexpected calls, trustee banks are permitted by law to require notice, the usual time being 60 or 90 days.

The co-operative savings banks or people's banks depend for their working capital on the accumulated savings of their members. Their aim is to help the economically weak and to develop thrift and good habits. Unlimited liability is accepted by the members. The purposes for which money is borrowed are closely inquired into, and due care is taken that the funds shall be applied for such purposes only.

Stocks savings banks pay dividends to stockholders as well as to depositors. Such a savings bank is not philanthropic in its management. It is a business concern where the investments are of the accepted savings-bank type. They issue capital shares, pay the depositors a stipulated rate of interest, and the profits are distributed to the stockholders as dividends.

The postal savings bank is not a bank so much as an adjunct of the Government, through which it attracts the savings of the people and invests them in its own securities.

Savings banks are as interested as commercial banks in ensuring the safety of funds entrusted to them, but there is this difference. The commercial banks keep their assets in liquid form, whilst savings banks proceed on the assumption that their assets need not be liquid. Recent economic thought and practice favour the belief that some parts of the assets of savings banks must be kept in liquid form, as investors or depositors are anxious that they should be able to get back their funds when they require them, as much as for the safety of such funds. Depositors have learnt from experience during financial crises that they should have as much security for their funds as human ingenuity can provide. This security implies ability on the part of the bank to pay on demand.

It has been thought advisable that investment banks, more specially savings banks, should keep a part of their assets in short loans. Depositors in savings banks are mostly *bona fide* depositors who save to provide for a rainy day or for their families ; most of these deposits are of the nature of fixed or long-term deposits. But depositors may sometimes require money immediately, and to provide against this contingency savings banks might well keep a portion of their assets in liquid form, in cash, and in short loans.

Insurance companies operate in the same way as savings banks, the difference being that savings banks draw funds directly, whilst insurance companies do the same work indirectly. With the present tendency to expansion in all directions—life insurance, accident, and sickness insurance—insurance companies constitute an important and potent instrument for promoting savings. The savings collected by insurance companies are available for investment ; they are of the same nature as savings banks deposits. Insurance companies are of the nature of investment banks ; they accumulate funds by way of premia which are not to be returned at once, but after years—and these enormous sums of money are available for investment in stocks and bonds.

The Essentials of Banking

The needs which banking institutions meet, and the services which they render to economic life, may be briefly summarised under three main heads :

(1) In the first instance, it is an essential function of banking to provide an elastic system of currency capable of adjusting itself to the shifting requirements of the community from time to time. Where banks possess the privilege of note issue, an elastic currency can easily be provided by expanding and contracting the volume of currency to meet public requirements. Even where the right of note issue is not entrusted to the banks, the

banks possess in the right of opening current deposit accounts to be drawn upon by cheques a yet more potent means of providing an elastic bank currency which, when wisely managed and controlled, can adequately fulfil and satisfy all the requirements of the community in this direction.

(2) Another essential of sound banking is the management of the bank reserve, which enables the banker to use the reserve to the utmost advantage by the creation of credit. Apart from currency to settle transactions and to secure the movement of commodities, every community requires capital for productive purposes, for the development of industries, and for the full utilisation of potential resources. It is one of the functions of banking institutions to create capital by the largest possible use of credit consistent with safety. For ultimately all credit must rest on the solid basis of cash, which is represented by the reserve of a banker. Holland and the United States of America are the only two countries where legislative restrictions are enforced with regard to the reserve ; and it has been rightly urged that this procedure is very much like that of a Government establishing military and naval reserves in times of peace, and then insisting that these forces should not be used in time of war, in order to maintain them intact as reserves.

(3) A third essential of banking is the provision of a central institution, a bankers' bank, which can fulfil the same function in relation to all banking institutions within the country that a single bank fulfils in relation to individual depositors and holders of funds. As any single bank mobilises the savings of individuals, collects money from institutions and localities where there is no need for it, and lends it to others who want it for productive purposes, so a bankers' bank mobilises the surplus money of the banks and makes it available for those who need it. A bankers' bank makes it possible for the money of the individual banks to do many times the work it would do if left in the separate institutions as cash reserves,

and to do it far more effectively. In times of difficulty a central bank can come to the help of individual banks as effectively as a bank could do in the case of an individual, and a bankers' bank thus diminishes the probability of financial crises ending in a crash.

CHAPTER XIX

HISTORY OF INDIAN CURRENCY

INDIAN CURRENCY IN THE PRE-BRITISH PERIOD

INDIA was familiar with a system of metallic currency from very early times; in documents belonging to the third century B.C. we find references and directions about the technicalities of coinage. Gold and silver coins were current side by side, giving the country a kind of unregulated bimetallism under both the early Mahomedan and the later Moghul rulers. Whilst the Hindu rulers preferred the use of gold coins, the Mahomedan rulers were inclined to favour the silver.[1] In a vast country like India a complete uniformity in the standard measure of values or in the media of exchange was not possible. Different provinces maintained different standards. In the Madras Presidency the gold pagoda, introduced about the sixteenth century, was the principal coin, whilst in Bengal a silver standard obtained, with gold coins circulating side by side with the silver. The official Treasurers of the Moghul Empire under Akbar were instructed to receive the land revenue in gold or silver or copper from the cultivators. So also under the Marathas in the Deccan, gold coins were freely issued and circulated conjointly with silver coins, and no attempt was made to regulate the ratio of exchange. Thus up to the end of the eighteenth century

[1] "The earliest Hindu currency was in gold with a single standard. The Mahomedans introduced silver, and in later times, up to British rule, there was a double standard, gold and silver" (Sir R. Temple, *Journal of the Institute of Bankers*, vol. xv. p. 9).

coins of all denominations made of gold and silver circulated in the country conjointly, their exchange values being determined by their fineness and weight. The Bengal Regulation of 1793 mentions no less than twenty-seven varieties of rupees in several districts.[1] Owing to the great inconvenience of the numerous varieties of coins which were in circulation in various districts in India, and in view of the importance of having one uniform coin, the East India Company declared its intention of establishing " one general system for the formation of the coin for the currency of the whole of our possessions on the Continent of Asia ".[2] A minute of the Governor-General in Council in 1806, which was prompted by Lord Liverpool's Note on the Coins of the Realm, declared the adherence of the Government to the principle of monometallism, and silver was selected, instead of gold, as the unit of value.[3] Both gold and silver coins were, however, allowed to circulate, and even in 1818, when new coins were struck, the coinage consisted of both gold and silver. This unregulated bimetallism was continued till 1835, when the East India Company declared the silver rupee to be the sole legal tender throughout India. It may be noticed, however, that this step was not taken without opposition. The Government of Madras at the time insisted on continuing the coinage of gold along with that of the rupee, and the Court of Directors observed in a despatch " that they were by no means desirous of checking the circulation of gold ". The people of India were so accustomed to the use of gold coins, especially in the South, that, though Government by the Act of 1835 enacted that " no gold

[1] The East India Company " found 994 different kinds of gold and silver coins current, of different weights and fineness, and whose value was constantly varying from day to day " (MacLeod, *Indian Currency*, (1898) p. 13).

[2] R. Chalmers, *A History of Currency in the British Colonies*, p. 338.

[3] It is worth noting that Lord Liverpool's Note, which subsequently led to monometallism on a gold basis in England, should have led the British rulers in India, where gold coins were already in circulation, to give their preference to silver as the unit of value.

coin shall henceforward be a legal tender for payment in any of the territories of the East India Company", it nevertheless authorised the coinage of a gold piece known as the *mohur*, of the same weight and fineness as the rupee, which was to circulate at its bullion value. Thus a uniform currency on a silver basis was introduced, and the rupee weighing 180 grains troy, 165 grains fine, became the sole legal tender throughout the country. But the strangest thing of all was that, whilst silver coins were declared sole legal tender, Government by a Proclamation of 1841 authorised its officers to receive gold coins at the rate of Rs. 15 per *mohur*. When, however, owing to the discovery of gold mines in Australia and California, silver appreciated in terms of gold, the Proclamation of 1841 was withdrawn by a fresh Proclamation in 1852, to the effect that no gold of any sort would be received at the public Treasuries. Gold was thus for the first time totally demonetised in India.

It is difficult to understand the reasons that led the Government of India to silver monometallism, when we remember that some of the local Governments were opposed to the idea, that the Court of Directors themselves were not entirely in favour of silver, and that according to all the evidence available the country was accustomed to the use of gold coins.[1] One can only regard the action of the Government of India as the first stage of a policy of light-hearted experimentation with the currency of the country, when we further remember that Great Britain had already been on a gold monometallic basis

[1] "As late as 1854–55 gold coin to the value of £412,000 was sent by the Government from India to London" (*Herschell Committee Report*, para. 100).

Cf. Sir R. Temple's Note of May 15, 1872: "The imperial dynasties which preceded us in India had a gold currency. . . . It may be said in general terms that on our accession to power in India we found a gold currency existing conjointly with the silver currency. And it was reserved for us to accord silver the dominant and exclusive position which it now holds in the currency. My own belief is that few nations have in their own minds a higher appreciation of gold than the natives of India."

since 1816, and that the Government of India drove gold out of circulation by legal enactments from 1818.[1]

The demonetisation of gold resulted in subsequent years in a serious monetary stringency, as the place of gold in currency was not taken either by an expansion of the silver currency or by increase in paper money, the total amount of the latter in actual circulation being very limited. Banking facilities were comparatively unknown, and the silver that was imported was mostly diverted to non-monetary purposes. To ease the money market, Government issued Indian Treasury notes, which in 1856 reached a total of £967,700.[2] The hardships felt by the country through the demonetisation of gold led to a universal demand for the restoration of the gold standard and currency, expressed through memorials by the Chambers of Commerce and voiced emphatically in a minute on "Gold Currency for India" by Sir William Mansfield. The Bombay Chamber of Commerce pointed out that the people themselves had devised a rude remedy for the deficiency of the silver currency by using gold bars stamped with the mark of Bombay banks as a circulating medium.[3]

That the Government of India was experimenting with

[1] Sir David Barbour, in his speech introducing the Coinage Bill in 1893 in the Legislative Council, observed: "In the beginning of the present century the currency of England was composed of inconvertible paper, and when, after the close of the great war with Napoleon, a return was made to specie payments, the legal standard of England was declared to be gold, mainly, I believe, on the ground that by their use of gold instead of silver for over 100 years the English people had shown their preference for that metal". If the use of gold for 100 years was sufficient reason for England to adopt gold monometallism in 1816, what shall we say of the policy of our rulers in introducing silver as the sole legal tender in India after the people had been familiarised with the use of gold for over 1500 years?

[2] "The demand for money has so far exceeded . . . that serious embarrassment has ensued and business has almost come to a stand from the scarcity of circulating medium" (quoted from Ambedkar, *Problem of the Rupee*," p. 34).

[3] The Bombay Chamber of Commerce considered the exclusion of gold from the currency of India to be a barbarous, irrational, and unnatural measure.

the currency of the country was manifested again in 1862, when a proviso was added to the Paper Currency Act authorising Government to cover part of the note circulation by the deposit of gold coin or bullion. Mr. Laing, the Finance Member, who was responsible for the proviso, wrote in his minute on " Currency and Banking " (1862) : " The object of this proviso was simply to leave the door open for *cautious and tentative experiments* with regard to the future use of gold. The importation of gold already exists and is increasing; and the metal is much appreciated by the native population." The Secretary of State endorsed the proviso with the remark that it would " effectually contribute to the introduction of a gold currency in India ".

The insistent demand of public opinion for a gold currency led the Government of India to issue a notification in 1864 authorising Government Treasuries to receive sovereigns and half-sovereigns at the rate of Rs. 10 to the sovereign, and to pay out sovereigns to those willing to receive them in payment of claims against the Government. The Bengal Chamber of Commerce recommended in 1866 the adoption of a gold currency, and asked for the appointment of a Commission. The Mansfield Commission, which was subsequently appointed, advised the Government, in view of the general desire of the country, " to cause a legal tender of gold to be a part of the currency arrangements of India ". The Government of India was evidently not prepared to accept this advice in its entirety ; and instead of making gold legal tender, it altered the relation of the sovereign to the rupee from Rs. 10 to Rs. 10 and annas 8 by a notification in 1868.[1] If,

[1] Sir Richard Temple, Financial Member of the Governor-General's Council, wrote a famous minute in 1872 recommending a gold standard and gold currency in India. " I have long believed that a gold currency is wanted in India; that its introduction ought to be an object for gradual, if not immediate attainment, and that the British Government ought to adopt measures from time to time towards that end. I do not say the introduction of a gold coinage, for we have that already in India. . . . I conceive that we should permit inducements to arise for the importation of gold into India, and for its retention in considerable

instead of adopting this half-hearted and halting measure, the Government of India had accepted the advice of the Mansfield Commission and introduced a gold standard, India would have been saved from all the difficulties which started with the fall in the value of silver from 1873.

At the end of the Franco-Prussian War the establishment of the new German Empire was accompanied by a new currency policy which demonetised silver and reduced it to the position of a token coin. The Latin Monetary Union in 1874 abandoned the free coinage of silver, which had hitherto absorbed large quantities of that metal from year to year. Even assuming that the total supply of the precious metals does not exceed the aggregate increased demand, the demand fell in such a proportion on gold as to increase materially its value, while throwing increasing quantities of silver on the market. Thus the value of silver fell from 52½d. per ounce in 1878 to 43¾d. in 1890. Appreciating the difficulties arising from the fall in the gold price of silver, the Government of India observed in 1878 that it was "led to the general conclusion that it will be practicable without present injury to the community as a whole, or risk of future difficulties, to adopt a gold standard, while retaining the present silver currency of India". In spite of the absorption of silver by the United States of America under the Sherman Act,[1] and by India from year to year,

quantities in the country; that whenever such quantity might be found adequate, we should take the first opportunity to declare the gold coins legal tender to an unlimited amount; that the gold pieces should continue to bear the fixed relation to the rupee; that for a time it might be necessary to permit the rupee to remain legal tender to an unlimited amount, which would involve temporarily the difficulty of double standard; that the transition period of double standard should be as short as possible, silver being reduced to a token coinage, and being legal tender up to a small amount only; and that gold should be ultimately the one legal standard."

[1] Under the Act passed in 1890 the duty was imposed on the Government of the United States of purchasing no less than 54,000,000 ounces of silver every year in lieu of the amount to be purchased under the Bland Act.

the price of silver continued to fall till it reached 37⅞d. per ounce in 1892.

The international problems with which the European countries were faced owing to the violent fluctuations in the gold price of silver, led to the convening of monetary conferences in 1878 and 1881, with a view to coming to an agreement on a bimetallic basis. No practical result was achieved. One more attempt was made in 1892, but in vain, when the Government of India through its representatives pleaded earnestly for international bimetallism. In brief, the inconveniences and difficulties arising from the adoption of the silver standard in India led the Government of India to look for a possible solution in international bimetallism in the period between 1878 and 1892; when, however, all hopes of a solution of this kind came to an end in 1892,[1] the Government of India telegraphed to the Secretary of State: "Our proposal is that we shall take power to issue a notification declaring that English gold coins shall be legal tender in India at a rate not less than 13⅓ rupees for one sovereign. . . . An interval of time of which the length cannot be determined beforehand should, we think, elapse between the mints being closed and any attempt made to coin gold in India." It was this telegram of the Government of India that led the Secretary of State to appoint the Herschell Committee to consider the questions arising from the grave difficulties with which the Government of India was confronted through the heavy fall in the gold value of silver, and the expediency of allowing Government to carry into effect the proposals for stopping the free coinage of silver in India with a view to the introduction of the gold standard in India.

Thus it will be seen that, at the time of the appoint-

[1] Even before the Brussels Monetary Conference (1892) ended its deliberations, the Government of India declared it to be its deliberate opinion that, if no bimetallic solution was arrived at, "it should at once close its mints to the free coinage of silver and make arrangements for the introduction of a gold standard" (vide *Herschell Committee Report*, para. 47).

ment of the Herschell Committee in 1893, public opinion in India was distinctly in favour of a gold standard. Till 1872 all the Finance Members of the Government of India, with the exception of Mr. Wilson, advocated a gold currency as among the urgent wants of India. A Special Commission appointed in 1866 to examine the whole subject reiterated the same view. In March 1892 Sir David Barbour in his Financial Statement declared: "I am unable to discover any permanent remedy for the evils which, day by day and year by year, press themselves upon our attention in India except either the general adoption of the system of double legal tender or the extension of the single gold standard. . . . If America altogether abandons silver, it would probably be best that India should change her standard. . . . The adoption of a gold standard would probably be attended with very serious consequences for Western nations; but, if, in this matter, they look only to what they conceive to be their own interest, they cannot reasonably object to India following the same course." [1]

Difficulties arising from the Fall in the Gold Price of Silver

Owing to the political relations of this country with Great Britain, India has to remit from year to year, in gold, a large sum of money known as the Home Charges, to meet certain obligations. The Home Charges include interest on sterling debt and on the stock of the guaranteed railway companies, pensions and furlough

[1] Cf. Lord Northbrook's evidence before the Fowler Committee, Question 8447: "When Lord Reay and Sir Louis Mallet were the representatives of the India Office at the Monetary Conference of 1881, after coming back from that enquiry *re infecta*, without having been able to do anything, they reported that India, by adopting a gold standard, could, in a few years, obtain a supply of gold sufficient for all purposes of her commerce as a standard of value, and that the difficulties derived their force rather from the interests of England and other gold-using countries than from those of India itself".

allowances payable in England, Army effective and non-effective charges, annuities of railway companies, purchase of stores in England on behalf of the Government of India, and the cost of Indian Administration in England. In 1873–74, the amount remitted for the Home Charges was £13,285,000, which at the exchange rate of 1s. $10\frac{1}{32}$d. was represented by Rs. 14,26,50,000. In 1892–93, the amount remitted was £16,532,000, which at the average rate of exchange in that year, namely 1s. $2\frac{1}{16}$d., required a payment of Rs. 26,47,80,000. Had this sum been remitted at the exchange rate of 1873–74, the country would have been saved nearly Rs. 12,00,00,000. Thus in the period between 1873–74 and 1892–93 there was an increase, in the first place, in the total amount of the Home Charges from £13,000,000 to £16,000,000,[1] requiring an additional five crores of rupees to be derived from taxation. In the second place, the fall in the gold price of silver from 1s. 10d. to 1s. 3d. necessitated a further provision of roughly eight crores of rupees. The problem before the Government was to make provision for this growing burden. Additional taxation became necessary, and from 1872 Government went on increasing the taxes.[2] Every fall by a penny in the value of the rupee involved an additional taxation of a crore of rupees. Government had exhausted by 1893 the available sources of revenue and the possibilities of economy in expenditure. Officials like Sir Theodore Hope and Sir Raymond West were agreed that it was financially imprudent and politically dangerous to resort to additional taxation.

[1] The Home Charges in 1890–91 amounted to £19,000,000 and in 1891–92 to £18,600,000.

[2] Thus in 1872–73 provincial rates were introduced for the first time; in 1875–76 an addition of one rupee per gallon was made in the excise duty on spirits; in 1877–78 the duty on Malwa opium was raised from Rs. 600 to Rs. 650 per chest. 1878–79 saw an increase in licence tax and local rates, and 1879–80 saw an addition of Rs. 50 per chest on Malwa opium. In 1886 the income tax was introduced, a duty of 5 per cent was imposed on imports of petroleum; the duty on salt was increased from Rs. 2 to Rs. 2.8 per maund in 1888. In 1893 an excise on malt liquor and salted fish was introduced.

The Government of India was faced with a further difficulty in the shape of heavy deficits arising out of the uncertainties and vagaries of the exchange value of the rupee. Sir David Barbour wrote: "The immediate cause of our financial difficulties, and the cause which, by comparison and for the time being, dwarfs all others, is the fall in the gold value of silver, which has added to the Indian expenditure in two years more than four crores of rupees. . . . Our financial position for the coming year is at the mercy of exchange. If we budget for the present deficit of Rs. 1,59,50,000, and exchange rises one penny, we shall have a surplus; if it falls a penny, we shall have a deficit of more than three crores; if we impose taxation to the extent of one and a half crores of rupees, a turn of the wheel may require us to impose further taxation of not less magnitude; another turn, and we may find that no taxation at all was required."[1]

The uncertainties arising from the fall in the gold value of the rupee were aggravated by the rumours of the possible repeal of the Sherman Act. Any absorption of silver by the Continental countries was very unlikely after the failure of the Brussels Monetary Conference. The annual production of silver increased from 2,450,000 kilos in 1876–80 to 4,800,000 kilos in 1892. All these conditions pointed to a further fall in the gold price of silver in the immediate future, and further embarrassments for the finances of the Indian Government.

In the next place, the European members of the Civil Service, who received their salaries in silver, found themselves involved in losses when remitting money home. They had to find more rupees for every pound sterling remitted with a fall in the value of the rupee, whilst their salaries were fixed.

In view of the violent fluctuations in the gold price of silver, the foreign trade of the country was seriously

[1] See *Herschell Committee Report*, para. 5.

dislocated. This can be seen from the following table of Indian exports :

Years.	Gold-using Countries. Percentage.	Silver-using Countries. Percentage.
1875–76 to 1879–80 . .	62	38
1880–81 to 1884–85 . .	69	31
1885–86 to 1889–90 . .	68	32
1890–91 to 1891–92 . .	67	33[1]

It will thus be seen that nearly 70 per cent of the import and export trade of India was with countries using a gold standard. Trade became a matter of speculation and gambling, and the fluctuations in the rate of exchange prevented the volume of trade from expanding to that extent which it might have attained under more favourable conditions.

Finally, the flow of capital from the gold-using countries to India was largely restricted owing to the element of uncertainty which the fluctuations in the rate of exchange involved. The Government of India wrote to the Secretary of State in 1886 : " Uncertainty regarding the future of silver discourages the investment of capital in India, and all find it impossible to borrow in silver except at an excessive cost ".

Such were the difficulties that faced Government and the country in 1893. What were the possible alternatives before the Government ? The possibility of an international bimetallic arrangement was already out of the question. The greater part of India's trade was confined to gold-using countries ; one country after another in the West had demonetised its silver currency and adopted the gold standard. The only sound policy for India, as its rulers themselves perceived, was to follow in the footsteps of the other countries and to adopt a gold standard. The Government of India outlined in very clear terms its ideas about the gold standard in 1892 : " The mints should be closed to the unlimited coinage of silver, and no further

[1] *Herschell Committee Report*, App. II. p. 242. The imports into India in 1891–92 showed that 74 per cent of the total came from gold-using countries, whilst 26 per cent came from silver-using countries.

steps taken until the effects of closing the mints had been ascertained". When this ratio had been settled, the mints were to be opened to the coinage of gold at that ratio, and gold coins were to be made legal tender to any amount.

The Herschell Committee and the Closure of the Mints

Instead of accepting in entirety the views of the Government of India, the Herschell Committee made a halting report. The Government of India, in its despatch of June 1892, not only desired the stoppage of the free coinage of silver, but was anxious that *arrangements* should be made for the introduction of a gold standard. Sir David Barbour in his minute attached to the despatch advocated the opening of the mints to the free coinage of gold as a measure towards the ultimate introduction of the gold standard.[1] The Herschell Committee, however, contented itself with the recommendation that the mints should be closed against the free coinage of silver; that, though closed to the public, the mints should be used by Government for the coinage of rupees in exchange for gold at the ratio of 1s. 4d.; and that Government Treasuries should receive gold at that rate in payment of public dues. The Herschell Committee, in other words, accepted the proposal to close the mints to the free coinage of silver, without making any specific provision or arrangement for the introduction of a gold standard. This has been clearly pointed out in a supplementary note by Sir T. H. Farrer and Sir R. E.

[1] *Herschell Committee Report*, App. I. pp. 146-49. The Government of India, in a despatch dated August 2, 1892, pointed out the advantages of a gold standard for India and observed that, in case no satisfactory settlement was arrived at, at the International Conference then sitting, "immediate steps should be taken to introduce a gold standard into India"; that Her Majesty's Government "ought not now to refuse to let us adopt the only other remedy open to us, namely, the adoption of the same monetary standard as that of the country with which we have our most intimate financial and commercial relations".

Welby : " Under these circumstances ", they observe, " we could not join in the recommendation contained in the Report, without at the same time recommending that the Government should, in view of the ultimate adoption of the whole of their plan, be prepared to secure the convertibility of their token silver currency, and should with that accumulate a sufficient reserve of gold."

The recommendation of the Herschell Committee led to the Coinage Act of 1893, closing the mints to the free coinage of silver, and to a notification announcing that Government Treasuries would receive sovereigns and half-sovereigns in payment of public dues at the rate of Rs. 15. Government also announced its intention to issue notes backed by gold. Sir David Barbour, in introducing the Bill embodying the Herschell Committee's proposals, observed that the object of the Bill was to alter " the Indian monetary standard from silver to gold ", and that other measures " necessary for the final and effective establishment of a gold standard in India will be provided for by future legislation ".

The predominant factor which determined the closure of the mints was the financial embarrassments of the Government of India, and it was hoped that these embarrassments would cease with the final adoption of an effective gold standard. Even as early as 1878 the Government of India had clearly realised the advantages of the adoption of a gold standard when it wrote : " It has further become plain that the current of all the most trustworthy opinion tends more and more towards the conclusion that so far as can now be foreseen there is no prospect of an early or complete recovery in the value of silver, and on the contrary, that the probabilities are all in favour of a further fall. The constantly increasing wealth of the chief countries of the world leads them more and more to desire a gold standard for their currencies, and the far greater activity of international trade renders more and more inconvenient the retention by them of different standards, and adds to the probability of the general and exclusive

adoption of the gold standard which has been accepted by the principal mercantile nations of Europe." [1] Thus when the Coinage Act of 1893 was passed, the Government of India seriously contemplated the introduction of an effective gold standard in the near future, and the country was reconciled to the temporary difficulties arising from the closure of the mints in view of the promised introduction of the gold standard.[2]

The closure of the mints was attended by serious consequences in the years that followed. The object of the Government was to raise the value of the rupee to 1s. 4d., and this object was achieved by limiting the volume of silver currency, and thus creating an artificial stringency in the money market. This point was well brought out by a number of witnesses before the Fowler Committee. Thus W. H. Cheetham stated : " The closing of the mints has reduced the volume of the currency in relation to trade. Population is always increasing, and trade is expanding ; if you do not continually add to the currency, you actually, in fact, reduce it ; that is to say, it is reduced in relation to requirements, and we have not got enough currency." [3] Sir Robert Giffen emphatically asserted : " There is hardly a case of money appreciating by reason of a contraction, or refusal to add to the amount, in which you have not, at some time or other, had difficulties in the money market. . . . I do not think you can say that any measure for contracting a currency and

[1] *Correspondence between the British and Indian Governments respecting the Silver Question* (1886), Appendix, p. 18.

[2] His Excellency the Viceroy, in his closing remarks in putting the Coinage Bill to the final vote, observed : " We know that other countries have discarded that metal [silver] and have prospered, and we see no reason why we should be precluded from following their example. . . . We trust that in process of time sufficient reserves of gold may be accumulated to enable us to render our gold standard effective, and thereby to complete the great change towards which we are taking the first steps to-day " (Proceedings of the Governor-General in Council, June 1893).

[3] *Fowler Committee Report*, Question No. 8713. See also Questions 6440, 7766, 7898.

making it of greater value is likely to be carried through without periods of considerable stringency in the money market." [1]

The effects on trade resulting from the contraction of currency were aggravated by the withdrawal to some extent of loanable capital by the banks.[2] This stringency was evidenced by the comparatively high rate of discount of the Bank of Bengal, which rose from a maximum of 6 per cent over the period 1891–93 to a maximum of 12 per cent over the period 1894–98.

The contraction of currency during the period 1894–98 was further displayed by the fall in the general level of prices or rise in the purchasing power of the rupee in terms of commodities. The following table indicates the movement of prices in the period 1893–99 : [3]

Year.	All Articles. Price. (100, index number based on the average of 1868–76.)
1893	125
1894	119
1895	116
1896	127
1897	149
1898	122
1899	117

To the depressing effects on trade following on the contraction of currency and the shortage of loanable capital, we must add the loss arising to the Indian exporter, and therefore to the country as a whole, from the artificial rise in the gold value of the rupee. Thus while the cultivator got less for his produce with falling prices, the country as a whole received less rupees than it would have got with an uncontrolled currency. When we are told of an expanding trade following upon the

[1] *Fowler Committee Report*, Question No. 10,089.

[2] See *ibid.* Questions No. 1811 and following, which contain extracts from the reports of some of the exchange banks, indicating the withdrawals of sterling capital.

[3] Abstracted from the table in Kemmerer's *Modern Currency Reforms*, p. 58. The rise in the index number in 1896 and 1897 was due to the failure of the monsoon.

closure of the mints, we may remember that the expansion might have been on a larger scale than it actually was.

It must also be remembered that the monetary and trading conditions of India are different from those of the Western world. Questions of currency are more intimately connected with the money market here than in the West. Before 1893, when silver bars and ornaments were convertible into rupees, this convertibility gave confidence to the thrifty portion of the population, and the expanding needs of loanable capital were met from such hoards. But after the closure of the mints in 1893 the savings of the people in the form of bullion or silver ornaments depreciated in terms of the currency, and thus deprived the people of the use of these resources in times of stringency. Mr. David Yule, an experienced Calcutta merchant, calculated the loss of loanable capital due to the closure of the mints at 150 crores of rupees.[1]

As the result of the closure of the mints, the exchange rate rose from 1s. 1d. in 1894 to 1s. 4d. in 1898, and the Government of India found itself in possession of large surpluses except in the famine year 1897–98. The additional taxation which had been rendered necessary in the years preceding 1893 by the vagaries of the rate of exchange was persisted in when the need had disappeared.

[1] Cf. *Herschell Committee Report*, para. 106. Before the closure of the mints, "in times of scarcity and famine a considerable quantity of silver ornaments has found its way to the mints". After the closure, the uncoined silver and silver ornaments ceased to be convertible into rupees.

CHAPTER XX

HISTORY OF INDIAN CURRENCY (*continued*)

THE FOWLER COMMITTEE AND THE COINAGE ACT OF 1899

IN January 1898, to relieve the severe stringency then prevailing in the Indian money market, the Government of India was compelled to pass an Act (No. II. of 1898) to issue currency notes in India on the security of gold received in England by the Secretary of State. But no gold was tendered for the purpose. In 1898, before the Fowler Committee was appointed, gold was not yet declared legal tender, though Government had notified its willingness to receive it in payment of public dues; the rupee remained legal tender to an unlimited extent; no legal ratio of exchange between the rupee and gold was yet fixed. When, therefore, in the beginning of 1898, the rate of exchange promised to reach 1s. 4d., as contemplated by the Herschell Committee in 1893, the time had arrived to reconsider the situation,[1] and the Government of India, in pursuance of definite promises

[1] Cf. Correspondence relating to proposals on currency made by the Government of India, 1898: "Our experience since 1893 has put beyond doubt one of the main principles on which the legislation of that year was based—a principle which was challenged at the time—namely, that a contraction in the volume of our silver currency, with reference to the demands of trade, has the direct effect of raising its exchangeable value in relation to gold. . . . Under these circumstances we believe that it would be wiser not to pursue a course of inaction which may be prolonged indefinitely, and that it is desirable in the interests of the State and of the mercantile community to terminate the period of transition without further delay."

made in 1893, might have recommended the adoption of a gold standard in India, with the rate of exchange fixed at 1s. 4d., the introduction of a gold mint, and the gradual demonetisation of silver. Instead of directly advocating such a solution, the Government of India in its despatch of March 1898 advocated a policy of borrowing sums not exceeding £20,000,000 to bring the exchange up to 1s. 4d. It would thus appear that the main interest of Government in 1898 was centred in the desire to keep the exchange value of the rupee at a steady level of 1s. 4d., and not in the desire to make gold legal tender in India. This latter measure was regarded as a future goal, when gold might flow into the country and remain in circulation.

The despatch of March 1898 led to the appointment of the Fowler Committee by the Secretary of State in April 1898, to report upon the proposals of the Government of India and to make suggestions of their own for the establishment of a satisfactory system of currency in India. The Committee examined, in addition to the proposals of the Government of India, two other schemes, one that of Mr. Leslie Probyn for establishing a gold standard without a gold currency, and the other that of Mr. A. M. Lindsay, who proposed that the Government should offer to sell without limit rupee drafts on India at the exchange of 1s. $4\frac{1}{16}$d. a rupee on the one hand, and on the other hand sterling drafts on London at the rate of 1s. $3\frac{3}{4}$d. a rupee, the funds necessary for the transaction to be kept separate from the ordinary Government balances in gold-standard offices in London and India. The Fowler Committee examined both these proposals, and it is interesting to notice the grounds on which the "gold-exchange standard" of Mr. Lindsay, a scheme later on conveniently adopted by the Government of India, though in 1898 it was unequivocally condemned by the same Government, was criticised by the Committee. The Committee called the scheme "ingenious", and observed: "It is difficult to avoid the conclusion that

the adoption of Mr. Lindsay's scheme would check that flow of capital to India upon which her economic future so greatly depends. Moreover, if the system were to be permanent, it would base India's gold standard for all time on a few millions of gold (or rather command over gold) in London, with a liability to pay out gold in London in exchange for rupees received in India to an indefinite extent."

Rejecting both these proposals, and also the argument that the hoarding habits of the people would come in the way of a gold currency, the Committee made the following recommendations :

> We are in favour of making the British sovereign a legal tender and a current coin in India. We also consider that at the same time the mints should be thrown open to the unrestricted coinage of gold on terms and conditions such as govern the three Australian branches of the Royal Mint. The result would be that the sovereign would be coined and would circulate both at home and in India. Looking forward as we do to the effective establishment in India of a gold standard and currency based on the principles of the free inflow and outflow of gold, we recommend these measures for adoption.
>
> Under an effective gold standard rupees would be token coins, subsidiary to the sovereign. But existing conditions do not warrant the imposition of a limit on the amount for which they should constitute a legal tender ; indeed, for some time to come, no such limitation can be contemplated.

Further on, to make these recommendations effective, the Fowler Committee proposed that " fresh rupees should not be coined until the proportion of gold in the currency is found to exceed the requirements of the public ", and that " any profit on the coinage of rupees . . . should be kept in gold as a special reserve entirely apart from the Paper Currency Reserve and the Ordinary Treasury Balances ".

It is thus clear that the Fowler Committee definitely recommended not merely a gold standard, but also a gold currency in active circulation. These recommendations were accepted in their entirety by the Government of

India, and effect was given to them by Act XXII. of 1899 making the sovereign legal tender throughout India at Rs. 15 to the £. Active steps were also taken about the same time for the opening of a mint for the coinage of gold in India ; as the coin was to be the English sovereign, the Government had to obtain the sanction of the British Treasury. In the Financial Statement for 1900–1, the Finance Member observed : " It has been decided to constitute a branch of the Royal Mint at the Bombay Mint for the coinage of gold. The terms of the proclamation to be issued under the Imperial Coinage Act have been settled, and we are merely waiting now until the Royal Mint has satisfied itself as regards the Mint premises and appliances at Bombay." But the British Treasury now began to object on technical grounds to the establishment of a gold mint in India, and when these were overcome they raised the question whether a mint for gold coinage was at all necessary in India. The Treasury urged that gold would not be sufficiently available in the country to keep the mint working, and they were anxious to save the cost of a mint to the Indian Exchequer. The Secretary of State, however, still insisted on the establishment of a mint " as the clearest outward sign that can be given of the consummation of the new currency system ". The British Treasury remained unconvinced as to the necessity for a gold mint in India, and the project was subsequently shelved.

It is significant how the innocuous proposal of the Fowler Committee recommending the use of the sovereign as the standard coin in India, led by a strange series of events to the abandonment of the scheme for a mint and to all the subsequent anomalies of the gold exchange system. A bold proposal in 1898 for the creation of a new gold coin—nay, even for the revival of the old gold *mohur* as the standard unit—would have brought about the realisation of a gold standard and currency, and saved the country from all the vicissitudes of the last twenty years.

It has been suggested in a recent publication that the Government had but slight faith in the proposal for a gold mint, and that "it was inconsequential to the working of the gold standard whence the coined sovereigns came. So long as a mint was open to the free coinage of sovereigns, the Indian gold standard would have been complete, irrespective of the location of the mint. Indeed, to have obtained coined sovereigns from London would have not only sufficed, but would have been economical." [1] The correspondence between the Government of India and the British Treasury is sufficiently decisive about the intentions of the Government. But it is only reserved for a country like ours to be seriously assured about the inconsequential character of the proposal for a mint. It is difficult to conceive of an effective gold standard, with ready convertibility of bullion into coin, in the absence of a mint ; and it must be remembered that all our subsequent currency difficulties arose out of this situation, which made it possible for the Government to maintain the so-called gold standard without a gold currency.

If we can, for a moment, survey the state of affairs reached in 1902, and glance rapidly at the previous history of the currency problem, we find that for centuries in the past India had a gold currency, that gold coins were in circulation till 1835 when the silver rupee was made the sole legal tender, and even after 1835 gold coins continued to be received in Government Treasuries. In 1857 the Bombay Government recommended the introduction of the sovereign as legal tender. A number of Finance Members of the Government of India in succession, including Mr. S. Laing, Sir Charles Trevelyan, and Mr. Massey, expressed their conviction that a gold currency was among the urgent wants of India. In 1864 the principal commercial associations in India recommended a gold currency, and in the same year the Government of India recommended the introduction of the sovereign as legal tender. A Special Commission appointed about

[1] B. R. Ambedkar, *The Problem of the Rupee*, pp. 159-160 (1923).

that time reported that " the demand for gold currency is unanimous throughout the country ". In 1872 Sir Richard Temple in his famous memorandum pleaded emphatically for a gold standard and currency. In 1876 the Bengal Chamber of Commerce addressed a memorial asking for the suspension of the coinage of silver; the Government replied that it would be impossible to suspend the coinage of silver without at the same time opening the mints to the free coinage of gold as unlimited legal tender. In 1878 again the Government of India recommended a gold standard and the ultimate adoption of a gold currency. If between 1878 and 1892 the proposal for a gold standard and currency fell into the background, it was because the thoughts of the Indian Government were diverted to the possibility of securing an international monetary arrangement on a bimetallic basis. When the hopes for such an arrangement were finally abandoned in 1892, the Government of India once again urged the desirability of altering the standard to gold. It was with this object that the mints were closed to the free coinage of silver in 1893, and finally the Fowler Committee definitely recommended the adoption of a gold standard and currency. Sir C. Dawkins, in a speech in 1900, triumphantly proclaimed that the goal had at last been reached : " India has at length emerged from a period of transition in her currency, has reached a goal to which she has been struggling for years, has established a gold standard and a gold currency ". Thus the country was unanimously in favour of a gold standard and currency; economic opinion and practice by 1900 had distinctly declared themselves in favour of gold ; the Government of India had consistently urged the introduction of a gold currency from 1864 ; and it was rightly thought that the country had after years of struggle obtained a sound system of currency in 1902.[1] Nobody could have dreamt

[1] Cf. Lord Northbrook's evidence (Fowler Committee), Question No. 8447.

" There is a remarkable fact which presents itself to me in looking

in 1902 that all these hopes for an effective gold standard would be suspended for years together by a policy of drift and, what was worse, by a policy of thoughtless experiment.

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back at all this again—because I knew it before—namely, that all through these papers, and all through the consideration and discussion of this question, there is hardly one single suggestion from any one with a knowledge of India—I doubt whether there is any suggestion at all—that a gold currency would not be popular in India if other circumstances rendered it desirable."

CHAPTER XXI

HISTORY OF CURRENCY EXPERIMENTS, 1899–1914

CONSISTENTLY with its honest intention of introducing a gold standard, the Government of India in 1899 made "an active effort to induce the people of India to use sovereigns as a medium of circulation". The Currency Offices and the Post Offices were authorised to offer sovereigns in exchange for notes. The Chamberlain Commission in 1914, with a desire to justify the Gold-Exchange Standard, suggested that in 1900 gold sovereigns were returned to the Treasuries through a dislike of gold coins, and that the rupees in some parts of the country were at a premium.[1] One can understand why the Chamberlain Commission looked upon this phenomenon as an evidence of the failure of Government to popularise a gold currency; but to us it admits of an easy explanation. In the first place, the introduction of a total of £2,000,000 into circulation in a country whose total currency requirements at the time might safely be estimated at not less than £150,000,000, can hardly be characterised as a serious attempt at introducing a gold currency. In the second place, no substantial addition had been made to the currency since the closure of the mints in 1893. The country's urgent demand even in normal times is a demand for coins of small denominations, and this demand was aggravated by the abnormal seasons in 1898 and 1900, when, faced with starvation, people were

[1] *Chamberlain Commission Report*, paras. 25-44.

forced to spend their savings in small amounts.[1] Under these circumstances, it is not surprising that sovereigns should have been returned to Government Treasuries. Even a year later, that is, in 1901, the Finance Member's hopes for the introduction of an effective gold standard were not in any way damped by such a gloomy interpretation of the behaviour of sovereigns as the Chamberlain Commission resorted to fourteen years later. In his Financial Statement for 1900–1 Sir C. E. Dawkins observed: "I believe that the rate at which gold is taken is likely to increase slowly, and that gold will pass gradually into general circulation in our seaports and large towns. No expectation was ever formed, nor is there any reason to desire, that gold would penetrate into the interior, or that the large mass of transactions in the country would ever be conducted except through the medium of silver and copper. Gold is behaving very much as we anticipated." Thus the Chamberlain Commission's assertion that the return of the sovereigns to Government Treasuries in 1900 is evidence of popular dislike for gold, or of the failure to force gold into circulation, remains unsubstantiated, and can only be accounted for by its ardent desire to defend the Gold-Exchange Standard. The Government of India never thought of utilising such an argument, and it was reserved for a committee of experts fourteen years later to make capital out of a harmless and easily intelligible incident.

The accumulation of gold in the Paper Currency Reserve and the demand for rupees compelled the Govern-

[1] "But besides the ordinary factors inducing demands for an increase of currency, abnormal influences have recently very seriously affected the situation. The great bulk of the population is purely agricultural. The agriculturist, in ordinary times, has little requirement for money in the shape of silver coin; he is himself the producer of a large proportion of the food he consumes, and his other wants which must be satisfied by purchase are trifling. In seasons of famine, however, the situation is changed. The food consumed by the suffering agriculturist must be purchased and paid for with coin, and as credit dries up in times of distress all his other requirements must equally be paid for in cash" (Sir Edward Law's minute dated September 6, 1900, *Chamberlain Commission Report*, Appendix I. p. 115).

ment to resume the coinage of rupees in 1900 on a considerable scale, and silver was purchased with the gold held in London as a part of the Paper Currency Reserve. Thus, under the abnormal conditions of 1900, which created a demand for rupees, the Government of India used part of the accumulated gold in the Paper Currency Reserve for purposes not directly connected with the sole function of a currency reserve, which is that of the convertibility of notes. That the Government of India drifted into this policy of steadying the exchanges by the use of gold in the Paper Currency Reserve without any premeditated design of introducing the Gold-Exchange Standard is clear from Sir Edward Law's minute of June 1900, in which he says : " The connection which has now arisen between the Currency Reserve and the maintenance of exchange appears to me to have come about in a somewhat fortuitous manner ". This mechanism, which was originally adopted under the stress of circumstances as a temporary measure, viz. the use of gold in the Paper Currency Reserve for the purchase of silver, was made permanent by the Act of 1902, which gave legislative sanction to the expedient.

The favourable balance of trade which India normally enjoyed had in the past been adjusted by the equally normal method of the remittance of specie. The gold liabilities of India in the shape of the Home Charges were met by the sale of Council Bills by the Secretary of State, which were ultimately paid from the Indian revenues. The sale of Council Bills served the double purpose of enabling the Government of India to discharge its gold liabilities and of partially settling India's claims on foreigners for her exports. The rest of India's claims were settled by the inflow of gold and silver. But the Government of India in 1900 and in the years immediately following had to resume the coinage of rupees for meeting the public demand. The Government of India assumed, on the strength of the return of sovereigns under abnormal circumstances to the Government

Treasuries in 1900, that the only currency that India demanded was a silver currency, and that therefore its only duty was to provide more rupees. On this assumption, Government thought that the normal remittance of gold to India at the expense of private individuals, and its reshipment by Government to London for the purchase of silver, was a clumsy and expensive device for both the people and the Government. These evils could be easily avoided, if only the Secretary of State could undertake to sell Council Bills on India without limit, that is over and above his requirements, at 1s. 4⅛d. per rupee, which is the gold export point from London. If the idea of a gold mint for India had not been abandoned, there would have been no necessity for the reshipment of gold to London for the purchase of silver, for the gold that flowed into the country would have passed into currency through the mint, as the Fowler Committee contemplated ; and it was the possibility of this constant inflow of gold that had led the Fowler Committee to recommend that no more rupees should be coined till gold occupied a predominant position in circulation. It was this fortuitous combination of circumstances—the abandonment of the project of opening a mint for the coinage of gold, the abnormal experience of 1900 and return of sovereigns to the Treasuries, and the demand for currency, which Government wrongly assumed to be a demand for rupees [1]—that led to the device of the surplus sales of Council Bills for adjusting India's balance of trade. The table that follows will indicate the extent to which the Secretary of State went on selling Council Bills over and above his requirements in the period

[1] There is, to us, nothing more evident than the fact that between 1893 and 1900 the mints were entirely closed to the coinage of metallic currency, and that the volume of trade in the same interval had definitely increased. What the country demanded was more money, and the opening of a gold mint would have automatically met this demand. The Government of India mistook this demand for money for a demand for rupees. The country was starved for money, and as it could not get sovereigns it naturally demanded rupees.

between 1900 and 1914. The amount of the surplus sales during these years represents the amount of gold which was prevented from flowing to India during these years. Moreover, the fact evidenced by the table that the Secretary of State normally sold his Bills below the gold export point indicates the desire of the Government to take advantage of this mechanism for preventing the flow of gold into India.

COMPARISON OF BUDGET ESTIMATES WITH ACTUAL DRAWINGS, 1900–1 TO 1913–14; AND AVERAGE RATES OF EXCHANGE AT WHICH DRAWINGS WERE MADE.

Year.	Budget Estimate.	Actual Amount.	Comparison with Budget. (+) Excess. (−) Shortage.	Average Rate.	Remarks.
				s. *d.*	
1900–1	16,440,000	13,300,277	−3,139,723 *a*	1 3·973	*a* Severe failure of crops in 1899.
1901–2	16,500,000	18,539,071	+2,039,071	1 3·988	
1902–3	16,500,000	18,499,946	+1,999,946	1 4·002	
1903–4	17,000,000	23,859,303	+6,859,303	1 4·049	
1904–5	16,500,000	24,425,558	+7,925,558	1 4·045	
1905–6	17,833,000	32,166,973	+14,333,973	1 4·042	
1906–7	17,800,000	33,157,196	+15,357,196	1 4·083	
1907–8	18,100,000	16,232,062	−1,867,938 *b*	1 4·029	*b* Failure of monsoon, 1907; monetary crisis in America; severe and general trade depression.
1908–9	18,500,000	13,915,426	−4,584,574 *b*	1 3·931	
1909–10	16,200,000	27,096,586	+10,896,586	1 4·041	
1910–11	15,500,000	26,783,303	+11,283,303	1 4·060	
1911–12	17,158,300	27,058,550	+9,900,250	1 4·083	
1912–13	15,500,000	25,759,706	+10,259,706	1 4·058	
1913–14*	19,455,000	31,200,000	+11,745,000	1 4·070	

* Net expenditure in the year, and not Budget estimate.

COUNCIL BILLS AND TELEGRAPHIC TRANSFERS [1]

The sale of Council Bills by the Secretary of State thus enabled him during these years not only to discharge his gold liabilities, but also to purchase silver for the coinage of rupees, to adjust the balance of trade, and to transfer and lock up the cash balances and surpluses of the Government of India, which under other circumstances would have been kept in India and would have led to reduction in taxation.[2]

[1] *Chamberlain Commission Report*, Appendix, vol. i. p. 232.

[2] Cf. Sir Edward Law's Minute (*Chamberlain Commission Report*, vol. i. p. 116): "The checking of the importation of gold, even though

With the abandonment of the project for a free mint for the coinage of gold, the rupee in India had become an inconvertible note printed on silver, and the Government of India fell an easy prey to the temptation to over-issue which is always incidental to inconvertible paper money. Even as early as 1900, when the coinage of rupees was just resumed, the Finance Member of the Government of India himself sounded a note of warning against the danger of over-issue: "The rapid increase of the rupee coinage without some definite guiding principle regulating the limits of increase, is to be deprecated as likely to induce whatever dangers are to be feared from subsequent redundancy of rupees". The following table will indicate the net coinage of rupees by Government from 1900 to 1914.

NET COINAGE OF RUPEES FROM 1899–1900 TO 1913–14

Year.	Net Coinage.
1899–1900	1,31,89,370
1900–1901	11,85,35,679
1901–1902	3,29,47,891
1902–1903	25,94,825
1903–1904	11,03,18,553
1904–1905	7,79,67,015
1905–1906	16,81,23,179
1906–1907	23,36,07,498
1907–1908	15,69,12,110
1908–1909	23,98,863
1909–1910	8,54,714
1910–1911	1,44,053
1911–1912	29,98,695
1912–1913	14,70,50,808
1913–1914	10,14,29,870

Roughly, from 1900 to 1914 the Government of India coined additional rupees to the number of 1,16,00,00,000,

temporary, when suddenly decided on, must prejudice the legitimate operations of private importers, and, in any case, measures tending to impede the free importation of gold are directly opposed to the wise general policy of encouraging such importation. Even abnormal transfers of Treasury balances are objectionable as involving considerable expense and upsetting the carefully considered plans for the manipulation of these balances."

which all remained in circulation. As Mr. Keynes observes, "Having once started on a career of furious coinage, they continued to do so with little regard to considerations of ordinary prudence—though their sins did not overtake them immediately". . . . "The effects of heavy coinage are cumulative. The Indian authorities do not seem to have understood this. . . . They framed their policy as though a community consumed currency with the same steady appetite with which some communities consume beer." [1]

The profits arising from the coinage of rupees were set apart in gold in accordance with the recommendation of the Fowler Committee. Instead of being kept in India, as the necessary backing to a gold currency, they were transferred to London on the alleged assumption that London was the place where the Reserve "would have to be applied on the occasion of the emergency against which it was being created".[2] But though this is the motive ascribed to Government by the Chamberlain Commission, there is no doubt that the transfer of gold in the Gold Standard Reserve to London, and also of £5,000,000 of sovereigns from the Paper Currency Reserve, was made with the double purpose of earning interest

[1] *Indian Currency and Finance*, pp. 133-134.

[2] We are quoting from the *Chamberlain Commission Report*, para. 27. It is clear that the Fowler Committee recommended the creation of the Gold Reserve so that Government may ultimately "discharge its obligations in India in gold instead of in rupees". But the mechanism of surplus sales of Council Bills enabled the Government to use the reserve for steadying the exchanges, and a policy into which Government had drifted by the force of circumstances, was subsequently justified by the Chamberlain Commission. The Chamberlain Commission, in its enthusiasm for defending the Gold-Exchange Standard and the policy of Government, attributes to the Government a motive in locating the Gold Reserve in London, which at any rate in the years 1900–4 the Government of India could never have entertained. In 1900 the Government of India in its despatch to the Secretary of State observes: "We consider it desirable that a reserve of gold should be formed outside the Currency Reserve; . . . this would be in accordance with the view of Lord Elgin's Government that the Reserve should not be used for the general purposes of our exchange policy."

and keeping the gold in London for the purchase of silver. The idea of utilising the Reserve for stabilising the exchanges had not yet definitely dawned on the mind of the Government. It was only subsequently, in 1907, when the Gold Reserve Fund had grown to nearly £12,000,000 and the advantages of keeping the Reserve in London were increasingly realised, that the Government of India sought a scientific justification for the object and location of the Reserve in the argument that it was built up to enable the Government of India and the Secretary of State to meet their sterling obligations in the event of a falling off in the demand for Council Bills. But even in 1907 the argument that the Reserve is to be an instrument for stabilising the exchanges does not appear in official documents. It was only in 1912 that the Financial Secretary stated in the Budget debate: "The location of our Gold Reserve in London, with the exception of that small portion of it which as liquid gold finds its way into our Indian currency chests in years of high exchange, is deliberate. It is intended to strengthen us and simplify our duty in maintaining the gold value of the rupee." The Chamberlain Commission wrongly attributed to the Government in 1900–4 a motive which does not appear in official pronouncements till as late as 1912.[1]

That the Gold Reserve built up out of the profits of coinage of rupees was not in the early years definitely intended to stabilise the exchanges is further clear from the fact that, on the recommendation of the Mackay Committee, the Secretary of State decided that in future half the profits of the coinage of rupees should be spent on capital expenditure on railways till the Reserve reached £20,000,000. In accordance with this decision, £1,000,000 was actually appropriated for this expenditure. There can be no more eloquent testimony than this to the purely

[1] Mr. Keynes, in his *Indian Currency and Finance* (1913), observes: "I do not think it has ever been thought out quite clearly for what precise purposes these Reserves are held".

experimental character of the policy of the Government of India in currency matters.[1]

This new experiment with the Gold Reserve Fund was given up in the very next year, when the trade balance went against India, owing to partial failure of the monsoon, general monetary stringency all over the world, and financial crisis in America.

Towards the end of 1907 the financial crisis in America led to a heavy strain on the London money market, resulting in a rise in the Bank rate to 6 per cent and ultimately to 7 per cent, a limit that was reached for the first time after 1873. Simultaneously, owing to unfavourable monsoon conditions, there was a falling off in India's exports, with a slackening in the demand for Council Bills and a fall in exchange below 1s. $3\frac{29}{32}$d., the gold export point from India. There was a demand for bills on London, and though the Government was morally bound to supply sovereigns in exchange for rupees, for some time it preferred standing by its legal rights. Subsequently, from April 1908, Government sold sterling bills on London to a total of £8,000,000, thus tiding over the crisis.

Meanwhile the heavy coinage of rupees from year to year led to a phenomenal rise in the price level, which is always attended with grave hardship in a country like India, where the mass of the population drag out a miserable existence. When prosperous conditions returned after 1908, the rupees that had temporarily accumulated in the Government Treasuries found their way into circulation, and in the years between 1909 and 1914 the demand for Council Bills following on favourable balances made it possible for Government to resume coinage on as elaborate a scale as in the years 1900-5. The hardships and inconvenience of the currency system, if it was

[1] Even Mr. Howard was compelled to recognise that the diversion of the profits arising from coinage to railway expenditure had the great disadvantage " of causing the public to have grave misgivings as to the future policy of Government in regard to the treatment of the Fund " (Memorandum, *Chamberlain Commission Report*, Appendix xxiii.).

a system at all, roused public opinion, and Sir Vithaldas Thakersey suggested during the Budget debate of 1911, and subsequently demanded in a resolution in 1912, a gold currency for India. As a result of public agitation for a sounder system of currency, the Government of India was obliged to make a pronouncement, and in a despatch to the Secretary of State, May 1912, it proposed once again the opening of a gold mint in Bombay. "It is, we think, an indisputable fact that the establishment of a gold currency was regarded as a natural and logical sequence of the closing of the mints to silver, and as the necessary accompaniment of the establishment of a gold standard. . . . Such a measure will mark a step along the path which has been authoritatively accepted as the line on which our currency policy must develop, and, in time, it will be of great assistance in maintaining the stability of our currency system. . . . Our proposal for a gold coinage has behind it the overwhelming support of Indian public opinion, the leaders of which are ready and anxious to extend the everyday use of the common coin of the Empire, and are unable to understand why India should be denied the same minting facilities as have been given to Australia and Canada."[1] The Government of India was thus even in 1912 consistent and honest in its intention to carry out the recommendation of the Fowler Committee for the introduction of a gold currency in India. It is only a later theorist of the

[1] Even in 1910, Sir James Meston, then Financial Secretary, during the Budget debate clearly stated: "The broad lines of our action and our objects are clear and unmistakable and there has been no great or fundamental sacrifice of consistency in progress towards our ideal. Since the Fowler Commission that progress has been real and unbroken. There is still one great step forward before the ideal can be reached. We have linked India with the gold countries of the world, we have reached a gold-exchange standard, which we are steadily developing and improving. The next and final step is a true gold currency. That, I have every hope, will come in time, but we cannot force it. . . . The final step will come when the country is ripe for it. I trust that it will not be delayed; for when it comes it will obliterate all the mistakes, all the inconveniences, all the artificialities of our present position."

Gold-Exchange Standard, like Mr. Keynes, who can see in this document that " the despatch reads as though it were an attempt to reconcile divergent and contradictory views which had received expression ". The hostility of the British Treasury once again stood in the way of opening a gold mint.[1] In view of the despatch and the strong attitude of the Government of India, a Royal Commission was appointed in 1913, in spite of the opposition of the Government of India.[2] The Chamberlain Commission investigated the whole question and made their report in the beginning of 1914, sanctifying the then existing system of currency, into which Government had drifted on the tide of circumstances. The Chamberlain Commission observe :

In spite of the fact that the Government adopted and intended to carry out the recommendations of the Committee of 1898, the Indian Currency to-day differs considerably from that contemplated by the Committee, whilst the mechanism for maintaining exchange has some important features in common with the suggestions made to the Committee by Mr. A. M. Lindsay. The system actually in operation has accordingly never been deliberately adopted as a consistent whole, nor do the authorities themselves appear always to have had a clear idea of the final object to be attained. To a great extent this system is the result of a series of experiments. But to state this is by no means to condemn the action taken or the system actually in force.[3]

The Commission sum up their conclusions in the following terms :

We cannot recommend on its merits the establishment of a gold mint in India. But if Indian sentiment genuinely

[1] The opposition of the British Treasury, which was responsible for once again putting off the opening of a gold mint, is characterised by Mr. Keynes as an act that came to the rescue of the Government of India. (See *Indian Currency and Finance*, p. 68.)

[2] *Vide* telegram dated May 18, 1912 : " Matter has been twice subject of debate in Imperial Legislative Council and during past years has been discussed vigorously in press and by commercial interests in India and England ; therefore (we) do not think it is necessary to collect further opinions ".

[3] *Report*, para. 45.

demands it, and the Government of India are prepared to incur the expense, there is, in our opinion, no objection in principle either from the Indian or Imperial standpoint, provided always that the coin to be minted is the sovereign (or the half-sovereign); and it is pre-eminently a question in which Indian sentiment should prevail. If, however, the final decision be against the opening of a gold mint, we recommend that the notification of the Government's readiness to receive refined gold at the Bombay mint should be renewed on suitable terms.

We have already stated that it is not to India's interest that further efforts should be made to encourage the circulation of gold as currency. We regard gold in circulation as wasteful, and we think that India should be encouraged to develop economical habits in matters of currency. . . .

To sum up, our view is that India neither demands nor requires gold coins to any considerable extent for purposes of circulation (as opposed to saving or hoarding), that the most generally suitable media of internal circulation in India are at present rupees and notes, and that the Government should, as opportunity may offer, encourage notes, while providing—and this is the cardinal feature of the whole system—absolute security for the convertibility into sterling of so much of the internal currency as may at any moment be required for the settlement of India's external obligations.[1]

The currency system into which the Government of India had drifted as a result of a process of trial and error extending over nearly twenty years, was thus for the first time characterised as a sound and scientific system by the Chamberlain Commission. The "discovery" that the system of currency known as the Gold-Exchange Standard, into which the Government of India blundered unawares during 1898–1914, was a sound and scientific system, was first made by Mr. Keynes. His conclusions were formulated in his book *Indian Currency and Finance*, published in 1913 before the appointment of the Chamberlain Commission. What could be more natural than that the

[1] *Report*, paras. 73, 74, and 76. It is somewhat strange that on the same page of the Report in which the Commission observe that they find it difficult to judge accurately of the depth and extent of Indian feeling for the opening of a mint for the coinage of gold, they should also dogmatically assert that India neither demands nor requires gold coins.

main findings of the Commission should be on lines similar to those of Mr. Keynes' book ?[1]

Sir James Begbie was the only member of the Chamberlain Commission who saw through the economic dangers of the policy which the Commission was attempting to sanctify. He insisted, in a dissenting minute, on the desirability of a gold currency for a country which absorbs gold on a large scale, and observed that " the true line of advance for the currency policy is to discourage an extension of the token currency by providing increased facilities for the distribution of gold when further increases in the currency become necessary ".

[1] See *Indian Currency and Finance*, p. 30. Mr. Keynes asserts that "the currency problem of each country is to ensure that they shall run no risk of being unable to put their hands on international currency when they need it, and to waste as small a proportion of their resources on holdings of actual gold as is compatible with this ". Compare with this statement the wording of paragraph 76 of the *Chamberlain Commission Report* already cited in the text.

CHAPTER XXII

HISTORY OF INDIAN CURRENCY, 1914–25

CURRENCY MEASURES AND EXPERIMENTS, 1914–19

BEFORE the recommendations of the Chamberlain Commission could be considered by the Government of India, the war broke out in August 1914. As an immediate result of the outbreak of war, the balance of trade went against India for a few months, and Reverse Bills were sold by Government to the extent of about £9,000,000. But the balance soon turned in India's favour, and the net excess of exports over imports for the three years ending 1918–19 was greater than in the five years preceding the war. The following table gives us the figures:

Year.	Net Exports.	
1909–1910	£47,213,000	
1910–1911	53,685,000	
1911–1912	59,512,000	
1912–1913	57,020,000	
1913–1914	43,753,000	
1914–1915	29,108,000	←(Adverse balance
1915–1916	44,026,000	in the first six
1916–1917	60,843,000	months of the
1917–1918	61,402,000	war.)
1918–1919	56,540,000	

During the war there was an increasing demand for India's food-stuffs and raw materials by both Great Britain and her Allies; at the same time there was a reduction in imports, as the fighting Governments were compelled to concentrate attention on the production of war materials. The balance in favour of India was further accentuated by the claims of the Indian Government on

the Imperial Government for money spent in occupied territories, which exceeded £240,000,000. The claims of India were met up to 1916 by the usual mechanism of the sale of Council Bills and the fresh coinage of rupees, till the price of silver reached 43d. an ounce.[1] The difficulties began when Government could not go on coining rupees at 1s. 4d., as it would have involved heavy loss. The price of silver rose above 43d. an ounce, owing to the increasing world demand. The balance of trade in favour of India had to be adjusted. As gold was mobilised for war purposes, it was not available. The fiduciary portion of the paper currency was increased by ordinances, and silver could only be purchased and coined at a loss to Government. As a result, the rate of exchange went up in sympathy with the price of silver as indicated below :

January 1917 . . .	1s. 4¼d.
August 1917 . . .	1s. 5d.
April 1918	1s. 6d.
May 1919	1s. 8d.
August 1919 . . .	1s. 10d.
September 1919 . . .	2s.
November 1919 . . .	2s. 2d.
December 1919 . . .	2s. 4d.

If the main object of the much-lauded Gold-Exchange Standard was the maintenance of stability in the foreign exchanges, the first thing that the Government of India should have done was to meet the loss on the purchase of silver from the Gold Standard Reserve. Thus, on the very first occasion on which the Gold-Exchange Standard was seriously tested, it broke down. The impossibility of liquidating the foreign claims of India led the Government after 1916 to desperate measures. The fiduciary portion of the Paper Currency Reserve was increased from

[1] The following table shows the net coinage of rupees in 1911–19:

1911 . .	1,52,66,335	1916 . .	21,29,00,210
1912 . .	12,41,89,206	1917 . .	26,47,82,876
1913 . .	16,32,65,951	1918 . .	41,36,50,628
1914 . .	4,83,70,150	1919 . .	42,76,06,284
1915 . .	1,52,72,118		

14 crores of rupees to 120 crores, by a succession of ordinances, on the backing of investments of which 100 crores could be sterling securities. The Government of India issued one- and two-rupee and half-rupee notes and nickel coins of various denominations. Exports from India were controlled by the issue of certificates. Between 1915 and 1916 the Government of India purchased silver to the extent of 538,000,000 ounces. When even these heroic measures failed to liquidate India's claims, the magnanimity of the Government of India came to the rescue with the vote of a free gift of £100,000,000 to the Imperial Government. This measure, which involved a heavy burden on the people of the country, was additional to other expedients like the raising of loans to the extent of Rs. 130,00,00,000 in three years, and Treasury Bills to the extent of Rs. 66,00,00,000. The exchanges ran riot, and at the end of the war the rate of exchange rose to 1s. 10d., the price of silver was 66d. an ounce, and all the expedients and measures adopted by Government had failed to secure stability.

Currency History after the War

In view of the difficulties arising from the advancing price of silver and the inadequacy of the supply for Indian requirements, and in view of the dangers of a suspension of specie payments in exchange for notes, the Government of India thought it necessary to examine various proposals for securing the convertibility of notes and for maintaining the Gold-Exchange Standard. Accordingly, in May 1919, a Committee[1] was appointed to examine the effect of the war on the Indian exchange and currency system and practice, and to consider whether, having regard to experience and possible variations in the price of silver, any modifications were required : " to make recommendations as to such modifications, and generally as to the policy that should be pursued with a view to meeting the requirements of trade, to maintaining a satisfactory

[1] The Babington-Smith Committee.

monetary circulation, and to ensuring a stable Gold-Exchange Standard ".[1] The Committee submitted its Report in December 1919, with one minute of dissent. The Committee emphasised the desirability of restoring the stability of the exchange value of the rupee, and re-establishing what they called the automatic working of the Indian currency system (para. 36). And yet in the same Report, just a few paragraphs earlier, the Committee observe that "for the current operations of trade, stability is an important facility rather than an essential condition. There are many instances, including that of India herself, before the closing of mints, which show that trade has flourished and can flourish with a fluctuating exchange."

The Committee gave its blessing to the Gold-Exchange Standard on the grounds that it had supplied suitable media for internal circulation, provided means for the settlement of the balance of trade, and secured stability between the rupee and sterling. But the system broke down when the price of silver rose above 43d. per ounce, a contingency that was not anticipated by any of the previous Committees. As a safeguard against this contingency, the Committee recommended that the rate of exchange should be fixed at 2 shillings gold, in the belief that the market price of silver was not likely to fall below that figure.[2] The Committee justified the higher rate of exchange on the grounds that a high rate of exchange would lead to a fall in the level of prices in India, would not seriously hinder industrial development, would not permanently hamper Indian trade, and would enable India to save Rs. 25,00,00,000 on Home Charges. Whilst defending the Gold-Exchange Standard and proposing a

[1] It is clear from the terms of reference of the Babington-Smith Committee that the Government of India had by this time given up the earlier objective of giving to India an effective gold standard. Its only anxiety now was to secure the stability of the Gold-Exchange Standard.

[2] Two shillings gold, and not sterling, was recommended in view of the disparity between sterling and the sovereign. The rupee was thus to be linked to gold instead of to sterling.

new rate of exchange for ensuring its stability, the Committee, in a fit of absent-mindedness which it is difficult to explain, also recommended the establishment of a gold mint for converting bullion into coin. The minute of dissent by Sir Dadiba Dalal pressed for adhering to the 1s. 4d. ratio ; he was the only one on the Committee to realise that the rise in the price of silver was the result of a combination of circumstances which was not likely to persist, and therefore he was opposed to the alteration in the rate of exchange which the Committee had so lightheartedly recommended.

The recommendations of the Committee were accepted by the Government of India, and by the Indian Coinage Amendment Act of 1920 the legal rate of exchange was altered from 1s. 4d. to 2s. gold in spite of the warnings of the representatives of Indian public opinion. But though the Government of India may have believed in the stability of the abnormal conditions which had led to the phenomenal rise in the prices of silver, the belief was falsified when immediately after the passing of the Act the maintenance of the new rate—2s. gold—became difficult. Even when the ratio was legally altered, the market rate of silver was higher than 2s. gold. In February 1920 it reached 1s. 11d. Government, having declared the legal rate to be 2s. gold, now announced its intention to maintain that rate by the sale of Reverse Bills on London at market rate, the loss arising from these sales to be debited to the Indian revenues. The favourable conditions under which the Reverse Bills were to be sold gave a powerful stimulus to the demand for such bills. All persons who could not remit money abroad during the war took advantage of the Government offer, and speculators were not wanting who rushed in to make money out of the foolishness of Government. From January 1920 to September 1920 the total amount of Reverse Bills sold reached £55,382,000, involving the Government in a total loss of more than 40 crores of rupees. The Reverse Bills were paid in London out of

the matured Treasury Bills and sterling securities belonging to the Paper Currency Reserve and built up out of India's surplus exports during the war. When these investments were made they were made at the rate of 15 rupees to the pound. When they were realised to meet the Reverse Bills it was at a rate below 10 rupees per pound. Thus the sale of Reverse Bills involved a double loss to the country, the exact amount of which can only be known to the Government of India.[1] Even as early as March 1922, the Finance Member in his Budget statement confessed that the attempt to regulate the rate of exchange by the sale of Reverse Bills had failed. By March 1921 the price of silver had fallen and the exchange rate reached 1s. 4d. Ever since September 1920, when the sale of Reverse Bills was given up, the exchange rate has fluctuated in response to market conditions, and the Government of India has abandoned all attempts at regulating the exchanges.

The rate of exchange reached the lowest figure, 1s. 3d., in the beginning of 1922, and since then has fluctuated between 1s. 4d. and 1s. 6d. sterling. Thus the market rate of exchange to-day corresponds neither to the legal rate of 2s. gold nor to the gold price of silver, which is 33d. an ounce, and which if it were the governing factor would give us an exchange rate of 1s. ¼d. This anomaly can only be explained as the result of the general currency policy which the Government of India has deliberately adopted, more especially after the Chamberlain Commission Report. Those who read carefully the events of the last three years cannot avoid the conclusion, not

[1] It was a childish attempt at befogging the issue about the total loss from the sale of Reverse Bills that the Finance Member made when, replying to the Budget debate in March 1922, he observed: "I want to put that to the test. How much additional taxation have we been obliged to propose on account of what some of our friends described as our mistakes in regard to selling Reverse Councils?" No additional taxation was necessary, because the heavy losses are concealed even to-day by the manipulations of the Paper Currency Reserve and behind the deflation policy.

only that the Government of India desires to persist in its policy of adhering to the Gold-Exchange Standard, but that it desires to stabilise the rate of exchange as near to 2s. gold as possible, irrespective of all other considerations affecting the general welfare of the country. Ever since 1922 the balance of trade has always been in favour of India,[1] giving her claims which can only be met by the import of the precious metals, capable of being converted into coin to meet the demands of trade under normal conditions. The machinery at the disposal of the Government of India enabled it to limit the volume of currency, with the object of pushing up the rate of exchange. Even before 1922 the process of deflation had been resorted to, resulting in the withdrawal of currency to the extent of more than forty crores. The normal demand for currency goes on increasing under prosperous conditions : but the Government of India has refrained from adding to the currency all these years, though there is an increasing demand on the part of the commercial interests. There can be no better witness to the demand for currency and the starvation policy of the Government than movements in the Bank rate of discount, which in these years has ranged from 4 per cent to 9 per cent within a couple of months. Reluctant to add to the volume of money, Government has nevertheless yielded to public clamour by issuing emergency currency, which

[1] The following table indicates the actual figures :

	In lakhs of Rupees.				
	Average of 5 pre-war years ending 1913–14.	Average of 5 war years ending 1918–1919.	Average of 5 years ending 1923–24.	1923–24.	1924–25.
Exports of Indian merchandise (private) . . .	+2,19,50	+ 2,15,98	+2,85,68	+3,48,84	+3,84,85
Re-exports of foreign merchandise (private) . .	+4,62	+8,16	+15,62	+13,07	+13,51
Imports of foreign merchandise (private) . . .	- 1,45,85	- 1,47,80	- 2,48,81	- 2,17,03	- 2,43,18
Balance of trade in merchandise (private) . . .	+78,27	+76,34	+52,49	+1,44,88	+1,55,18

this year reached the figure of twenty-four crores. Whilst the Bank rate in India indicates an extraordinary demand for money, the Government of India goes on selling sterling in India and transferring funds to London over and above the requirements of the Secretary of State, thus locking up Indian money in London. Whereas the Finance Member pointed out in March 1924 that there were £14,000,000 in the Paper Currency Reserve, available, if necessary, to meet India's sterling obligations, thus requiring the transfer of only £13,000,000 to £14,000,000 to meet sterling obligations, in the absence of borrowing in London, the Government of India remitted no less than £43,000,000 to London in the year closing with March 1925. In the past the surplus sales of Council Bills by the Secretary of State involved the issue of additional currency in India, satisfying the growing trade demand. But the new policy of selling sterling bills in India and Council Bills in London without issuing currency, and meeting them by manipulations of the Paper Currency Reserve, by drawing upon the Post Office Savings Bank deposits, and even by the issue of Treasury Bills, cannot admit of any other explanation but that Government intends to reach a higher rate of exchange. This is clear from the reply which Sir Basil Blackett, the Finance Member, gave in September 1924 to a question in the Legislative Assembly. "Moreover, before action can be taken, very careful consideration must be given to the question whether a rate of 1s. 4d. gold or some higher rate is most likely to be beneficial to India, regard being had to the interests of the consumer and the taxpayer as well as other interests concerned."[1] While this is the

[1] Even as early as March 1923, the Finance Member in his Budget statement (para. 28) suggests in an adroit manner the desirability of a rate higher than 1s. 4d. "There is no sanctity in this era of instability about any particular rate of exchange, whether 1s. 4d. or 2s. or anything else; it is simply a question of what rate of exchange best suits India's needs. Ultimately India's payments outside India are, and must be, made in the form of exports of Indian goods and services. But if we look at the matter from the narrow point of view of the Budget, the

conclusion forced upon us by the acts and pronouncements of Government officials, we need not be surprised at the occasional professions of those officials made in deference to the demand of the Indian mercantile community for stabilisation at 1s. 4d. gold.[1] With a favourable balance of trade and limitation of the volume of currency, any rate of exchange can be artificially achieved and maintained, more especially if those who are bent on attaining such a result can look with complacence on the natural consequences — prolongation of trade depression, of unemployment and starvation, and of that monetary stringency which is so harmful to the rise and development of industries in a country lacking in banking facilities and organisation of credit.

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following statistical data are of interest. The Government of India sterling debt of £240 millions sterling at 1s. 4d. amounts to 360 crores, at 1s. 5d. it amounts to 339 crores, at 1s. 6d. it amounts to 320 crores, while at 2s. it amounts to 240 crores. Of the deficit for 1922–23, 5½ crores would have been saved had the exchange been at 1s. 6d., and 9½ crores if it had been at 1s. 8d. Statistics proverbially can be made to prove anything. Nevertheless, these figures are striking, and it must be remembered that, apart from the sterling indebtedness of the Government of India, there are large sterling debts owed by municipalities, port trusts, and many other Indian borrowers, who would all be individually benefited by a higher exchange so far as their sterling indebtedness is concerned."

[1] Cf. Sir Basil Blackett's speech before the Indian Merchants' Chamber in July 1924: "Our policy is to reach 1s. 4d. gold at the earliest possible moment". Subsequently, in January 1925, Sir Basil Blackett was more explicitly in favour of a higher rate; he maintained that there was no ideal ratio of exchange, and that the choice of a ratio depended on what was in fact easily attainable and maintainable—namely, 1s. 6d.

CHAPTER XXIII

ORIGIN AND THEORY OF THE GOLD-EXCHANGE STANDARD

The Origin and Evolution of the Gold-Exchange Standard

Down to the end of the Franco-German War, as we have already stated in a previous chapter, England was the only country that had a composite standard based on gold. The rest of the world was either on a bimetallic basis or, as in the East, using silver as the principal metallic money. But with the demonetisation of silver and the adoption of a gold standard by Germany and by a number of other countries in the period between 1871 and 1893, there arose an extraordinary demand for gold, which, accompanied as it was by the abandonment of silver for monetary purposes, led to violent fluctuations in the gold price of silver. This created a serious situation for all countries which were on a partially bimetallic basis, like the members of the Latin Monetary Union, or on a purely silver basis, like India and China, and which had intimate commercial relations with gold-using countries. There were only two alternatives which could have solved the difficulty, namely, the adoption of international bimetallism or the universal adoption of a gold standard. But international bimetallism, even if theoretically sound, was out of question as a measure of practical politics, owing to the partiality in favour of gold in banking and commercial circles, and in view of the rapidly declining price of silver. It is not surprising, therefore, to find that the Monetary Conferences

which met between 1871 and 1893 were unable to secure international agreement in favour of bimetallism. The tendency to adopt a gold standard was accordingly further accentuated from 1893. The " scramble for gold " which followed led the civilised nations to economise its use by the development of credit organisation on a larger scale, especially as the demand for gold not only increased on account of its adoption as a monetary unit by countries which were formerly using silver, but also on account of the increasing commercial prosperity of the Western nations.

Even before these difficulties were fully realised, as early as 1872 a French economist, M. Léon Walras, suggested the abandonment of bimetallism in favour of a system under which both the metals were to be used for the purposes of currency ; whichever happened for the moment to be the cheaper metal was to be treated as a token coin, and its free coinage on private account was to be suspended and the output regulated by Government.[1] This is the earliest attempt at formulating a currency system which, under the pressure of events, the Government of India blundered into accepting after 1900, and which has been subsequently familiarised as the Gold-Exchange Standard.[2] A little later than Walras, Mr. A. M. Lindsay, Treasurer of the Bank of Bengal, proposed a scheme of a similar character in 1876, this scheme being subsequently published in 1892 in a pamphlet entitled " Ricardo's Exchange Remedy, a Proposal to regulate the Indian Currency by making it

[1] See Conant, *Principles of Money and Banking* (1905), p. 377.

[2] " When the Government of British India sought, in 1893, to give a fixed value to about £120,000,000 in rupee silver, it undertook an experiment of great importance to the financial world, and one which was naturally viewed in many quarters with grave misgivings. The experience of fifteen years which have followed that experiment has taught many lessons in monetary science" (Conant, "The Gold-Exchange Standard in the Light of Experience," article in *Economic Journal*, June 1909). Even Mr. Conant is obliged to recognise that the lessons were learnt—have they been learnt ?—at the expense of India in some directions.

expand and contract automatically at fixed sterling rates with the aid of the silver clause of the Bank Act ". This proposal was considered by the Fowler Committee, who rejected it as unsound and unsuitable for India. By a strange succession of accidents, the Government of India adopted in practice a currency system which had some important features in common with Mr. Lindsay's scheme. The system actually in operation in India between 1899 and 1914 was never deliberately adopted as a consistent whole; the Chamberlain Commission, even though it justified the system adopted in India on practical considerations, did not elaborate a theoretical defence of the Gold-Exchange Standard.[1]

Theory of the Gold-Exchange Standard

The theoretical foundations of a Gold-Exchange Standard were first laid down by Mr. Keynes in his book on *Indian Currency and Finance*. " The currency problem of each country is to ensure that they shall run no risk of being unable to put their hands on international currency when they need it, and to waste as small a proportion of their resources on holdings of actual gold as is compatible with this. . . . It is as an attempt to solve this problem that the Gold-Exchange Standard ought to be judged." " The Gold-Exchange Standard arises out of the discovery that so long as gold is available for payments of *international* indebtedness at an approximately constant rate in terms of the national currency, it is a matter of comparative indifference whether it actually *forms* the national currency.

" The Gold-Exchange Standard may be said to exist

[1] " To a great extent the system is a result of a series of experiments ", is the observation which the Chamberlain Commission make about the Indian Currency system even while defending it. It is worth remembering that the theory of a Gold-Exchange Standard was evolved after its accidental discovery by the Government of India, and, as applied to India, was formulated in 1913 by Mr. J. M. Keynes. Practice had demonstrated its convenience, and the theory was only evolved later to bless the practice.

when gold does not circulate in a country to an appreciable extent, when the local currency is not necessarily redeemable in gold, but when the Government or Central Bank makes arrangements for the provision of foreign remittances in gold at a fixed maximum rate in terms of the local currency, the reserves necessary to provide these remittances being kept to a considerable extent abroad." [1] In another passage Mr. Keynes points to the following as amongst the essentials of a Gold-Exchange Standard: "The use of a local currency mainly not of gold, some degree of unwillingness to supply gold locally in exchange for the local currency, but a high degree of willingness to sell foreign exchange for payment in local currency at a certain maximum rate". It will thus appear that the characterisation of the Gold-Exchange Standard in theory by Mr. Keynes is simply a description of the then existing currency system and the mechanism of adjusting the trade balance of India.

The one theoretical proposition that Mr. Keynes urges in its defence is the argument that it economises the use of gold and maintains the stability of foreign exchanges. "Speaking as a theorist", he observes, "I believe that it contains one essential element—the use of a cheap local currency artificially maintained at par with the international currency or standard of value (whatever that may ultimately turn out to be)—in the ideal currency of the future." Though twelve years have now elapsed since Mr. Keynes' work appeared, his main arguments have not been improved upon by other advocates and apologists. Sir Basil Blackett, the Finance Member of the Government of India, speaking in December 1923, could only repeat Mr. Keynes' contentions.[2] He observed:

[1] *Indian Currency and Finance*, pp. 29-31.

[2] Sir Basil Blackett's speech before the Associated Chambers of Commerce, December 4, 1923. The reference to Plato in defence of the system is amusing; and the reference to the Genoa Conference is beside the point, as the recommendations of the Conference were based on abnormal monetary conditions which involved the practical disappearance of the precious metals.

" My first authority is Plato, who in laying down laws for his ideal State pronounced strongly in favour not of a gold currency, but of the Gold-Exchange Standard. . . . My second authority is again Mr. Keynes. . . . This brings me to my third authority in favour of the Gold-Exchange Standard system. . . . If the resolutions of the Currency Committee of the Genoa Conference are carefully studied, it almost seems as if Europe intended to work her way towards something very like the system which we have had established in India for many years past."

The advantages of the Gold-Exchange Standard have thus been summarised by Mr. Charles A. Conant: (1) " Diminution of the pressure upon the world-supply of gold. (2) The maintenance of par of exchange between Oriental and Western countries. (3) Adaptability to poor and undeveloped countries.[1] (4) The opening of the market for silver with the result of steadying its value."

The system has thus been upheld on the grounds that it economises the use of gold for internal purposes, releasing the economised gold for the development of industries and expansion of commerce; that it secures the stability of foreign exchanges, eliminating the speculative element of uncertainty in foreign trade, and thus facilitates the movements of capital. It has special advantages for a country which has adverse balances, and which requires gold for adjustment of the balances.

Examination of the Theory

If Mr. Keynes is to be taken at his word, the only purpose of a sound currency is to secure the stability of foreign exchanges and to provide facilities for foreign remittances at a fixed maximum ratio in terms of the local currency. Now any one who is familiar with the elementary principles of currency knows that a sound

[1] Conant, *Principles of Money and Banking*, vol. i. pp. 392-403: " The advantage of a token coinage for comparatively poor or undeveloped countries is the same as the advantage of paper credit—it permits economy of capital ".

system of currency fulfils certain indispensable objects and satisfies a few basic needs of economic life. As we have already pointed out, it supplies a standard of values, offers a universally acceptable medium of exchange, serves as a standard for deferred payments, and is a store of values. All these objects can be summarised in the statement that a sound system of currency secures relative stability in the purchasing power of the monetary unit in terms of commodities. In the work to which we have referred, however, Mr. Keynes makes the fixity of foreign exchanges and an adequate provision to meet foreign obligations the be-all and end-all of a sound monetary system. He thinks that the medium of exchange is the only function money performs. But money has other functions of equal if not greater importance, as we have stated. A currency system must be judged in the light of its efficiency in discharging all, and not only a single one, of these functions.[1] A currency which may be good for the purposes of a medium of exchange may be bad as a standard for deferred payments or as a store of values. Paper money, for example, is good as a medium of exchange but worthless as a store of values.

In his *Tract on Monetary Reform* (1923) Mr. Keynes shifts the ground and abandons his earlier view with regard to the problem of currency. "Stability of exchange is in the nature of a convenience which adds to the efficiency and prosperity of those who are engaged in foreign trade. Stability of prices, on the other hand, is profoundly important for the avoidance of the various evils" which he describes elsewhere.[2] The one merit claimed for the Gold-Exchange Standard is that it secures stability of foreign exchanges; and now Mr. Keynes admits that this

[1] Nicholson's article on "Indian Currency and the Gold-Exchange Standard", *Economic Journal*, June 1914: "Does it follow, because the stability of the gold price of the rupee has been established for the purposes of foreign exchange, that therefore it may be taken for granted that all the other functions of good money are fulfilled by the rupee as so 'managed'?"

[2] Pp. 155-56.

is only a convenience to those engaged in foreign trade, and is not of intrinsic importance to the soundness of a monetary system. Thus, if the claim made on behalf of the Gold-Exchange Standard is sound, it exists for the benefit of foreign trade, ignoring the other and more important functions of sound money. The *Tract on Monetary Reform* thus makes it clear that, even if the Gold-Exchange Standard makes gold available for international payments, it is not "a matter of comparative indifference", as Mr. Keynes remarked in his earlier volume, "whether it actually forms the national currency".[1] Mr. Keynes points out himself that internal transactions are as important as, if not more important than, external transactions in the economic life of a country; and if the Gold-Exchange Standard secures stability of foreign exchanges, it leaves out of account altogether a vital portion of the economic life of a country.[2]

As for Mr. Keynes' reference to "unwillingness to supply gold locally in exchange for the local currency", and to "a high degree of willingness to sell foreign exchange for payment in local currency", the argument is founded on the assumption that the entire system of currency will consist of token coins without any legal obligation on the part of the Government to convert them into gold at the will of the holders. Under a gold standard, the issue of token coins or paper money for internal purposes is limited by the ability of Government to secure their convertibility. It is this necessity to provide for convertibility which precludes Governments from falling a prey to the temptation to over-issue. Under a Gold-Exchange Standard the token coinage is inconvertible for internal purposes; and even for external purposes

[1] What we desire to emphasise here is not the necessity of having gold in actual circulation, but the necessity of securing ultimate convertibility into gold of all the actual media of exchange.

[2] Cf. *Tract on Monetary Reform*, p. 156: "Contracts and business expectations which presume a stable exchange must be far fewer, even in a trading country such as England, than those which presume a stable level of internal prices".

there is to be only a high degree of willingness to convert the internal media of exchange into gold. The characteristic vice of the Gold-Exchange Standard is thus the temptation to over-issue the token currency.

But it has been urged that the Gold - Exchange Standard is only an extension of the bank-note system to token coins. "The token coin is, in effect, a metallic bank-note, whose maintenance at gold par is subject to the rules of sound banking. Its advantages over the bank-note in undeveloped countries are that it conforms to a strong prejudice in favour of 'hard money', not subject to the vicissitudes of tropical climes, and that the output can be more safely regulated where new coins are issued only for gold than where a bank may increase its note-issues to take over assets of speculative or doubtful character."[1] Conant's argument that the Gold-Exchange Standard system may be regarded as an extension of the bank-note system presupposes a legal liability on the part of Government to convert token coins into gold, as there is a legal liability on the part of banks to convert their notes into gold. This legal obligation does not exist under the Gold - Exchange Standard system as described by Mr. Keynes. If the principle of convertibility does exist, we do not see much of a difference between the gold standard as we understand it and the Gold - Exchange Standard. With no legal obligation to convert token coins into gold, at the present stage of human experience and knowledge, no mortal Government can resist the temptation to over-issue the token coinage, thus incurring all the perils of inflation. If economy of gold is to be effected at the cost of inflation and abnormally high prices, it is a question whether the cost is worth paying.[2]

[1] Conant: "The Gold-Exchange Standard in the Light of Experience", *Economic Journal*, June 1909.

[2] Cf. *Plain Talks on Economics*, by F. Franklin (1924), p. 275: "A final word by way of reminder of the essential vice of inconvertible paper money. If Government could be trusted to regulate the issue in such a way that the purchasing power of the money should remain unaltered,

The Gold-Exchange Standard, as described by Mr. Keynes, presupposes a gold reserve located abroad. This may be desirable for a country which has a normally adverse balance of trade; but a country which has a normally favourable balance of trade is deprived of all the advantages of the economy of gold if its reserves are kept abroad, while at the same time it is subjected to all the evils of inflation.

Moreover, the maintenance of reserves abroad and of an artificial exchange rate by the manipulation of the reserves under the Gold-Exchange Standard requires regulation of the foreign exchanges by Government. Regulation of foreign exchanges and interference with the normal flow of trade are in themselves not desirable; but even assuming they are desirable, they can only be of advantage if they are intelligently handled in the interests of the country. With the conflicting interests of different sections of society, it is difficult even for the democratic Governments of our times to secure intelligent regulation of the exchanges in the general interests of the country. "The percentage of administrators and legislators who understand the gold standard is painfully small, but it is and is likely to remain ten or twenty times as great as the percentage that understands the Gold-Exchange system. The possi-

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and if everybody knew that the Government would do this, paper would serve the purpose of money (except for international transactions) as well as gold. But it is idle to suppose that anything of the kind would happen. When the Government was in a tight place, it would be tempted to issue more money in order to meet its own expenses; and whenever people in general, or some important section of the people, felt that a more abundant supply of money would stimulate business or otherwise promote prosperity, the pressure for more money to be put into circulation would be very hard to resist." The rupee is fiat money stamped on silver, and under the Gold-Exchange Standard system it becomes inconvertible. If, under an autonomous self-governing regime, the inherent liability to over-issue is so great, what shall we say of the potentialities for evil underlying an inconvertible fiat money in the hands of rulers whose interests may not be identical with the interests of the ruled?

bility of a Gold-Exchange system being perverted to suit some corrupt purposes is very considerably greater than the possibility of the simple gold standard being so perverted."[1]

Finally, the successful working of the Gold-Exchange Standard assumes that the Government that works it is a national Government whose policy is determined by the single consideration of national interests. Where, on the other hand, as in India, the reserves are in the hands of a foreign Government, the probabilities are that the exchanges will be manipulated, and the reserves used, from considerations not solely limited to the welfare of the country for whose benefit the Gold-Exchange Standard is maintained.[2]

[1] See Foreword by Professor Edwin Cannan to *The Problem of the Rupee*, by B. R. Ambedkar (1923).

[2] Cf. Conant, in the article referred to in the preceding pages: "There is no reason why the Gold-Exchange Standard should not be successfully maintained so long as the country where it was established retained its national independence and pursued a sound financial policy". Writing in January 1905 in the *Revue Économique Internationale*, he said: "This project, granting to each Government the right to regulate its own monetary system without concerning itself with the systems of other nations, has this important corollary—that it leaves each State free to choose the means of exchange which conform best to its local conditions. Rich nations are free to choose gold, nations less rich silver, and those whose financial methods are most advanced are free to choose paper. Each is able to plant itself on the gold standard and to maintain the parity of foreign exchange by the methods which to it seem the most efficient."

CHAPTER XXIV

THE GOLD-EXCHANGE STANDARD IN INDIA

The Mechanism of the System

The main features of the Gold-Exchange Standard in India, as it worked before the war and works to-day, may be summarised as follows: The rupee is unlimited legal tender, though reduced to the position of a token coin (180 grains—165 grains fine silver and 15 alloy) and legally inconvertible. For all practical purposes it is an inconvertible note printed on silver. The sovereign and half-sovereign are legal tender, but do not constitute an appreciable part of the actual currency of the country. The relation of the sovereign to the rupee was fixed at 15 to 1 in 1899; this ratio continued till it was changed in 1920 to 10 to 1, on the recommendation of the Babington-Smith Committee. The Government of India to-day is under a legal obligation to convert gold into rupees; and so long as the price of silver before the war did not go beyond 43d. an ounce, Government was but too willing to effect this conversion. To-day, so long as the price of silver does not go beyond 60d. an ounce, it pays Government to fulfil this legal obligation. But there has never been any legal obligation on Government to convert rupees into gold, though when the demands of trade require transmission of gold abroad, and it is convenient to Government to do so, Government may sell sterling for rupees.

The relations of India to Great Britain involved from early days payments in gold in the form of Home Charges.

These were met, even before 1893, by the sale of Council Bills by the Secretary of State, up to the limit of his requirements. After 1899 the practice of selling Council Bills was extended to the financing of India's trade. The Secretary of State undertook to sell bills of exchange on India without limit of amount at 1s. $4\frac{1}{8}$d. per rupee as a maximum rate, thus fixing the gold export point from London or the upper limit of variations in the value of the rupee. He also maintained, though without formal notification, the practice of not selling below 1s. $3\frac{29}{32}$d. per rupee. Thus the Secretary of State seeks to maintain the ratio of 1s. 4d. by this practice, preventing the rupee from going above 1s. $4\frac{1}{8}$d. and from falling below 1s. $3\frac{29}{32}$d., and variations in the exchanges are confined normally within these two limits. But this part of the mechanism of the Gold-Exchange Standard has fallen into disuse since 1920, when the rate of exchange was altered to 2s. a rupee. The Secretary of State has now definitely abandoned the practice of selling bills to maintain the legal ratio, though he still goes on selling bills not only to meet his immediate requirements, but to liquidate the balance of trade in favour of India. It must be remembered that the gold points thus fixed by the Secretary of State are arbitrary and have no reference to the market or bullion value of the rupee.

Normally, when the balance of trade is in favour of India, there is a great demand for bills on India; and the Secretary of State announces his intention at the beginning of the week to sell bills of a definite amount, and invites tenders. He assigns these bills on the notified day to the highest bidders; if the demand is greater than the supply, he notifies his intention to sell a larger sum in the succeeding week.[1] If there is an urgent demand, the Secretary of State resorts to telegraphic transfers, charging at a somewhat higher rate than the highest he obtained for his bills at the last sale. These

[1] It may be noted that in case of a weakening in the demand the Secretary of State accepts tenders even below 1s. 4d.

bills are known as Council Bills, as they are sold with the sanction of the India Council. They are drafts or orders on the Government of India to pay to the holders the specified sum in rupees. They are paid by the Government of India either from public revenues, or from the Paper Currency Reserve, or by means of additional coinage of rupees.

When, however, the balance of trade turns against India, the Government of India may for convenience sell bills at 1s. $3\frac{29}{32}$d. on the Secretary of State to be paid in gold from the Gold Standard Reserve or from the cash balances in London. These are known as Reverse Bills.

In normal times, with a favourable balance, India would have adjusted this balance by the import of gold coins or bullion. Under the mechanism of the Gold-Exchange Standard, with the Secretary of State selling bills to an unlimited extent, this balance has been generally liquidated by the purchase of silver with India's gold, and by consequent additions to her token currency.

The Objective of Currency Policy since 1893

The difficulties that faced the Government of India, and led to the closure of the mints to the free coinage of silver in 1893, were exclusively difficulties arising from fluctuations in the rate of exchange. The question referred to the Herschell Committee was the devising of the measures for meeting the grave difficulties with which the Government of India was confronted in consequence of the heavy fall in the gold value of silver.[1] When the mints were closed, when subsequently, on the recom-

[1] Cf. Sir David Barbour's Financial Statement: "If that fall could be stayed, and the rate of exchange with England fixed permanently at even its present low figure, the difficulty of dealing with the present deficit would be comparatively light. . . . Unless some settlement of the currency question is obtained, there is no prospect of even the most moderate degree of stability in the rate of exchange."

mendation of the Fowler Committee, the sovereign and half-sovereign were declared legal tender in India, and throughout the succeeding years even to the present day, the main object of the Indian currency policy has been the stabilisation of the exchange value of the rupee with a single eye to her foreign trade. There was not a single occasion when it was even remotely suggested by the Government and its currency experts that the sole object of a sound currency organisation for India should be the maintenance of stability in the purchasing power of the standard coin in terms of commodities—in other words, the maintenance of a comparatively stable level of prices. The Chamberlain Commission asserted that the cardinal feature of the whole currency system is " absolute security for the convertibility into sterling of so much of the internal currency as may at any moment be required for the settlement of India's external obligations ". Writing on behalf of the Government of India in 1919,[1] Mr. H. F. Howard observed that the main objective of all the various commissions and committees which have inquired into currency question was " to devise measures which would prevent the exchange value of the rupee from falling below 1s. 4d. ". Even the terms of reference of the Babington-Smith Committee were confined to making recommendations with a view to " ensuring a stable Gold-Exchange Standard ". That the sole object of Government in its currency measures was stability of exchange, and not the desire to give a stable standard of value, is amply evidenced by the confession made by Mr. M. M. S. Gubbay, Controller of Currency, in 1919 before the Babington-Smith Committee : " In the Government of India's statement, the problem is the consideration of the means of securing the greatest practicable stability of the rupee in terms of the sovereign. . . . From the trade point of view there is no doubt that stability of exchange is almost a necessity. There are countries which work on a very fluctuating exchange, so that you

[1] See *Babington-Smith Committee Report*, App. I. D, p. 29.

could not say it is an absolute necessity ; but in the conditions to which India is accustomed in the last twenty years my own feeling is that stability is really an essential necessity to trade." [1] Sir Basil Blackett, in his Financial Statement in March 1923, tells us : " I do not think the time has come for fixing on a new policy in regard to exchange. . . . If therefore the time has not yet come for an attempt finally to stabilise the currency of India, stability is our goal, and we mean to achieve it at the first opportunity."

If, as we have repeatedly observed, the fundamental object of a sound currency policy is the maintenance of relative stability in the purchasing power of the monetary unit, then there is not the slightest doubt that those who devised the Indian currency system, and those who are responsible for its working to-day, have blissfully ignored this object in their ardent desire for securing a stable exchange. Their minds were so obsessed by this one problem that they subordinated to it all other considerations of sound money.[1] No one will dispute that stability of exchange is desirable in itself and is advantageous to those engaged in foreign trade, and especially advantageous to the Government of India with its large annual sterling obligations. But there are larger interests at stake in every country than the interests of those engaged in foreign trade ; and a sound monetary system will secure the conditions of national growth and prosperity by providing a medium of exchange for the purposes of internal trade and industry, a currency that will automatically expand and contract in response to the demands of trade, and that will also serve as a store of values. These objects were sacrificed to the one desire to secure stability of exchange—an advantage that might easily

[1] Cf. Nicholson's article on " Indian Currency and the Gold-Exchange Standard " in the *Economic Journal*, June 1914 : " The admirable history of Indian currency since 1893 given in the general report shows at once that in all the various changes the dominant force, whether in initiation or modification, has been the stability of the foreign exchange value of the rupee in relation to gold ".

have been secured, as it is secured by all the civilised countries with a gold standard, by a sound currency policy. The Babington-Smith Committee, whilst it supported the Government of India in its preoccupation with stability of exchanges, also asserted, rising above all spurious considerations of consistency : " Our conclusion, after considering the views put before us, is that for the current operations of trade, stability is an important facility rather than an essential condition ". We have also found an ardent advocate of the Gold-Exchange Standard like Mr. Keynes making the same kind of admission in his *Tract on Monetary Reform*: " Stability of exchange is in the nature of a convenience which adds to the efficiency and prosperity of those who are engaged in foreign trade ". It would thus appear that the main purpose underlying the entire series of currency measures since 1893 was to afford facilities to those engaged in foreign trade. The idea that there might be large numbers of people in India who are not engaged in foreign trade, and whose interests may be as vitally affected by the currency measures of the Government for the worse, did not dawn on the minds of currency experts till the year 1923.

For the first time, in March 1925, we find the Government of India suddenly changing the line of defence and proclaiming that the currency policy which the Government was obliged to adopt as the result of the abnormal conditions created by the war has conferred on India an enormous benefit in the shape of a relatively stable level of prices as compared with European countries. This benefit to India was first discovered in 1923 by Mr. Keynes, who acknowledged that it was more the result of chance than design, and suggested that the Government of India had not utilised this defence of its currency policy as effectively as it might have done.[1] The Government of India has not been slow in adopting this line of defence, and we find Sir Basil Blackett in his

[1] *Tract on Monetary Reform*, p. 156.

Budget speech (March 1925) declaring: "What the country as a whole wants is stability—stability first and foremost in internal prices, and next in importance stability of exchange". He also maintains, speaking during the debate on the Paper Currency Amendment Act in January 1925: "Our successful effort for the last few years to prevent rupee prices from rising rapidly, and thereby bringing social and industrial unrest, will be frustrated if we tie the rupee to gold or sterling at the wrong moment, and subject India to a severe rise in internal prices, involving new demands for increased salaries and wages".[1] As a matter of fact, the Government of India found it impossible during the war to maintain the fixity of the exchanges owing to a rise in the gold price of silver. Subsequently when the new rate of exchange, namely 2s., was adopted, the Government of India found it impossible to maintain the exchange at that rate owing to the fall in the gold price of silver, and this lesson was learnt by the Government at a cost of nearly forty crores of rupees to the country. It was an accident that, as the result of this temporary abandonment of the policy of maintaining stability in exchange, the level of prices in India remained relatively steady; and this relative stability was further maintained by the desire on the part of Government, which is now increasingly clear, to stabilise the rate of exchange again at a higher level, a policy which led it to starve the currency needs of the country in times of growing trade and industry by allowing the exchange to go up.

In spite of Sir Basil Blackett's contention, it may still be pointed out that the real objective of Government in its currency policy has been to secure fixity of exchange. If at this moment Government is not ready to adopt a fixed ratio, it is not because it has definitely abandoned the object of securing fixity in the rate of exchange, it

[1] See also his Budget speech (1925): "The effect of a rising rupee exchange has been in the main to keep the rupee prices from rising in sympathy with world prices".

is only because it desires to stabilise the exchanges when the higher level which it is contemplating shows signs of persistence. This is clear from the fact that, in October 1924, when the exchange was going up, " the Government of India intervened to make large purchases of sterling in order to check the rise in exchange for the time being ". The desire to fix the exchange at a higher rate is also evident from Sir Basil Blackett's declaration that it is better to leave the final decision of the ratio to be determined by the Currency Committee which the Government of India has promised to appoint, " at whatever figure may be most truly in the interests not of this or that section, not of the producer or the consumer, or the taxpayer, considered in isolation, but in the best interests of India as a whole ". Fixity of exchange is still the goal of currency policy ; but if, during an interregnum of unstable and rising exchange, Government has to face criticism, stability in the internal level of prices, accidentally resulting from a failure to stabilise exchanges, is to be exhibited as a deliberately achieved result that promotes the best interests of the country. Stability in the level of prices has never been foremost till now in the minds of our currency experts ; and even to-day, by talking of fixing the rate of exchange in the immediate future, they plainly show that stability in the level of prices is only subordinate to the main purpose and may readily be sacrificed to it.[1]

But the Finance Member does not like to leave us in doubt as to the fundamental object of the currency policy of the Government of India. Speaking at a meeting in Bombay in July 1925,[2] he said, " From the first moment of my arrival in India two and a half years ago, my aim, frequently expressed, has been to secure the stabilisation

[1] It is necessary to add that for our part we are not prepared to admit that stability in the internal level of prices, in the sense in which it is understood and defended by Sir Basil Blackett, is an unalloyed boon to our country.

[2] At the meeting of the Committee of the Indian Merchants' Chamber on Friday, July 3, 1925.

of the exchange value of the rupee at the earliest possible moment ". If relative stability of prices had precedence of stability of exchange in the Finance Member's mind, it was only during the transitional period when world conditions and prices were subject to violent fluctuations. The Finance Member proceeded to indicate that, without prejudice to the findings of the Currency Commission then under contemplation, the Government of India had no desire in present circumstances to see a further rise in exchange above 1s. 6d. There could be no clearer evidence than this afforded by the Finance Member as to the underlying objective of the currency policy of the rulers of this country for the last thirty years.

CHAPTER XXV

THE GOLD STANDARD RESERVE

Its Purpose

The Gold Standard Reserve was established in accordance with a recommendation of the Fowler Committee: "We also recommend that any profit on the coinage of rupees should not be credited to the revenue or held as a portion of the ordinary balance of the Government of India, but should be kept in gold as a special Reserve, entirely apart from the Paper Currency Reserve and the ordinary Treasury Balances". The Fowler Committee had recommended the creation of this Reserve mainly for the purpose of converting the rupee coinage into a gold currency; but in the years that immediately followed, the idea of introducing a gold currency was shelved, while the profits arising from the coinage of rupees were used for building up a Gold Reserve, located at first in India but soon transferred to London. The Fowler Committee distinctly indicated that the Gold Reserve was to be kept in India in order that, in case of an adverse balance, the Government of India should make the gold easily available for shipment abroad, during the transition period when India was on the way to adopting an effective gold standard.[1] Instead of keeping the Reserve in India, the Government of India found it more convenient to locate it in London, as it would thereby serve two purposes—"to supplement temporarily the resources in

[1] *Fowler Committee Report*, para. 59.

London of the Secretary of State at times when he is unable to sell Council Bills except below specie exporting point, and to serve as a fund for enabling an adverse balance of trade to be liquidated without a fall in exchange". Thus, whilst the Fowler Committee contemplated the use of the Reserve to meet an adverse balance, during the transitional period when gold coins circulating in India did not occupy a predominant position, the Government of India, on the other hand, found the Reserve useful for other purposes. That the Government of India was itself not quite clear as to the purpose of the Reserve is apparent from the fact that in 1906–7 one million pounds of the Reserve were used for capital expenditure on railways.[1]

The creation of a silver branch of the Gold Standard Reserve, which was subsequently abandoned, is also evidence of the lack of any precise idea as to the purpose of this Reserve.[2]

[1] Cf. Mr. Howard's note of evidence submitted to the Chamberlain Commission (*Report*, App. XXIII.): "I do not approve of the action taken in 1907 when funds previously allocated to the Reserve were used for railway development in India. I consider that this was premature, and it had the great incidental disadvantage of causing the public to have grave misgivings as to the future policy of Government in regard to the treatment of the Fund."

[2] See Sir Edward Law's letter to the London *Times* dated August 15, 1906: "It must be remembered that, as the public was officially informed, this Fund was solely formed for the purpose of maintaining the exchange value of the silver token rupee coin. For this purpose, it must consist either of gold or of readily realisable gold securities; a silver reserve cannot be considered as a proper guarantee for the maintenance of the exchange value of a silver currency. If the very large purchases of silver which have recently been made by the Indian Government were necessary, it would seem that the funds should have been found from any other source rather than from the Gold Reserve Fund, the utility of which, as regards its only legitimate purpose, is endangered by altering its constitution."

So also the Secretary to the Bengal Chamber of Commerce in a letter to the Secretary, Government of India, dated December 7, 1906: "I am directed by the Committee of the Bengal Chamber of Commerce to address you with regard to the change which has recently been made in the constitution of the Gold Reserve Fund, under which its designation has been altered to the Gold Standard Reserve Fund, and a portion

If the object of the Reserve is to support exchange, the last thing that should have been done was to keep a portion of it in a metallic form that was useless for purposes of shipment. If the object of the Reserve is to support exchange and to convert rupees into gold, the use of the Reserve by the Secretary of State to meet his requirements in emergencies is an accidental advantage arising out of the situation; and Sir Lionel Abrahams was the first to suggest that this was one of the purposes for which the Reserve was established. The Secretary of State's ability to meet his Home Charges can have nothing to do with a currency measure intended to stabilise exchange.

Size, Form, and Location of the Reserve

With regard to the size or amount of the Reserve, the Government of India has changed its ideas from time to time. There was a time when £10,000,000 was thought a sufficient limit for the Reserve; but after the crisis of 1907–8 no one ventured a definite opinion as to the maximum which the Reserve should reach. The Chamberlain Commission believed £30,000,000 would be sufficient, and the Babington-Smith Committee declined to express any definite opinion with regard to the maximum limit. To-day the Gold Standard Reserve as held in London has reached a total of £40,000,000, and would have reached a higher level but for the use of

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of it is to be held in silver instead of in gold. . . . The Committee had always understood that the Gold Reserve Fund was to be maintained in gold or in British Government securities, readily convertible into gold, as the only sound security for the maintenance of exchange. The steps now taken appear to them to be in direct contravention of the principles laid down by the Government of India when the Gold Reserve Fund was first initiated, and the Committee view with grave apprehension the possible consequences which may follow on this change of policy. Further, the Committee are of opinion that the constant changing of currency methods is greatly to be deprecated." (Appendices to the *Chamberlain Commission Report*, vol. iii. pp. 706-707.)

the interest on this Reserve for the reduction of "created securities".[1]

The Fowler Committee had recommended that the entire Reserve should be kept in gold in liquid form, to be freely available for remittances abroad in case of an adverse balance. It is surprising to find the Chamberlain Commission urging that the Fowler Committee were not certain as to whether they meant the Reserve to be kept in the form of sterling securities or actual gold. The Fowler Committee could not have dreamt of keeping the Reserve in the form of sterling securities, as it was to be kept in India. The Government of India, however, departed from the recommendation from the very start, and invested the Reserve in sterling securities. During the crisis of 1907–8, it was with great difficulty and some loss that these securities were converted into liquid assets to meet the adverse balance. In subsequent years Government realised the necessity of keeping a portion of the Reserve in liquid form, and the Chamberlain Commission recommended that a considerable portion of it should be held in actual gold, and suggested that the total gold holding should be raised to £15,000,000, and that the authorities should thereafter aim at keeping one-half of the total Reserve in actual gold. The Babington-Smith Committee, while endorsing the principle of the Chamberlain Commission, kept in view the post-war conditions and suggested that "the most satisfactory course lies in keeping the Reserve as liquid as possible by an ample holding of securities with early dates of maturity". But the recommendation referred only to times when gold was relatively scarce in London, and when the process of liquidising £40,000,000 of securities would have precipitated a crisis. It must not be forgotten that the principle endorsed both by the Chamberlain Commission and by the Babington-Smith Committee

[1] One would like to know if the use of the interest in this way either supports exchange or enables the Secretary of State to meet his requirements.

was to keep at least half the portion of the Reserve in actual gold. But to-day the Government of India and the Secretary of State, in complete disregard of the recommendations of their own experts, keep the entire Reserve in sterling securities.[1]

The whole of the Reserve is now located in London and invested in sterling securities. The Babington-Smith Committee recommended the location of a portion of the Reserve, not exceeding half, in India. " In currency matters, the possession of public confidence is an asset of great value, and we therefore think it advisable to comply with the Indian demand so far as this can be done without detracting from the utility of the fund for the purposes for which it exists." [2]

It has been urged in defence of the location of the Reserve in London that " London is the clearing-house of the world ; India's chief customer is the United Kingdom, and London is the place where money is required both for the expenditure of the Secretary of State on India's behalf and for payment of India's commercial obligations to this country and the world in general. If the Reserve is kept in India, it would have to be shipped to London to be used. This would involve delay at a moment when immediate action is essential." [3] It is also urged that if the Reserve were located in India, owing to the absence of a short-loan market, the country would be deprived of the interest which the Reserve earns in a place like London.

As for the use of the Reserve for meeting the Home Charges, that is beside the point in considering the location

[1] Statement showing the composition of the Gold Standard Reserve July 31, 1925 :

In India	*nil*
In England :	
Cash at the Bank of England .	£514
British Government securities .	40,419,244
	£40,419,758

[2] *Report*, para. 85.

[3] *Chamberlain Commission Report*, para. 90.

of the Reserve as a currency measure. It may be an incidental advantage, but it cannot be urged as an argument for keeping the Reserve in London. Above all, it must be remembered that with an effective gold standard in India, the necessity for any Reserve in London to meet the Home Charges or for any other purpose would at once disappear. It has been contended that, as London is the clearing-house of the world, it would be desirable to keep a Reserve in such an international centre. This argument would be valid on the assumption that India is, from year to year, a debtor country and called upon to make payments in gold. Normally, however, India is a creditor country, and has to receive gold, not to pay it.[1] If, once in a decade, the balance of trade turns against India, it can be adjusted in a variety of ways—by raising the Bank rate, by temporary borrowing, and in the last resort by the shipment of bullion. It is ridiculous to suggest, as an argument for locating the Reserve in London, that once in ten years India may require gold on the spot for adjusting her balance. And nowhere outside India has it been suggested that one of the normal functions of Government in normal times is to supply the means of adjusting the balance of trade. It may be possible and

[1] The following table bears witness to the extent of India's favourable balance of trade :

SEA-BORNE TRADE IN THOUSANDS OF RUPEES.

	1911–12.	1912–13.	1913–14.	1914–15.	1915–16.
Net exports of merchandise .	83,93,43	79,58,86	57,69,96	37,24,53	61,39,33
Net imports of treasure . .	43,09,70	51,19,99	36,35,67	16,51,89	3,72,04
Excess of exports	40,83,73	28,38,87	21,34,29	20,72,64	57,67,29

	1916–17.	1917–18.	1918–19.	1919–20.	1920–21.
Net exports of merchandise .	87,12,85	80,54,92	66,74,71	1,14,31,93	79,49,16 *
Net imports of treasure . .	32,03,54	44,22,04	62,35,51	64,55,91	8,59,22
Excess of exports	55,09,31	36,32,88	4,39,20	49,76,02	88,08,39 †

* Net imports. † Excess of imports.

convenient for private enterprise and banking organisations to keep their credit resources in the form of gold in international centres,[1] and those who keep such resources can also withdraw them at any time. But in the case of India, Government assumes the functions of a banker, and, wielding irresponsible power, can manipulate reserves on grounds not purely economic, and on considerations not entirely directed to the promotion of the trade and the industrial prosperity of the country.[2] Perhaps heredity in this case counts for more than sound economics ; and the traditions of the East India Company which was associated with this country for so long have left a heritage behind.

[1] The examples that are sometimes brought to our notice of countries who keep through their banks part of their gold reserves in London are Japan, some of the South American Republics, and recently Germany. But these countries do not stand on the same footing as India : they are all countries which have to settle some of their obligations through London, and their banks find it desirable and profitable to keep in London part of their reserves. In the case of India, she has no indigenous banking organisation to manage these reserves : they are wholly kept in London by an alien Government with objects somewhat different from those which govern the banking policy of other countries.

[2] Cf. Sir M. de P. Webb's memorandum of evidence submitted to the Chamberlain Commission, App. XI. p. 560: "In connection with the general policy of holding the bulk of the Gold Standard Reserve in London, I submit that Government have gone entirely beyond their province in undertaking to provide not only gold for export, but gold ready delivered at a financial centre on the other side of the globe. The business of Government, so far as the maintenance of the sterling value of the rupee is concerned, is to provide gold in India for export, if required, and not to endeavour to anticipate the requirements of the public by laying down £20,000,000 of India's money in London (or elsewhere) in advance. No doubt, London is in all probability the centre where the gold in an economic, financial, or political crisis, involving a change in the balance of trade against India, would be required. But Government's duty ends when it provides that gold in India. To deposit the bulk of the gold in a centre where the banking community are already, on their own initiative, considering how they can strengthen their own admittedly slender and inadequate gold reserves, is to expose India to risks and dangers from which she has every right to expect complete protection."

CHAPTER XXVI

STABILITY OF EXCHANGE AND PRICE STABILITY

The Gold-Exchange Standard and Stability of Exchanges

We have already pointed out that the main objective of the currency policy of the Government of India has been the stabilisation of exchange. It has been urged by some economists that before the war the Gold-Exchange Standard secured to India the undoubted advantage of stability of foreign exchange. If the exchange was steady between 1899 and 1914, it was not the result of the soundness of the monetary system, but the natural outcome of other factors—namely, the price of silver, which always kept below 43d. an ounce, and the normal favourable balance. So long as these forces were in operation, the monetary policy of the Government was never seriously tested ; and when it was tested even to a small extent as in 1907–8, and on a large scale during the war, it broke down miserably.[1] Even when, after the war, the Government of India made a fresh endeavour to fix the rate of exchange and maintain it at a new ratio, the attempt met with failure, through the wide divergence between the legal rate and the market rate of exchange. Of course, given a favourable balance from year to year, and also assuming that the gold price of silver is below 43d. an ounce, it is possible for Government to attain and maintain any rate of exchange above 1s. 4d. The

[1] See Memorandum B, by Sir Lionel Abrahams, p. 60, vol. ii. *Minutes of Evidence*, Babington-Smith Committee.

success of this policy, in the future as in the past, depends on the presence of these two conditions, and not on any intrinsic merit of the Gold-Exchange Standard. If the claims that it is " scientific " rest on its ability to maintain stability of exchange, these claims rest on sand. No mechanism of this kind has any intrinsic virtue, and its success will depend on the co-operation of outside factors which are subject to influences of their own. The Brussels Monetary Conference was fully alive to the futility of artificially controlling the exchanges. " Attempts to limit fluctuations in exchange by imposing artificial control on exchange operations are futile and mischievous." [1] The fluctuations in the foreign exchanges of any country, under normal conditions, are a reflection of variations in the country's imports and exports ; and to put up artificially the rate of exchange is as useful in the long run as to look for an improvement in a patient's condition by putting up the thermometer when he is feeling cold. Nay, a policy of this kind may be positively harmful to a country like India in its immediate effects, by giving a subsidy on imports and forcing the country to receive less for her exports.

Over-zealous advocates of the Gold-Exchange Standard sometimes ask us to compare the relatively limited variations in the exchange value of the rupee with the phenomenal variations which took place in the value of the German mark and the Russian rouble. No one charges British statesmanship in India with a repetition of the financial expedients of countries in desperate straits. The fluctuations in the exchange value of the

[1] Resolution XV. The resolution goes on to assert that, in so far as such attempts are effective, they " tend to remove natural correctives to such fluctuations and interfere with free dealings in forward exchange which are so necessary to enable traders to eliminate from their calculations a margin to cover risk of exchange, which would otherwise contribute to the rise in prices. Moreover, all Government interference with trade, including exchange, tends to impede that improvement of the economic conditions of a country by which alone a healthy and stable exchange can be secured."

rupee can only be compared to the fluctuations in the exchange value of the American dollar, and Indian statesmanship will not find room for congratulation on the basis of such a comparison.

But though in the past the attempt to stabilise the exchanges has repeatedly failed when seriously tested, the Government of India proposes once again to resort to the same futile device ; on the one hand we are told that " the responsible authorities have every reason to be satisfied " with the results of their present policy of leaving the foreign exchanges to themselves, thus " giving stability to Indian prices such as no other country has enjoyed during the last few years ", while on the other hand they have been manipulating the exchanges with the definite purpose of stabilising the exchanges at the earliest possible opportunity. If the gold price of silver in the past has been subject to such enormous fluctuations as those ranging between 30d. an ounce and 80d. an ounce, is there any guarantee that it will remain stable in the future, sufficiently stable to enable the Government of India to maintain the 1s. 6d. ratio ?

The Gold-Exchange Standard and Stability of Prices

We have already made it clear that with the exception of one observation of Sir Basil Blackett in his speech introducing the Budget in March 1925, there is not the faintest trace of any evidence to show that the main objective underlying the currency policy of the Government of India was to secure the stability of the internal level of prices. Even Mr. Keynes admits that stability of exchange is only a convenience to those engaged in foreign trade, and that the paramount object of a sound monetary system ought to be stability in the level of prices.[1] He acknowledges that the gold standard secured

[1] One could not find a more scathing criticism of the Gold-Exchange Standard as worked in India than this statement by Mr. Keynes.

this object most satisfactorily in pre-war times, but though he realised this truth as a general principle, he apparently lost sight of it when defending the Gold-Exchange Standard as it obtains in India.

Assuming that stability in price level is the fundamental criterion of a sound monetary system, let us examine briefly the currency organisation in India in its relation to the price level. We shall divide the history of prices in India into three periods, 1900–14, 1914–20, and 1920–25.

Taking the first of these periods, the trend of prices in India offers a sufficient criticism of the Gold-Exchange Standard. The general level of prices in India during the period was higher than the level of prices throughout the rest of the world.

The following table shows us the trend of prices in India, the United Kingdom, and the United States of America:

Year.	India *	United Kingdom.†	U.S.A.‡
1899	96	61	92
1900	116	68	100
1901	110	63	99
1902	106	62	103
1903	99	62	103½
1904	101	63	103
1905	110	65	105
1906	129	69	111
1907	137	72	118
1908	138	66	111½
1909	124	67	115
1910	122	70	125
1911	129	72	118
1912	137	77	127
1913	143	77	118
1914	147	77	118

* The index number for India is based on the prices of eleven imported articles and twenty-eight articles exported from, and consumed in, India, with 1873 as the base year.

† We have used Sauerbeck's index numbers for the United Kingdom, modified by using 1873 as the base year to enable a closer comparison to be made with Indian prices. See Sir Lionel Abrahams' evidence, *Babington-Smith Committee Report*, vol. i. p. 89.

‡ The index number for the U.S.A. is calculated on 1900 as the base year.

When we compare the trend of prices in India and in countries like Great Britain and the United States, in the period 1899–1914, we must take account of the fact

that the rise in prices in the latter countries was perhaps due to natural conditions such as the increased production of gold. In India, however, the rise in prices can mostly be traced to enormous additions to the volume of the token currency. Had it not been for the fact that during the same period there was an increase in trade and commercial activities in India, the rise in prices would have been still higher. As early as 1909, Mr. Keynes, speaking of price trends in India, said that " a comparison with Sauerbeck's index number for the United Kingdom shows that the change in India is much greater than can be accounted for by changes occurring elsewhere ".[1] It has been repeatedly pointed out that the Indian rupee is a token coin, and that the currency system is subject to all the evils of inconvertible paper money. The currency, being token, can neither be hoarded, melted, nor exported; every addition of a rupee or a note leads to a permanent and active increase in the volume of money, and is reflected in the level of prices. If we examine the index number of the volume of money, and the index number of prices during the years 1899–1914, we find a close and definite correspondence between the two. Even taking into account the fact that world prices were rising during the period, that Indian commodities were in demand, and even admitting the contention that the internal demand for commodities was increasing, the actual rise in the price level cannot be adequately explained except by a reference to the large increase in the volume of token money. Under the gold standard we have a mechanism that automatically adjusts the volume of currency to the demands of trade, by allowing either of expansion to meet the demands of a period of business activity, or of contraction when the volume of currency is in excess of trade requirements. But under the Gold-Exchange Standard, whilst Government can add to the volume of currency whenever there is a favourable balance, it has no mechanism by which it can contract this volume.

[1] *Economic Journal*, March 1909, p. 54.

Normally, before the closing of the mints in 1893, when India had the benefit of a silver standard, one method—and that too a potent method—for the contraction of currency was that of melting down for use in the arts and industries. Sir James Westland had estimated that 50 per cent of the annual coinage was so melted down. This method of contraction is not open to the country under the Gold-Exchange Standard.

It is argued that the Gold-Exchange Standard works as automatically as the gold standard, and that it is as capable of contraction as of expansion. This contention has not much value in the light of facts. The only method by which Government can contract the volume of currency is by the sale of Reverse Bills, and this may take place once in ten years when there is an adverse balance.[1] Mr. Keynes, however, finds it difficult to understand why Indians suppose that a gold standard would lead to any greater stability of internal prices. He does not see any difference whatever between the two systems in their effect on prices. The difference between a gold standard and a Gold-Exchange Standard is the difference between a currency convertible at will into gold, and therefore exportable, and a currency not convertible at will into gold, and therefore not exportable. In other words, a Gold-Exchange Standard has all the vices of inconvertible paper money—over-issue resulting in inflation. There could be no more trenchant criticism of the system than that implicit in the following observation of the Cunliffe Committee : " We have found nothing in the experiences

[1] It may be noted that if the Secretary of State suspends the sale of Council Bills, and if the Government of India resorts to the sale of Reverse Bills, these measures are undertaken primarily with a view to prevent a fall in exchange. The contraction of currency is only an incidental result ; and we may judge the inadequacy of this process of contraction by taking into account the total coinage of rupees between 1893 and 1914, and the amount of sales of Reverse Bills during the same period. During the war period between 1914 and 1919, the additional coinage of rupees amounted to 120 crores, and the additions to the paper circulation to ninety crores, whilst the sales of Reverse Bills amounted to £10,000,000.

of the war to falsify the lessons of previous experience that the adoption of a currency not convertible at will into gold or other exportable coin is likely in practice to lead to over-issue, and so to destroy the measure of exchangeable value and cause a general rise in all prices and an adverse movement in foreign exchange". Now the currency system in the period we are considering provided media of exchange which were not convertible at will either into gold or into other exportable coin, and therefore in practice led to over-issue, with all its attendant evils.

As the price level in India in 1900–1914 was higher than the price level outside of India, the country was subjected to a double disadvantage. Her export trade did not increase so much as it might have done, because she had to face world competition. If the statistics for the period in question show an increase over the volume of exports in the years immediately preceding 1899, this is easily explained when we remember that India's exports are exports of food produce and raw materials—so necessary to industrialised countries. With world prices at a lower level than Indian prices, and with a fixed exchange, the foreign imports secured an indirect advantage in the Indian market, to the detriment of India's industrial development. Under normal circumstances, a higher price level in any single country as compared with the rest of the world stimulates imports and discourages exports till the balance of trade is adjusted at a new level, and equilibrium is restored ; but in the case of India the higher price level between 1900 and 1914 was associated with expanding commerce and a continuously favourable balance of trade. This not merely involved an encouragement to the foreign importer and hampered the development of Indian industries ; it involved an economic isolation of India, which was prevented from working out its full consequences only through the nature of the commodities she was exporting. With the foreign exchanges left to themselves, as in the days before 1893,

the level of prices in India would have been adjusted to the level of prices in the rest of the world, and the shifting rate of exchange would only have been a reflection of trade conditions. With a gold standard, the fluctuations in the exchanges would normally have been confined to the specie points. The Gold-Exchange Standard, in the period 1900–1914, involved all the evils of rising prices without any of the compensating advantages. India's continuously favourable balance of trade was adjusted by the payment of her dues in token coinage ; her measure of value was thus subjected to violent changes ; she was the victim of an injury all the more difficult to estimate in definite terms as it was disguised under the appearances of increasing and expanding commerce.

In a country like India, with no organised system of banking, unaccustomed to the use of credit to any large extent, a sudden rise in prices like that which occurred in the period under consideration inevitably reacts unfavourably on the well-being of the people. With a large percentage of the population living on the bare minimum of subsistence, any increase in the price level due to artificial causes aggravates the misery of the people. Wages are slow in keeping up with the cost of living, and the compensating advantages in the shape of increased production are lacking.

During the period 1914–1920, when the belligerent countries were using their printing presses so freely for the manufacture of paper money, their prices rose to a giddy height, while Indian prices were relatively stable. This was not the result of the Indian currency policy. It was due to the fact that India was not actively engaged in the struggle and was not compelled to over-issue to the same extent as the European countries. The following table bears witness to the relative stability of Indian prices during the period.[1]

[1] Taken from Keynes' *Tract on Monetary Reform*, p. 3.

INDEX NUMBERS OF WHOLESALE PRICES EXPRESSED AS A PERCENTAGE OF 1913

Monthly Average.	United Kingdom.	U.S.A.	Canada.	India.	France.	Italy.
1913	100	100	100	100	100	100
1914	100	98	100	100	102	96
1915	127	101	109	112	140	133
1916	160	127	134	128	189	201
1917	206	177	175	147	262	299
1918	227	194	205	180	340	409
1919	242	206	216	198	357	364
1920	295	226	250	204	510	624

It is significant enough, however, that though the Government of India to-day would emphasise the fortuitous boon of a comparatively stable price level during the war period and subsequently, in the statement that was submitted to the Brussels Monetary Conference (1920), Government readily acknowledges that there was "a serious rise in the prices of all necessaries in India" and that this rise "is liable to have far more important results in the case of an Eastern country than in an advanced Western community, leading to great and widespread hardship and unsettlement".

After 1920 Indian prices show a downward tendency and have continued to retain relative stability. We reproduce below the table giving the necessary information.

INDEX NUMBERS OF WHOLESALE PRICES EXPRESSED AS A PERCENTAGE OF 1913

Monthly Average.	United Kingdom.	U.S.A.	Canada.	India.	France.	Italy.
1921	182	147	182	181	345	577
1922	159	149	165	180	327	562
1923	159	154	165	181	419	582
1924	166	149	164	174	485	..

The stability of prices revealed by these figures is the natural outcome of the exchange policy of the Government of India, which has made it endeavour to attain and maintain a higher exchange rate than 1s. 4d., with the

result of starving the currency requirements of the country. We are afraid, however, that in too readily recognising the soundness of this sudden change of attitude on the part of Government, which makes it use the argument of stability of prices in defence of a policy of rising exchange, we may fall victims to the tyranny of an economic theory, sound in the abstract, but dangerous if applied with reference to the peculiar economic and industrial conditions that obtain in India. We are afraid we are exposing ourselves and our country to new and untold wrongs in the name of " stability of prices ". Even in the abstract, what is economically desirable is not a dead stability of prices nor even a day-to-day stability—if such stability is at all obtainable in a human society. What we desire is an absence of violent fluctuations in the price level, which destroy confidence and frustrate hopes and anticipations.

Sir Basil Blackett maintains that in the last few years, though the exchange was rising, the price level has remained stable. Apart from the fact that this is not the result of a policy of securing for India a stable price level by a far-sighted control of currency in the best interests of the country, Sir Basil looks upon this state as something intrinsically advantageous. Now a stable level of prices is desirable in the abstract, but a stable level of prices that refuses to move automatically in response to changes in the world price level may not be economically desirable; and Sir Basil Blackett himself offers the best commentary on the value of such a policy. Speaking against the advisability of returning to fixity of exchange in India on the pre-war basis, he pointed out the danger of all prices in India moving up and down with the value of the counter which is used as a medium of exchange. He implied that there was at present an adjustment of prices in India to world prices on the basis of 1s. 6d. as the ratio of exchange; and that if fixity of exchange was to be once more the goal, any disturbance of the ratio from 1s. 6d. to 1s. 4d. would

involve a disturbance in the internal level of prices. Is there any guarantee that world prices, even with a definite return to gold on the part of Great Britain, will remain steady at the present level ? Sir Basil Blackett would agree that what we require for India is a level of prices that will move up and down with gold prices—a level that would be automatically adjusted to world prices under a universal gold standard. A stability that isolates India from the world is not a stability economically worth having. Such adjustment can be secured by allowing the foreign exchanges to take care of themselves, and not by artificial regulation of the exchanges. This artificial regulation has not succeeded in the past, and if to-day 1s. 6d. can be maintained successfully, to-morrow new conditions may arise requiring a fresh shifting of the ratio in order to secure adjustment.

Fixity of exchange as the only objective is intrinsically unsound, whether the ratio be 1s. 4d. or 1s. 6d. Any attempt at fixity in the case of India cuts off the operation of those natural forces that bring about an adjustment between the internal level of prices in India and world prices. It may be that world prices have been subjected to violent fluctuations during the last ten years ; but with a return to gold in the case of England and other countries, we have before us the prospect of more limited movements in prices. Those in India who talk of fixity of exchange do not realise that they are thereby depriving India of the chance of organising her currency policy on the only sound basis—an effective gold standard—on which she can enter on equitable terms into commercial relations with the rest of the world, securing at once stability in internal prices and stability of exchange.

We regret to find so much confusion of thought in the matter of stability of prices. Management of currency is desirable for the purpose of securing within any single country that relative stability in price level which fosters trade and industry. Such stability demands an automatic adjustment between the amount of currency—

and, in the case of India, more especially metallic currency —and the requirements of trade and commerce. This adjustment could be secured by a developed banking organisation controlled or managed by Government in the interests of the country. Management and control of the currency for these purposes does not necessarily mean control of the exchanges. As a matter of fact, control of the exchanges in India in the past has definitely resulted in an inelastic currency that expands indefinitely without providing for contraction. It is the same ultimate aim of fixing the exchange at a higher ratio than 1s. 4d. that has led to an artificial management of currency to-day, resulting in a starvation of the country in currency matters, and in a monetary stringency that saps her industrial and commercial vitality. If a healthy stability of prices is the fundamental purpose of a sound system of currency, then the Gold-Exchange Standard with fixity of exchanges defeats that object by creating an artificial inflation of prices, and thus disturbing the equilibrium between internal prices and world prices.

India has often suffered in the past at the hands of over-zealous legislators and statesmen whose minds were dominated by the idea that economic and political devices which were good for their own country were equally good for India ; and in the desire of English currency experts in India to-day to secure stability of prices by manipulations of her monetary mechanism we have one more instance of this type of mentality. It is true that the best monetary policy for Great Britain to-day, in view of her peculiar industrial conditions, may be that of maintaining a stable level of prices, in the sense of preventing a further fall in the price level. What Mr. Keynes and others belonging to his school of thought are afraid of, is a change in the price level in the direction of falling prices, resulting from a definite policy of deflation with a view to restoring the gold standard.[1] This is the secret

[1] See the *Nation and Athenæum*, March 7, 1925. "The essence of our industrial health, it seems to me, lies in confidence—that is, in

of his ardent advocacy of " monetary reform " for stability of prices ; and it is regrettable, to say the least of it, that a stable level of prices is exalted in India—and we are likely to hear more of it in the immediate future—as the criterion of her monetary policy.[1] Mr. Keynes may be right in his apprehensions of the evil effects of falling prices in Great Britain ; but this does not mean that those who advocate stability of prices at the present level in India, and desire to prevent a rise in prices by currency manipulations, are serving the true economic interests of this country.

Mr. Keynes has a further reason for advocating stability of prices in Great Britain. Writing in February 1925, he says, " The United States live in a vast and unceasing crescendo. Wide fluctuations, which spell unemployment and misery for us, are swamped for them in the general upward movement. A country, the whole of whose economic activities are expanding, cannot avoid, and at the same time can afford, temporary maladjustments. This was our own state during a considerable part of the nineteenth century. Our rate of progress was so great that stability in detail was neither possible nor essential. This is not our state now. Our rate of progress is slow at the best, and faults in our economic structure, which we could afford to overlook whilst we were racing forward, and which the United States can still afford to overlook, are now fatal. The slump of 1921 was even more violent in the United States than here, but by the end of 1922 recovery was practically completed. We still, in 1925, drag on with a million unemployed. The United States may suffer industrial and financial tempests in the years

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the business world being able to lay its plans free from anxiety, lest their anticipated profit will be obliterated by a falling price level" (J. M. Keynes).

[1] We are as ardent advocates as any one else of stability of prices, if by that phrase we mean absence of violent fluctuations in the price level. The stability, however, which Mr. Keynes is thinking of for Great Britain, and Sir Basil Blackett for India, is not the absence of violent fluctuations, but the retention of the present level of prices.

to come, and they will scarcely matter to her; but we, if we share them, may almost drown.[1]

Mr. Keynes' argument, in brief, is that for a country like Great Britain, whose industrial potentialities have been already worked out almost to their maximum capacity, monetary policy ought to be directed to maintaining the actual rate of production by inspiring confidence with regard to the trend of the price level. In the case of a country like the United States, with vast potentialities of further industrial development, a price level fluctuating over short periods may stimulate production when prices are rising, and may involve, when prices are falling, evils which can be faced and endured without permanent damage. Has India reached in her industrial production the stage at which Great Britain finds herself to-day? If not, shall not India have the courage to face the consequences of a fluctuating price level like the United States of America? The question of securing "stability in detail" does not arise, and such stability in detail "is neither possible nor essential" so long as there are possibilities of industrial development at a rapid rate in India.

Finally, we readily recognise the theoretical advantages of a conscious control of currency on the bases of index numbers—if such control on these lines is practicable at all. Mr. Keynes desires to adopt a managed currency of this kind for various reasons: "The most important of them flow from my belief that fluctuations of trade unemployment are at the same time the greatest and the most remediable of the economic diseases of modern society, that they are mainly diseases of our credit and banking system, and that it will be easier to apply the remedies if we retain the control of our currency in our own hands."[2] If these are the considerations that make Mr. Keynes plead for stability of prices by his scheme of a Managed Currency, his followers in India must reflect long before they think

[1] "The Return towards Gold," *Nation and Athenæum*, February 21, 1925.

[2] *Ibid.*

of urging in favour of the Gold-Exchange Standard that it secures stability of prices in this country. In the first place, it must be remembered that Indian banking is still in its infancy, her credit superstructure is of the crudest type, and it is obviously ridiculous to speak of "the diseases of *our* credit and banking system". In the second place, industrialism in the proper sense of the expression is just coming into being; "trade unemployment", in the sense in which Mr. Keynes uses the expression, does not exist in an acute form in this country. We have a problem of unemployment of a different and of a more acute nature—namely, a surplus population living parasitically on the land. If a policy of keeping a stable price level meets the economic problem of Great Britain, it cannot meet our own; what we need is industrial development, which requires *inter alia* an upward trend of prices. There can be no room for the play of business enterprise and industrial activity with a dead level of prices, and where credit and banking are in their initial stages their growth necessarily implies a fluctuating price level. To stop the fluctuations may mean the destruction of credit and the drying up of the life blood of economic life.[1]

The plea for stability of prices in India seems to find favour with very many people to-day, for reasons of diverse character. We have friends who are seriously disturbed by the idea of introducing an effective gold standard in India, who tell us that at a moment when the rest of the world is abandoning gold, India might find herself flooded with the yellow metal at the cost

[1] "In the first place, I am not sure that it has been shown that a perfectly steady level of prices is the economic ideal. Periods of rising prices are periods of expanding trade. Periods of falling prices are periods of economy, when waste and extravagance have to be put out, and dead wood destroyed. The ups and downs, provided they are not too violent, represent what Sir William Beveridge had called the pulse of the nation, and if we really knew how to eliminate them altogether, we might find that instead of life and vigour we had attained stagnation." (W. T. Layton, *Proceedings of the Academy of Political Science*, New York, January 1925, p. 189.)

of a serious rise of internal prices.[1] If America could absorb an enormous quantity of the yellow metal during the last ten years, and yet keep her internal level of prices relatively stable, there is no reason why British statesmanship in India cannot achieve the same result with a control of currency as effective as that of the Federal Reserve Board. But the greatest need of India to-day is capital, and the credit superstructure that may be built up on this basis of gold may stimulate production internally and enable the country to purchase in the international market the industrial equipment which she so badly needs. Under such circumstances, rising prices which are accompanied by increased production may be far from being injurious to the economic life of the country.

In this connection, we are thankful to our friends who speak of rising prices following the import of gold, for giving us the credit of allowing the gold to remain in circulation and not stupidly hoarding it. We rejoice at this admission in view of the oft-repeated shibboleth with regard to the hoarding habits of the people of India.

There are other friends of India who, in defence of locating the Gold Standard Reserve in London under the present Gold-Exchange Standard, point out that the transference of this fund to India would lead to a sudden rise in prices. There are still others who, like Sir Basil Blackett, put forward the plea of a stable level of prices in defence of a rising rate of exchange. We are told that had the Government not allowed the exchange to go up, Indian prices would not have remained stable. Stability of prices seems to have come into fashion in the currency world, in Great Britain, and it has been caught up by the representatives of various shades of

[1] The best evidence of the abandonment of gold by the rest of the world is found in the statistics of the *growth* of the gold reserves of the Continental States which we have given elsewhere. It is interesting to note that Great Britain's gold reserve increased from 170 million dollars in 1913 to 755 million dollars in 1924, that of the United States from 691 million dollars in 1913 to 4468 millions in 1924, while that of Japan increased from 65 millions in 1913 to 599 millions in 1924.

opinion in India, by those who are opposed to the location of the Gold Standard Reserve in India, and by those who are in favour of a rising exchange. Has the plea of stability of prices been exhausted by this time, or has it other potentialities for the future ?

The Gold-Exchange Standard and the Criterion of Elasticity

One of the fundamental requisites of a sound monetary system is that it should be elastic in its operation, capable of expansion and contraction in response to the requirements of the business community. In our complex economic organisation, it is difficult for any human agency to anticipate and ascertain the currency demands of a country. This difficulty was overcome before the war by the mechanism of the gold standard with an open mint, which enabled the community to adjust the quantity of the currency to its requirements. In India, under the Gold-Exchange Standard, the supply of money is entirely controlled by the Government, which can increase the volume of currency, but cannot contract it.[1] Thus in a country of seasonal demands for money, there is no automatic provision for adjusting the volume of money to trade requirements. A Government which is not as intimately in touch with the business community as banking institutions are in other countries, and which enjoys a monopoly of the issue of paper money, cannot meet promptly and effectively the demands of trade, in a country which has no free and open mint. This fact is amply evidenced by the sudden and violent fluctuations in the Bank rate. These were the defects which made

[1] Cf. Letter from the Punjab Chamber of Commerce to Government, June 1909 : " Redundancy has not been reckoned with, and no provision has been made for its relief. The country has been left to work off its surplus rupees as best it could, and when this is taking place when trade is dull, there is a dislocation of the value of commodities to that of coin more or less artificial. Naturally the purchasing power of the redundant coin declines ".

the currency system inelastic before the war. To-day the currency is inelastic for another reason. In the past our complaint was about the inflation of currency, to-day it is the starvation of currency needs that calls for comment. The exchange is left to take care of itself, and with a 2s. statutory rate and the ultimate object of fixing a rate higher than 1s. 4d., a policy of starvation is almost inevitable, though it involves monetary stringency of an acute character. In spite of the provision of emergency currency during recent years, the inelasticity of the monetary system is evidenced by the fluctuations of the Bank rate, which are even more violent to-day than they were in the pre-war period.

CHAPTER XXVII

CURRENCY POLICY—WHAT IS AND WHAT MIGHT BE

Objective of Currency Policy in the Past

What, then, has been the objective of the currency policy of our rulers during the last forty years? Has it been economy of gold? If so, that object has not been realised by the Gold-Exchange Standard. It has been claimed that the Gold-Exchange Standard is very much more economical than the gold standard in avoiding the costly locking-up of gold or the wasteful use of gold in circulation. The result of the working of the system has, however, been just the reverse of what its advocates claim for it. From the point of view of this country, the savings on the coinage of rupees under the Gold-Exchange Standard, which now amount to £40,000,000, are not available either for the development of our credit institutions or for the development of our nation-building departments, as these savings are located and invested in London. The Gold Standard Reserve Fund also cannot be used for the purchase of industrial equipment in the world market, as it is solely intended to maintain the stability of foreign exchange. We are told that if a gold standard had been introduced instead, India would by now have been the poorer by £40,000,000. One wonders what benefit the Gold Standard Reserve Fund secures to India as long as it is locked up in London! With the Fund in London this country is as badly off as if the Fund had not accumulated with the Government, if not worse off. Under a gold standard, the amount which now stands credited to the Gold Standard Reserve Fund would have gone into the coffers of the people,

and there is every reason to believe that it would have found its way into the reserves of the banks.

As regards the suggestion that, under a gold standard, gold would be locked up internally, or, in other words, hoarded by the people, the one effective rejoinder is that the Gold-Exchange Standard is itself responsible for this unproductive habit of hoarding.[1] So long as there is the fear that gold once parted with will not return to the holder, there will always be a desire to hoard. Under the Gold-Exchange Standard there is no certainty that people will get gold when they require it in exchange for their rupees; and this is responsible for the disappearance from circulation of all the gold that India obtains from year to year. Far from economising the

[1] "It is objected that India is a bottomless sink for the absorption of the precious metals, and that gold and silver once passed into general consumption in India is permanently lost to the rest of the world. This attempt to fasten upon India an exceptional and invidious responsibility for the consumption of bullion cannot be too vigorously combated. India is still an illiterate country, where the practice of holding small savings in gold and silver ornaments is centuries old. Yet its normal demand for the industrial arts, and for the satisfaction of the social customs of three hundred and fifteen millions of people, was met before the war by about ten millions of gold annually. The United States of America was reported recently to be absorbing a million sterling in gold per month for industrial purposes. Yet no one says that the United States is a bottomless sink in the matter of her gold absorption. It is stated that in England one of the most flourishing trades during the war was that in cheap jewellery, in which form the working classes invested a substantial proportion of their increased earnings. Every country in the world uses gold and silver for industrial and domestic purposes, and it induces a sense of angry injustice to find that the Indian demand for the precious metals, for precisely the same purposes, is perverted into senseless hoarding, especially when the history and conditions of India would justify larger gold absorption than the Western nations with their general literacy and easily organised credit system can claim" (Memorandum by Sir Stanley Reed before the Babington-Smith Committee. App. p. 130).

Even the Finance Member of the Government of India, in the Budget discussion in March 1921, was candid enough to confess that the average poor man in India "has no banking facilities; he is not sufficiently educated to have acquired the Savings Bank habit, and until he improves sufficiently by education to appreciate the investment habit, or until we can provide him with the necessary banking facilities, silver and gold are practically his only means of banking".

use of gold and giving the country the benefits of cheaper media of exchange, the Gold-Exchange Standard has, in actual working, resulted in the most foolish, extravagant, and wasteful dissipation of the country's gold resources, both internally and externally. The Government of India is as much to be blamed for hoarding gold externally as the people of India for hoarding it internally; and both alike have been forced into this habit by the Gold-Exchange Standard.

Hoarding of Gold

The growing absorption of gold by India from year to year is clearly evidenced by the following table:

Total Imports and Exports of Gold Coin and Bullion

Year.	Imports of Gold in Rs.	Exports of Gold in Rs.	Net Imports in Rs.
1900–01	11,89,80,197	11,05,58,846	84,21,351
1901–02	8,30,75,346	6,36,98,940	1,93,76,406
1902–03	13,19,23,677	4,43,78,018	8,75,45,659
1903–04	20,14,78,694	10,21,62,097	9,93,16,597
1904–05	21,81,19,781	12,10,60,922	9,70,58,859
1905–06	14,75,89,722	14,29,09,836	46,79,886
1906–07	18,53,33,819	3,67,73,424	14,85,59,395
1907–08	20,75,26,407	3,38,49,127	17,36,77,280
1908–09	8,40,42,310	4,04,87,653	4,35,54,657
1909–10	25,03,10,218	3,35,17,110	21,67,93,108
1910–11	27,89,25,145	3,91,38,600	23,97,86,545
1911–12	41,49,36,060	3,73,38,300	37,75,97,760
1912–13	41,29,07,850	7,28,95,725	34,00,12,125
1913–14	28,22,64,075	4,90,26,075	23,32,38,000
1914–15	10,70,38,230	3,05,64,075	7,64,74,155
1915–16	5,28,16,815	6,39,08,010	– 1,10,91,195
1916–17	13,33;78,695	10,25,205	13,23,53,490
1917–18	29,09,49,300	3,91,63,395	25,17,85,905
1918–19	2,27,63,160	7,83,99,840	– 5,56,36,680
1919–20	48,25,15,571	12,92,13,211	35,33,02,360
1920–21	23,57,38,134	21,46,55,723	2,10,82,411
1921–22	13,82,04,421	16,68,48,848	– 2,86,44,427
1922–23	41,32,39,178	13,30,632	41,19,08,546
1923–24	29,25,31,532	6,67,517	29,18,64,015
1924–25	74,13,82,707	36,32,121	73,77,50,586

The growing absorption of gold by any country is not in itself a crime, particularly when the country has a claim on this gold on account of her trade balance. What is

economically disastrous, not only for this country, but for the rest of the world, is that this enormous quantity of the precious metal should be hoarded or allowed to remain idle at a time when it is so urgently required for the purposes of national development; and for this economic disaster the one factor that is supremely responsible is the currency policy of the Government. The Controller of Currency is inclined to account for the phenomenal imports of gold during the last few years by attributing them to the fall in the price of gold bullion, accompanied by the uncertainty as to whether gold would continue to be so cheap.[1] But the purchasing power of the people in India has not increased appreciably during the last ten years, though nominal wages and incomes may have gone up; and all the gold that to-day remains idle in the hands of the people would be available to the Government and to the banks for the supply of capital and credit, if only there was the certainty—which an effective gold standard alone could give—that the gold which was parted with would return to them when required. At a time when the rest of the world is centralising its gold reserves in banks against the issue of notes, and reducing the active circulation of gold, those who advocate a gold standard for India are foolishly accused of proposing that gold should actively circulate in the country. It is a ridiculous charge at best, because an effective gold standard only requires ultimate convertibility of the media of exchange into gold, and not gold in active circulation.[2] What the advocates of an effective

[1] *Report of the Controller of the Currency*, 1924–25, p. 6.

[2] The following observations, which we cull from a newspaper, are typical:

Year.	Monetary Gold.		Total Gold in Circulation as Percentage of Total Monetary Gold.	
	In Banks, etc.	In Circulation.		
1912	$5,408,000,000	$3,072,000,000	$8,480,000,000	36·3%
1923	$9,300,575,000	$107,186,000	$9,407,761,000	1·1%

"These telling figures indicate the tendency of all advanced countries

gold standard point out is the criminal waste involved in the unproductive use of gold in this country, mainly due to the fear on the part of the people that the gold may never return to them even under a fixed exchange. India cannot afford, and does not need, much gold in active circulation, but she needs the conservation of her gold resources for national purposes, which she cannot secure under the Gold-Exchange Standard.

When we advocate a gold standard, we are charged with the wasteful use of gold in circulation. A gold standard does not mean a monetary system under which gold alone is to be the principal medium of exchange. Great Britain before the war possessed, and the United States to-day possesses, a gold standard ; and yet in both countries alike an effective banking organisation made the utmost economy of the use of the metal possible. All that is necessary under a gold standard is the ultimate convertibility of all other media of exchange into gold at the option of the holder. Those who charge the advocates of a gold standard with the wasteful use of the metal are oblivious of the fact that a gold standard may secure greater economy of the metal in circulation than a Gold-Exchange Standard, and may enable the country through her banking institutions to make her gold resources go as far as they possibly can in promoting industrial development. Whilst the rest of the world to-day conserves its gold resources and utilises them to the utmost for the purposes of national development, in India we find a Government persisting year after year in a currency policy that leads to the dissipation of her enormous accumulated gold resources.

Is the objective of the currency policy of Government the stability of foreign exchange ? If so, the Government of India has sacrificed the fundamental object of a sound

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towards centralising the gold reserve in banks against the issue of notes, and reducing the active circulation of gold. In the face of these figures, it would be hard to sustain the Indian demand for a gold currency in active circulation."

monetary system to what Mr. Keynes characterises as merely a convenience to those engaged in foreign trade. Whenever the system has been seriously put to the test it has failed; and to-day, recognising the futility of stabilising the exchanges in unfavourable conditions, Government has shifted its point of view and talks of stabilising the internal level of prices.

Is the objective, then, the stability of internal prices? This was never suggested as the aim of the currency policy of the Government in the past. If to-day Government refers to stability of prices, it is as an incidental benefit arising out of its recent currency experiments: it has not been accepted as the avowed object of India's monetary system. With a Gold-Exchange Standard—with the rate of exchange fixed, no matter at what level—Indian prices cannot remain unaffected by world prices. What is more, with a currency that can expand, but cannot contract, such as the Gold-Exchange System involves, Indian prices may not only rise in sympathy with world prices, but may rise much higher, as they did in the past, and may not fall with falling world prices. The only currency system that can secure stability of exchanges is an effective gold standard; and to-day a gold standard can be regulated and managed as effectively as Mr. Keynes' Managed Currency regulated on the basis of index numbers. There is this one further advantage in the case of the gold standard, that whilst it can be managed, it cannot be tampered with as easily as the Gold-Exchange Standard or Mr. Keynes' scheme. Conscious control of monetary policy and of price levels can best be obtained under a gold standard by close co-operation with a developed and centralised banking system, which can adjust the volume of money to the shifting conditions of trade by a proper management of the reserves.

Tampering with the Standard

If the only monetary policy which the Government can think of for the future is adherence to the Gold-Exchange Standard, with fixity of exchange, the country is committed to all the evils and vices of a fundamentally unsound currency system. But worse than all the evils that have grown out of the currency experiments of our rulers in the last thirty years is the way in which, by this very policy of experimentation, Government has tampered with one of the sanctities of civilised economic life—namely, the standard of values. One of the fundamental conditions of the growth of economic life is the confidence which men entertain about the stability of the unit of purchasing power; and the reckless manner in which the Government of India has repeatedly altered the legal meaning of this unit has had effects which because they are imperceptible are not therefore the less harmful. Changes in the legal meaning of the monetary unit may seriously affect the growth of savings, and therefore of capital; they may even affect the motives for work and industry. They may involve injustice as between debtors and creditors, and they may create an atmosphere of uncertainty and suspicion in which there will be no room for economic growth. This is the more serious consequence to be considered when pronouncing a final opinion on the history of currency measures during the last thirty years.

An Effective Gold Standard Desirable and Practicable

The only sound monetary system for India, as for the rest of the world, is the adoption of an effective gold standard which gives sufficient latitude for conscious control. A gold standard, we repeat, does not mean the exclusive use of gold coins in circulation. It is consistent with the greatest economy of gold in circulation; it secures stability of foreign exchanges, and stability in the

level of prices; it alone is proof against interested manipulations of currency by Government or financial cliques. The gold standard may not be a perfect standard of value. It has been unstable in the past to some extent, it may also be found to be unstable in the future; but the civilised world has not as yet evolved any substitute which can effectively take its place.

If an effective gold standard is theoretically sound for India to-day, it is also eminently practicable. As preliminary steps towards the adoption of the gold standard, we want in the first place precise legal definition of all token coins and of their relations to the standard coin. The most convenient relation between the token silver rupee and the sovereign would be 1 to 15. As regards the value of the Indian standard gold coin (it may be called *mohur*, but for convenience its weight and fineness might be identical with the weight and fineness of the English sovereign) in the international market, it may be left to take care of itself when the mint par has been defined. In the next place, we require a free and open mint for the coinage of gold. The Secretary of State must necessarily cease from financing Indian trade by the sale of Council Bills. The reversion from the present hybrid Gold-Exchange Standard to an effective gold standard cannot be secured at once. But the present moment is opportune for adopting the first interim measures which may ultimately enable us to reach the goal. India needs to-day, and will need increasingly, with favourable balances and increasing trade, additions to the volume of her currency. All such additions should now take the form of gold notes or certificates backed by gold. Further coinage of rupees must be definitely abandoned. The silver token rupee may be made legal tender up to 100 or 150 rupees. The total amount of the token money will necessarily be larger in India than in other countries, on account of the poverty of the population and the want of adequate banking facilities.

It may be asked, have we sufficient gold resources in

India available to Government for such a conversion of the silver currency into a gold currency?[1] The total volume of money in India is roughly Rs. 250,00,00,000.[2] The gross circulation of currency notes to-day is not more than Rs. 180,00,00,000. There are no gold coins in circulation. The total volume of money that must be converted into gold is Rs. 430,00,00,000; but as India is a country of small transactions, it will require even under a gold standard a sufficiently large volume of token money—say Rs. 200,00,00,000 in silver. We require, therefore, the conversion of only Rs. 230,00,00,000 into gold—in other words, we require 17,40,00,000 gold mohurs (or sovereigns). As against these liabilities, assuming that the work of conversion is to be accomplished at once, our assets in gold are £40,000,000 in the Gold Standard Reserve, £22,000,000 in the Paper Currency Reserve, and £20,000,000 in the sterling securities belonging to the Paper Currency Reserve. In addition, to make up

[1] The total purchasing power of India is roughly Rs. 430,00,00,000 (Rs. 250,00,00,000 + Rs. 180,00,00,000 paper money). The 180 crores of paper money are covered by Rs. 22 crores worth of gold, equal to £22,000,000 at Rs. 10 to the £, and Rs. 100,00,00,000 in silver, the rest being fiduciary. The fiduciary portion comprises Rs. 20,00,00,000 worth of sterling securities, equal to £20,000,000 at Rs. 10 to the £. We have thus silver coins, Rs. 250,00,00,000 + Rs. 100,00,00,000, and gold worth £22,000,000 + £20,000,000. We have also gold worth £40,000,000 in the Gold Standard Reserve.

ASSETS.		LIABILITIES.	
Rs. 350,00,00,000 in silver.		Conversion of Rs. 230,00,00,000 at Rs. 15 to the mohur will require for circulation	174,000,000 mohurs or sovereigns
Less Rs. 200,00,00,000 for token circulation under gold standard.		Less the revaluation of 50 crores of rupee securities in the fiduciary portion of the Paper Currency Reserve	33,300,000
Rs. 150,00,00,000			140,700,000
These Rs. 150,00,00,000 will yield us at 31½d. per ounce (165 grains pure silver in the rupee)	£67,675,781		
	40,000,000 in the Gold Standard Reserve.		
	42,000,000 in the Paper Currency Reserve.		
	£149,675,781		

[2] This is the estimate of the circulation of rupees given by Professor Jevons for the year 1920. There have been no appreciable additions to the currency since 1920.

our 17,40,00,000 gold mohurs, we have our existing silver resources to fall back on—these include Rs. 230,00,00,000, the balance left over after allowing for token currency, and Rs. 65,00,00,000 in the metallic portion of the Paper Currency Reserve. We must also bear in mind the fact that the £22,000,000 in the Paper Currency Reserve, and the £20,000,000 of securities belonging to the same Reserve, are calculated in the Paper Currency returns on the basis of a two-shilling ratio.

If the silver resources at the disposal of the Government of India, after deducting the amount required for token coinage, are taken into account, they are more than sufficient to carry out the scheme of conversion. It may be objected that if such enormous quantities of silver are thrown on the market, the price of silver will fall, involving our country in heavy losses. But the conversion into gold need not be effected in a single year ; the work of conversion may be spread over a term of years, thus preventing loss on the sale of silver. In fact, we do not insist on conversion at all as an immediate measure. The conversion of rupee notes into gold notes on the backing of such gold resources as the Government of India possesses to-day in the Paper Currency Reserve, and the addition to the currency of further gold notes in the future, do not involve any risk at all. This is all that need be done as a first step towards the final establishment of an effective gold standard. The adoption of these measures also implies the opening of a mint for the free coinage of gold, and the stoppage of further coinage of rupees. By means of these measures the country will already have advanced far in the right direction, and with a normal excess of exports over imports, and a keen demand for Indian produce in the world market, India can well afford to start on a policy and programme of an effective gold standard. To any one who has occasion to reflect dispassionately on the currency experiments of the Government of India during the last thirty years, there comes a sense of sadness, if not despair, at the enormous opportunities for the

economic development of this country so thoughtlessly neglected. India is said to have had a gold standard in some sense ; the Gold-Exchange Standard is alleged to have economised the use of gold and to have secured stability in foreign exchanges. And finally, if stability of exchanges has had to be abandoned for some years, we are told that our currency system has secured stability in the internal level of prices. Not one of these claims can stand serious examination by any one who has followed the history of currency regulation with care. We have not a gold standard in India so long as our measure of value is the silver rupee ; the gold is merely linked to the rupee by legislation, and that linkage is maintained in practice so long as the Government finds it convenient. Neither have we a Gold-Exchange Standard in the strict sense of that expression. Such a system of currency is based on two principles—that Government should convert such gold as is offered to it into silver coins for the purposes of internal demands for currency, and that Government should be willing and able to convert silver into gold for the purposes of meeting external demands in case of an unfavourable balance. The Government of India has fulfilled the first of these duties, because it has not been difficult for it to do so ; but it has often failed to supply gold for export when an adverse balance has created a demand of this kind, but there was no legal obligation to meet it.

Has the Gold-Exchange Standard economised the use of gold ? The only method of economising gold that Government in its wisdom has devised is that of locking up £40,000,000 in the Gold Standard Reserve for meeting an emergency that may arise once in ten years. Even more wasteful has been the huge dissipation of the gold that is absorbed by India in increasing quantities from year to year without being productively used, directly owing to the currency policy of a Government that cannot inspire the people with confidence that they will get back their gold when they want it. No more effective method has been, or can be, devised by human ingenuity for

wasting vast resources in the shape of precious metal in unproductive use year after year than the system misnamed the Gold-Exchange Standard.

Has the system stabilised the foreign exchanges ? The experience of the past has proved the hollowness of such a claim. The Government of India has manipulated the resources at its command so long as the gold price of silver has made it convenient and possible for it to keep up the artificial value of the rupee ; but it has allowed the exchanges to run amok—and no human Government could do otherwise—when the price of silver has risen to a point where it would not be profitable to convert gold into silver. Has the system stabilised the internal level of prices ? No claim of this kind was set up for the Gold-Exchange Standard till recently ; and it is now set up only for a period of years when the fixity of exchange which is the essence of the Gold-Exchange Standard has been definitely abandoned. If fixity of foreign exchanges is the goal of the currency policy, and if the machinery that is to secure this fixity is that which has been in operation for the past twenty-five years, then the Gold-Exchange Standard makes the currency inelastic, and directly contributes towards an inflation of prices of an economically detrimental character. The lessons of the war and the post-war years have been thrown away on a Government that can look forward in its currency measures to a return to a halting clumsy device that secures neither stability of foreign exchanges nor stability of prices, and inevitably involves the wasteful absorption of millions of pounds' worth of gold that do nobody any good. And whilst the rest of the civilised world can make itself heard in a League of Nations, India must rest content with meaningless effusions about her growing economic prosperity under the benign influence of her British rulers, while her leaders and statesmen remain more or less blissfully ignorant of the presence of the canker that eats away her economic vital parts.

CHAPTER XXVIII

HISTORY OF INDIAN PAPER CURRENCY

History, 1839–1914

Before 1839, paper currency was unknown in India. There were a variety of credit instruments, such as *hundis* of well-known firms, which passed from hand to hand, but paper money in the strict sense of the word was first introduced under British rule. The Acts of 1839–43 authorised the Presidency Banks of Bengal, Bombay, and Madras to issue notes payable on demand. Before 1839 there was a free banking system, and any bank could have issued notes. The Presidency Banks got a special status, because they were authorised by the Government, and for this privilege they were placed under legislative control. As the idea and the use of paper money were new to the people of the country, the privilege was not exercised on a large scale even by the Presidency Banks, whose notes were practically confined in circulation to the three Presidency towns. In 1861, the Presidency Banks were deprived of their right to issue notes, and the issue of paper money since that time has been the monopoly of Government. No bank was allowed to issue notes after 1861. As there was no State bank then in existence, the work was entrusted to a Government department.[1] The Government Paper

[1] In introducing the Paper Currency Bill in March 1860, Mr. Wilson said: "There are peculiarities in our position in India and in the system which I am about to propose, which would render it even more difficult than usual to employ the agency of banks in India. In the first place, the system is to be universal. How many years should we have to wait before we could expect that any banks, however extensive their capital, could establish branches throughout the whole country

Currency was launched into existence by the first Finance Member of the Government of India, Sir James Wilson.

The Paper Currency Act of 1861 was based on very rigid principles. The Government of India was largely influenced by the controversy in England which led to the Bank Charter Act of 1844. The note-issuing function was regarded as something entirely different from other banking functions, and the issue of notes was to be covered by metallic reserves, except a fixed amount—the smallest that experience has proved to be necessary for the monetary transactions of the country. The Act of 1861 authorised the Government of India to issue notes on the backing of securities to the extent of four crores of rupees, the remaining portion of the note issue to be covered by metallic backing in the form of either coin or bullion, silver or gold. The underlying idea of the Act was that the people of India should be educated

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for this purpose ? We have still another difficulty which I regard as insurmountable. Our notes are to be a legal tender ; they are to be received by every private person as well as by the Government in discharge of all ordinary claims. To attach this condition to our notes, we must provide absolute security for their payment, not only for their ultimate payment, but for their convertibility into coin, when required. If we employed the agency of a bank, we should require not only a deposit of securities which would ensure the ultimate payment of the notes, but also a proper reserve of bullion. . . . But the business of a bank established upon such a scale could not be, and it would not be desirable that it should be, confined to the issue of notes. It would extend to all other banking business. It would hold deposits ; it would issue bills of exchange ; it would discount and negotiate mercantile paper ; in short, it would have a great variety of creditors other than those who hold its notes. Would it then be practicable, would it be fair towards the great body of its creditors, if so large a share of its assets should be set aside as security for its notes in favour of one class of its creditors, to the possible injury of all other classes ? Would it be fair to protect the note-holders at the possible risk of the depositors ? If there are special reasons why banks in India cannot be used for this purpose, there are others as special and peculiar to India which point to the remarkable facilities possessed by the Government for the issue and management of a paper circulation. Throughout India, in every part, the Government has an organised body of public officers. . . . The Government Treasuries may be said practically to represent the great bulk of monetary transactions in most districts."

and familiarised with the use of notes, and that the Government should be enabled to use the fiduciary portion for public purposes. But this process was to be slow in an illiterate country like India, where people were not accustomed to the use of paper money. It was thought necessary in the beginning to cover a considerable portion of the note issue by metallic backing. In course of time, the amount of the fiduciary portion was raised from 4 crores in 1861 to 6 crores in 1871, 7 crores in 1891, 8 crores in 1892, 10 crores in 1897, and 12 crores in 1905, of which 2 crores might be in sterling securities. It was further raised to 14 crores in 1911, of which 4 crores might be in sterling securities. Thus before the outbreak of the war the fiduciary portion consisted of 14 crores, the remaining portion of the note issue being covered by metallic backing. The following table indicates the growth of note circulation in the country :

In Crores of Rupees.

Year.	Currency Notes in Circulation.	Metallic Reserves.		Invested Reserves.	
		Silver.	Gold.		
1863–64	519 *	..	..	249	..
1899–1900	2,796	1142	654	1000	..
1913–14	4,966	3291	475	1200	2 crores in sterling
1913–14	6,555	1801	3354	1400	4 crores in sterling
1919–20	17,168	4464	2920	8686	..
1923–24	17,901	8823	2349 †	7153	..

* These figures indicate gross circulation in every year on March 31.
† The gold is valued at Rs. 10 per £ according to the legal ratio of 2s. per rupee.

The large increase in gross circulation from 1919 to 1920 was the result of the measures adopted during the war.

It will thus be seen that down to 1901 the circulation of notes was not large, and currency notes occupied a subordinate position in the currency system of the country. There were various reasons for this limited

use of paper money in the early years of issue. We will briefly review them.

(*a*) In the first place, people were entirely unfamiliar with the use of notes, and it took time for the notes to acquire popularity.

(*b*) The lowest denomination of notes under the Act of 1861 was Rs. 10; the notes issued were of the denominations of Rs. 10, 20, 50, 100, and 1000. India is a country of small transactions, and a 10-rupee note was too large to take the place of metallic money. The issue of 5-rupee notes in 1891 was followed by an increase in the total amount of circulation.[1]

(*c*) The existence of the circle system resulted in difficulties in cashing notes. For the purpose of note issue India was divided into various circles. The currency notes were in the form of promissory notes payable to the bearer on demand, and were originally cashable only within the limits of the circle of their issue. This hampered the popularity of the notes and limited their circulation. The division of the country into circles for the purpose of note issue was influenced by the desire on the part of the Government to provide absolute security and immediate convertibility. It was feared that if the notes were universally cashable, merchants would remit money from province to province during the busy season in notes, and the Government would thus be forced to keep large cash reserves within each circle, and might become financially embarrassed.[2] That the circle arrangement checked the circulation of notes

[1] The Finance Member, in introducing the Bill in 1860, remarked: "If we bear in mind that the highest denomination of coin in circulation is one of only a single rupee or two shillings, while in England the common coin is one of twenty shillings, it would appear that we should be justified in adopting the old practice in Ceylon, and the present practice in many countries, and adopt notes of a denomination as low as two or two and a half rupees."

[2] The Government accepted its dues in notes of any circle, and so also railways accepted notes of any circle for freight charges, and recovered cash from the Government; again, for the accommodation of the public, notes of one circle were cashed in other circles to the extent of the convenience of the office.

is clear from the fact that the circulation increased rapidly with the process of universalisation. This process began in 1903, when 5-rupee notes were made cashable throughout the whole country except Burma. Till 1910 other notes were legal tender only within the circles of issue, and could be cashed as of right only at the head office of the circle of issue. In 1910 all notes up to Rs. 100 were universalised. With the partial abolition of the circle system, and the universalisation of notes of all denominations up to Rs. 100, the total circulation of notes increased enormously, as can be seen from the table already supplied.

We have already observed that the Paper Currency Act of 1861 was based on the principles of the Bank Charter Act of 1844. Under this Act the paper currency becomes inelastic, as the fiduciary portion is confined to a fixed maximum. With increasing trade and commerce, a community requires more money. The inherent defects of the Charter Act of 1844 were not felt to the fullest extent in England, as the Act was suspended in times of crisis, and as new methods of meeting the community's currency requirements were evolved, especially in the development of the cheque system, which soon took the place of bank-notes to a considerable extent.[1] India has not yet been familiarised with a developed cheque system. The great expansion of trade and commerce made the need for a more elastic currency keenly felt, and the paper currency system of India was found to be increasingly inelastic and inconvenient owing to the rigidity of the provisions of the Currency Acts. Some element of elasticity was needed, and it was considered that the provisions regarding the fiduciary portion required modification.

[1] "The complete inelasticity imposed by the Act of 1844 upon the currency of notes, an inelasticity which can only be modified temporarily and as a last resort by extra-legal power assumed by Government of suspending the Bank Charter Act in a crisis, has only been tolerated because of the discovery in the cheque system of an alternative means of obtaining an elastic paper currency which could not be obtained through the note issue under the terms of the Act" (*Chamberlain Commission Report*, para. 104).

The composition of the Reserve on 31st March 1913 was as follows :

In Crores of Rupees.

Total Circulation.	Metallic Reserve.			Fiduciary Reserve.	
	In India.		In England.	In India.	In England.
	In Silver.	In Gold.			
68·97	16·45	29·37	9·15	10	4

The total gross circulation was 68·97 crores of rupees ; the maximum fiduciary portion was 14 crores, of which 4 crores were invested in sterling securities in London, and 10 crores in rupee securities in India. Nine crores of rupees of the metallic reserve were kept in London. All notes up to the denomination of Rs. 100 were universalised, and the circle system was in process of abolition. The location in London of 9 crores worth of gold belonging to the metallic portion of the Paper Currency Reserve invoked criticism. It was aptly pointed out that the metallic portion of the Paper Currency Reserve is meant for the convertibility of notes into cash, while the fiduciary portion, which enables the Government to effect an economy in the use of the precious metals, should be available for nation-building purposes. The location of 9 crores in London was criticised as wrong, and the investment of 4 crores from the fiduciary portion as unfair.[1]

[1] " Although the Indian rupee currency is purely an Indian concern, the practice has been initiated in recent years of holding a part of the reserve against the Indian note issue in London. Such a practice—the practice of holding a country's Paper Currency Reserve in some other country on the other side of the world—is, I believe, unprecedented in the history of any nation. Nor have any of the reasons advanced on behalf of Government in the case of the Indian Paper Currency Reserve convinced me that the holding of £7,000,000 of the Reserve in London, invested in India, is other than a wasteful and a thoroughly bad policy from the point of view of India.

" The principal arguments used in favour of holding a large proportion of the Indian Paper Currency Reserve in London rather than India have been as under :

" (*a*) So long as gold is not in active circulation in India, what the

All these questions concerning the Indian Paper Currency were referred to the Chamberlain Commission, which

presenter of currency notes requires is not sovereigns, but rupees. By keeping gold ready in London, the India Office can quickly buy silver to coin into rupees.

"(*b*) The India Office can easily appropriate and interchange the money with the general Treasury Balances and with the Gold Standard Reserve as may be found convenient from time to time.

"(*c*) Investments in sterling securities in London are better for India than investment in Government of India rupee paper, because such securities are not necessarily influenced by the causes which might shake public confidence in the Indian Paper Currency.

"(*d*) The money would be readily available to support exchange in case of a diminished demand for rupee currency.

"(*e*) The money is not required in India for the payment of notes, since a sufficient metallic reserve is held in India for that purpose.

"These arguments have only to be stated in juxtaposition to each other to stand self-condemned. Apart from the fact that they are in a large measure mutually destructive, no one of them will bear examination. Thus the idea of holding permanently £6,000,000 to £10,000,000 in London in case the India Office might suddenly want to enlarge the Indian token currency by the amount, is preposterous. The silver coinage ought to be replenished regularly and continuously in small sums (so as not to inflate unduly the token currency, or force up the silver market against Government). As a matter of fact, the Paper Currency Reserve lying in London was not utilised for the recent large purchase of silver, although there was nearly £7,000,000 lying in London for this special purpose.

"The facility for chopping and changing argument is perhaps the worst that could be employed in connection with a Paper Currency Reserve. The Indian Paper Currency Reserve has been created for a special object, namely, to encash the Indian paper currency in India, and nothing is more likely to shake confidence in this currency than the knowledge that the specie necessary for its encashment is liable to be removed to the other side of the world and invested in securities that in an economic crisis or great war in Europe might prove absolutely unsaleable.

"The argument employed by the Under-Secretary of State for India, that if the Gold Standard Reserve proved inadequate for satisfying an adverse balance of trade, the portion of the Indian Paper Currency Reserve that is held in London might be appropriated to support exchange, is particularly vicious, in that not only is it radically unsound but it casts a suspicion on the efficacy of the Gold Standard Reserve. Apart from the extreme improbability of the Gold Standard Reserve breaking down, the fact that a portion of the Paper Currency Reserve was held in London instead of India would have no bearing on the situation at all. And for this reason, if the Paper Currency Reserve

pronounced definite views on every aspect. The inelasticity of the system was recognised, and the Commission recommended that the fiduciary portion should be raised at once to 20 crores of rupees, and that the maximum fiduciary portion should be fixed at the amount of notes held by the Government in Reserve Treasuries plus one-third of the net circulation for the time being. It further recommended temporary investments and the granting of loans to the banks either in India or in London. By these recommendations the Commission hoped to secure for the country an automatic currency system. Regarding the location of a portion of the metallic reserve in London, and the partial investment of the fiduciary portion in London, the Commission offered an apologia on grounds that may be considered entirely irrelevant.[1] This policy

consisted very largely of sovereigns, the sovereigns would be just as effective in supporting exchange in a grave emergency whether they were made available from the Treasuries in India or from the vaults of the Bank of England. Indeed, did the crisis happen to be a Western crisis rather than an Indian crisis, the gold would be far more valuable in India (and possibly to Great Britain) were it held in India rather than in the United Kingdom. The argument is, therefore, both worthless and misleading." (Abbreviated from Memorandum submitted by Sir M. de P. Webb to the Chamberlain Commission.)

[1] "The policy pursued in quite recent years has been to locate from about 5 to 7 millions sterling in London, and only to secure the presence in London of further gold belonging to the Reserve when the money is wanted to purchase silver. This policy has been criticised by some of the witnesses who appeared before us. It seems to us, however, to be at present justified by two considerations. In the first place, it is reasonable that for the purchase of silver some part of the Paper Currency Reserve gold should be kept in London as the principal source of supply; for this purpose no great amount is required. But, second, there is the maintenance of exchange to be considered. The facts are that the gold in the Reserve in India has been much in excess of the demand, that the Gold Standard Reserve has not in itself been sufficient to secure beyond question the stability of exchange, and that gold in London is more directly and indubitably effective for this purpose than gold in India. In these circumstances, so long as the Gold Standard Reserve is insufficient by itself for the support of exchange, we think that the policy is justified" (para. 108). It seems that for India not only her metallic currency but her paper currency exists for the maintenance of the exchange rate.

was justified on the ground that the gold belonging to the Paper Currency Reserve is a second line of defence for the maintenance of the rate of exchange. Silver could easily be bought with the credit of the Secretary of State. One does not understand why silver should be bought at all, when, with a gold standard, gold could profitably flow into India, and be converted into currency to meet the demands of trade ! The Paper Currency Reserve has nothing to do with the maintenance and stability of the rupee exchange rate. It exists for the convertibility of notes into cash. The Commission emphasised the desirability of making notes more popular and for this purpose recommended that the Government should increase wherever and whenever possible the number of places where notes are cashable, and should also universalise notes of the denomination of Rs. 500.

History, 1914–25

The war broke out in 1914, and Government could not consider the recommendations of the Commission. New problems were forced upon the attention of the country. India's favourable trade balance became enormously large, and it had to be settled. For two years it was settled by the shipment of silver and other means, but the rising price of silver created further difficulties. When the price of silver went above 43d. an ounce, it became unprofitable to coin rupees. Various steps were taken by the Government to cope with the situation. Among them, the most important was to increase the fiduciary portion of the Paper Currency Reserve. This step had to be taken owing to the difficulties experienced by the Government in obtaining sufficient quantities of the precious metals for coinage and for the backing of the issue of additional notes. From November 1915 to December 1919, the legal limit of the fiduciary portion of the Reserve was modified nine times by ordinances, till it stood at 120 crores of rupees, of which 20 crores might be invested in the securities of

the Government of India. The gross circulation of notes increased threefold during these years, and as the result of raising the limit of the fiduciary portion the percentage of metallic backing decreased by nearly one-half. In March 1914, the percentage of metallic backing was 78, while in November 1919 it was 44·6 of the total circulation. Notes of low denominations, one and two-and-a-half rupees, were also issued. This enormous increase in the issue and circulation of notes necessitated a corresponding adequate metallic backing to maintain their convertibility. As the metallic backing was not readily available, British Treasury Bills were used as part of the Reserve. Large payments were due to India from year to year from Great Britain and the Allies on account of the purchase of foodstuffs and other commodities. These payments could not be effected through the medium of specie. The Secretary of State received the amounts due to India and invested them in British Treasury Bills, on the backing of which currency notes were issued in India.[1] The result was that notes were at a discount in the country.

[1] The limits to the invested portion of the Reserve were fixed from time to time as follows :

In Crores of Rupees.

Year.	Rupee Securities. Total Admissible.	Sterling Securities. Total Admissible.	Combined. Total Admissible.
1861 . . .	4	..	4
1871 . . .	6	..	6
1890 . . .	8	..	8
1896 . . .	10	..	10
1905 . . .	12	2	12
1911 . . .	14	4	14
1915 . . .	20	4	20
Ordinance I. of 1916	20	10	20
Act IX. of 1916 .	20	10 6 British Treasury Bills	26
Ordinance VI. of 1916	20	10 18 British Treasury Bills	38
Ordinance VII. of 1916 . .	20	10 30 British Treasury Bills	50
Ordinance of 1917	20	10 42 British Treasury Bills	62
Act VI. of 1918	20	10 66 British Treasury Bills	86
Act II. of 1919	20	10 80 British Treasury Bills	100
September 1919	20	10 100 British Treasury Bills	120

This has been officially acknowledged: "There was in many parts of India a considerable discount on notes, especially the new two-and-a-half-rupee and one-rupee notes when they were first issued in large quantities to replace rupees. Discounts as high as 15 per cent and 19 per cent have been reported." [1]

The Babington-Smith Committee (1919) considered the whole question of Indian paper currency, and welcomed the increased use of paper money. The Committee believed that this increase was due to the growing popularity of notes, forgetting to take account of the fact that the notes were partially forced into circulation in the emergencies of war. The Committee gave its blessing to the then existing state of things and laid down a few principles for future policy. With regard to the limit of the metallic portion of the Reserve, the Committee recommended that "the statutory minimum for the metallic portion of the Reserve should be 40 per cent of the gross circulation". With regard to the composition of the fiduciary portion, it recommended that the holding of securities issued by the Government of India should be limited to 20 crores of rupees, the balance to be held in securities of other Governments comprised in the British Empire, and of the amount so held not more than 10 crores should have more than one year's maturity, and all should be redeemable at a fixed date. The balance of the invested portion above these 30 crores should be held in short-dated securities with not more than one year's maturity, issued by the Governments within the British Empire. The sterling investments were to be revalued at 2 shillings a rupee. To meet the seasonal demand for additional currency, provision was to be made for the issue of emergency currency notes to the extent of 5 crores over and above the normal fiduciary issue, as loans to the Presidency Banks on the security of export bills.[2]

[1] *Report of the Committee on Indian Exchange and Currency* (1919), para. 29.

[2] *Ibid.* paras. 78, 79, 80.

These recommendations were considered by the Government in 1920. Government did not accept the suggestion of a 40 per cent limit for the metallic Reserve, on the ground that the peculiar conditions of India, the conservative habits of the people, and their illiteracy, demanded a larger percentage of metallic Reserve; accordingly, in the Paper Currency Amendment Act, it was provided that the fiduciary portion should not exceed the metallic portion of the Reserve—*i.e.* that the metallic portion should not fall below 50 per cent of the total circulation of notes. The Paper Currency Amendment Act further provided that not more than 20 crores of the fiduciary portion of the Reserve should be invested in securities of the Government of India, and authorised the issue of 5 crores of rupees as emergency currency on the backing of commercial bills, to meet seasonal stringency. The monetary stringency during the years 1922–24 was so acute that the limit of the issue of emergency notes was raised from 5 crores to 7 crores and then to 12 crores. To make the system elastic, Government has modified the forms in which emergency currency is to be issued. The conditions for the issue of emergency currency were that no loan against exchange bills was to be made to the Imperial Bank of India from the Paper Currency Reserve unless the Bank rate was not below 6 per cent, that no more than 4 crores were to be issued when the Bank rate was below 7 per cent, a further 4 crores when the Bank rate was 7 per cent, and the remaining 4 crores when the Bank rate was 8 per cent. This principle is now modified, and the Government is permitted to issue 4 crores when the Bank rate is 6 per cent, and the remaining 8 crores when the Bank rate is 7 per cent and over. The Government of India hopes that this modification of the rules will ensure greater elasticity for the emergency currency.

CHAPTER XXIX

PRESENT POSITION OF THE INDIAN PAPER CURRENCY

THE currency notes are promissory notes payable to bearer on demand. They are of the denominations of Rs. 1, 2½, 5, 10, 50, 100, 500, 1000, and 10,000. The Government has decided not to issue 1-rupee and 2½-rupee notes any more. The following table gives particulars about the position of the paper currency on January 31, 1925 :

In Crores of Rupees.

Notes in Circulation.	Metallic Reserve.			Fiduciary Reserve.			Percentage of the Metallic Portion to the Circulation.
	In India.		In England.	In India.	In England.	Notes Issued on the Backing of Bills.	
	Silver Coin.	Gold Coin and Bullion					
181	78	22*	..	57	201*	4	56

* Valued at Rs. 10 to the £.

In this case the metallic portion is greater than that allowed by the statutory limit.

During the war period the Government over-issued the paper currency to meet the exigencies of those years of difficulties. This enormous issue had to be curtailed. A policy of deflation followed, and within one year nearly 50 crores were withdrawn from circulation—not only from the circulation of paper money, but from the total circulation of currency. By the Indian Coinage Act of 1920, the exchange rate was altered from 1s. 4d. to 2s., and, on the recommendation of the Babington-Smith Committee, the sterling securities and the gold in the Paper

Currency Reserve were revalued at the new ratio. The new legal ratio soon became inoperative with a fall in the price of silver, and the Government endeavoured to maintain it by the sale of Reverse Bills, but to no purpose. Ever since that time the exchange rate has been left to itself. The ratio on the statute book still remains at 2s. a rupee, though the market rate fluctuates round 1s. 6d. in spite of the fact that the price of silver is only 32d. an ounce. During the last four years India has had a large favourable balance, but there has been no addition to the currency. The coinage of rupees and the issue of paper currency are entirely within the hands of the Government, and the latter, bent upon maintaining the exchange at a higher rate than 1s. 4d., refuses to add to the volume of currency, though there is a demand for money with a continually large favourable balance. It is this policy which has been responsible for the stringency in the Indian money market during the last two years. Seasonal stringency may have its share in the present monetary difficulties, but it is aggravated by the currency and exchange policy of the Government. If there is an open mint, people can get more by tendering bullion, or if the banks are allowed to issue notes, they can meet the public requirements. But neither of these conditions obtains in India. As the legal ratio is 2s. to the rupee, those who get gold for their exports cannot tender it to the mint, as they can obtain only Rs. 10 to the £.

Seasonal stringency in the money market is not so peculiar to this country as it is assumed to be; other countries also witness it, but they have devised methods for meeting this seasonal demand for money. The Government of India can resort to these methods only to a limited extent so long as it has in view the maintenance of a high rate of exchange. The limit is entirely arbitrary, at the discretion of the Government of India, and depends upon the objective of the exchange policy, whether the rate aimed at is 1s. 6d. or 2s. With an

enormous favourable balance for the last few years, the exchange has jumped up to 1s. 6d. as the natural result of the limitation of the supply of currency, and if the same policy of currency starvation is continued, and the trade balance continues to be favourable, it may be possible to raise it to 2s. within a year or two. And the policy may be defended by a callous and clever bureaucracy on the ground that it maintains stable prices in India.

To meet the demands of trade and commerce, Government issued emergency currency in 1923–24 to the extent of 12 crores of rupees ; and this issue is referred to by the Finance Member as evidence disproving the contention that the Government is refusing the currency required by the country. If the Government of India is prepared to issue 12 crores as emergency currency, it does so with the full assurance that the issue of this amount will not affect the exchange policy. It realises that if this amount of emergency currency were not forthcoming, the stringency would be even more acute and would result in a depression of prices. The country requires a definite addition to the currency, and it also requires an elastic machinery for meeting its seasonal demands. The Government has only one object in view, namely the maintenance of the exchange rate ; the need for providing an automatic machinery for the expansion and contraction of the volume of currency is to be subordinated, if not sacrificed, to this fundamental purpose. If the monetary stringency becomes too acute, temporary relief must be provided by the issue of emergency currency, but at the same time the rate of exchange is to be maintained at 1s. 6d. The Paper Currency Amendment Act of 1925 authorised the Government to increase the fiduciary portion of the Reserve from 85 to 100 crores of rupees, or by 15 crores, which could all be invested in sterling securities. This measure, it is professed, will relieve the monetary stringency, and the Government of India is so anxious that it takes these powers in anticipation

of the demand.[1] Introducing the Paper Currency Amendment Act of 1925, the Finance Member referred " to the recent rise in the rupee and sterling " and dwelt on the action taken by the Government to prevent a rise above 1s. 6d., because such a rise must depress internal prices unduly and disturb trade. " The Government had been, therefore, providing against future requirements in sterling in advance, thereby hoping to secure greater stability in exchange. . . . There remained a margin of 8 crores of rupees for issuing additional currency against sterling securities, besides 10 crores of rupees of emergency currency which could still be issued. It might be that these amounts would suffice, but it was better to be prepared in advance to meet the legitimate demands of trade ", and this additional margin of 15 crores of rupees which the Bill sought to secure was to be invested in sterling securities.

The principle underlying the Paper Currency Act regarding the metallic portion of the Reserve is sound and conservative. In a country like India, where the people are illiterate and of conservative habits, it is better to err on the safe side and have a proportionately adequate Reserve to guarantee the convertibility of notes. With the spread of education, however, and with greater facilities of banking and cashing, the limit of the metallic reserve might safely be reduced to 40 per cent of the total circulation.

[1] This demand, if the Government so chose, could be easily met by the issue of notes covered by gold or by additional gold currency ; but that would conflict with the exchange policy. It is curious to notice how a policy which is claimed to be intended to relieve monetary stringency is likely to aggravate this stringency by locking up Indian funds in London. Again, whilst the Government has been showing its solicitude to meet the demands of the business world, it remitted £40,000,000 to London between April 1924 and January 1925, though the budgeted provision for sterling requirements for 1924–25 was only £27,000,000. We do not see any mystery about the causes that aggravate monetary stringency in this country. The bugbear of seasonal demand may be definitely laid to rest, though its ghost may still haunt the imagination.

The following table bears witness to the growing use of paper currency in India.[1]

In Lakhs of Rupees: Sovereigns valued at Rs. 15 = £1.

Year.	Rupees.	Notes.	Total.	Sovereigns and Half-Sovereigns.	Grand Total.
1909–10	13,22	5,03	18,25	4,31	22,56
1910–11	3,34	19	3,53	2,15	5,68
1911–12	11,50	4,44	15,94	13,33	29,27
1912–13	10,49	2,71	13,20	16,65	29,85
1913–14	5,32	2,65	7,97	18,11	26,08
Total for 5 years, 1909–10 to 1913–14.	43,87	15,02	58,89	54,55	1,13,44
1914–15	– 6,70	– 6,01	– 12,71	– 8,43	– 4,28
1915–16	10,40	9,23	19,63	29	19,92
1916–17	33,81	13,89	47,70	3,18	50,88
1917–18	27,86	17,22	45,08	14,26	59,34
1918–19	45,02	49,29	94,31	5,81	1,00,12
1919–20	20,09	20,20	40,29	– 8,32	31,97
1920–21	– 25,68	– 5,90	– 31,58	– 4,38	– 35,96
1921–22	– 10,46	9,35	– 1,11	2,78	1,67
1922–23	– 9,56	3,87	– 5,69	9,48	3,79
1923–24	7,62	7,96	15,58	6,74	22,32
Total for 10 years, 1914–15 to 1923–24.	92,40	1,19,10	2,11,50	38,27	2,49,77

These figures show that, whilst the absorption of rupees during the ten years commencing with the war is just double that of the quinquennium before the war, the absorption of notes in the later period is six times as much as in the earlier period.

Composition of the Fiduciary Portion of the Reserve

The fiduciary portion of the Reserve under the Act is limited to half the total circulation of notes. At present it is 100 crores of rupees, of which 20 crores may be

[1] Extracted from the Reports of the Controller of the Currency for 1923–24.

invested in the securities of the Government of India. Looking at the figures of the composition of the Reserve, we find that, out of the total investments of 77 crores, 20 crores are invested in sterling securities, and the Government of India has power to increase this amount to nearly 45 crores of rupees. The present figure of 20 crores as shown in the currency returns is calculated at Rs. 10 to £1, and to that extent it may mislead. At Rs. 15 to £1, it is 30 crores of rupees. This investment of 20 crores of rupees from the fiduciary portion of the Reserve in sterling securities is open to serious objection. The statutory provision of keeping 5 crores' worth of gold in London is also open to objection. It seems as if the Government of India has entirely ignored the fundamental principles of paper money. A country uses paper money in order to economise the precious metals, so that these may be available as loanable capital for nation-building purposes. If the notes are issued by the Government, the Government can save interest on the loans (within limits) and use the funds for such national purposes. If the notes are issued by a bank, the latter can use the precious metals thus released from direct money work for building up a credit superstructure (on a safe basis) to help the industries, trade, and commerce of the country. The benefits arising from the use of paper money in any country are primarily enjoyed by the country itself. If paper money is to be used and popularised in India, it should be primarily for the sake of the advantages that the economy of the precious metals thus involves. There is no reason why a single farthing of the fiduciary portion of the Indian Paper Currency Reserve should be invested in London. All the arguments advanced in favour of the Paper Currency Reserve in London are simply beside the point. It is urged that these investments should be short-dated investments, in order to provide for the convertibility of notes in case of a panic. With a metallic backing of 50 per cent of the total circulation, there is no danger of any sudden rush, nor any difficulty in securing

the immediate convertibility of notes. Supposing that there is a danger of this kind, it is not true to-day to maintain that there is no short-loan market in India. With our present experience of the Treasury Bills and the operations of the banks, we find that investments for short terms can safely be made in India. Even if it is contended that long-term investments cannot be made, there is no reason why these funds should not be made available to banks in India for creating credit. At present it may not unreasonably be asserted that the paper currency of India is partly used for the benefit of the London money market.

It is still more surprising to those who have grasped even the elementary principles of paper money, to find it urged that the Paper Currency Reserve—both the metallic and fiduciary portions—is to be looked upon as a second line of defence for the maintenance of the rupee exchange.[1] The bullion reserve is no longer held solely with the object of securing the ability to meet the obligation to cash notes in legal tender (rupees or gold) on demand. It is now utilised for holding gold by means of which the Secretary of State can support exchange in times of depression, and maintain at par the gold value of the rupee. For the sake of this object, the Government is content to forgo the extra profit which might be gained by increasing the investments, and has steadily increased the gold portion of the Reserve instead. The Paper Currency Reserve is thus used to provide the gold which is the first line of defence of the currency system as a whole, and hence can hardly be distinguished from the resources of

[1] Mr. Keynes, discussing the objects of the use of paper money in India, writes: "For large payments, therefore, it is important to encourage the use of notes to the utmost extent possible—from the point of view of economy, because by these means the Government may obtain a large part of the reserves necessary for the support of a Gold-Exchange Standard" (*Indian Currency and Finance*, pp. 37, 38). It is interesting to notice how even an economist of international reputation may lose sight of the most elementary truths in the desire to defend what he considers to be a surprising monetary discovery revealed to the currency experts of Great Britain in India.

the Gold Standard Reserve proper.[1] This apology is entirely irrelevant and unjustifiable. Unless we assume that the sole purpose of the paper currency of India is the maintenance of the rate of exchange—and no one who has an elementary knowledge of the principles of currency can ever suggest this view—the argument is absurd and unmeaning. What has the Paper Currency Reserve to do with the Gold Standard Reserve ? The one exists for securing the convertibility of notes into cash, the other for the maintenance of the rate of exchange. To look upon the Paper Currency Reserve as a second line of defence for the maintenance of the exchanges is to distort the proper function of the Reserve. One may perhaps adduce plausible considerations for the location and investment of the Gold Standard Reserve in London, if they can be seriously maintained at all, but there is not the slightest ground for the location and investment in London of any portion, however small, of the Paper Currency Reserve.[2]

Sir Basil Blackett, in introducing the Paper Currency Amendment Act (1925), endeavoured to make out a case for the investment of 15 crores in sterling securities. " India, following the example of the majority of countries of the world, preferred sterling reserve because of its rapid conversion in an international exchange ". He gave an instance from his personal knowledge, relating how, towards the end of July 1914, he was rung up by the India Office, and within an hour arrangements were made to release India of a certain contract about Treasury Bills and a reserve was made available in cash for India's currency needs. One cannot understand what the paper

[1] J. M. Keynes, *Indian Currency and Finance*, p. 51.

[2] " The whole of the Paper Currency Reserve should be held in India. Whilst it may be a convenience to the Secretary of State to hold a small proportion of the Reserve in London, to facilitate the purchases of silver, that convenience is dearly purchased by the weakened confidence which arises from the transfer of any portion of the Reserve from its proper home, India, to an artificial home, London " (Sir Stanley Reed, Memorandum submitted to the Babington-Smith Committee).

money of India has to do with international exchange. There is reason to fear that Sir Basil Blackett has confused the function of the Gold Standard Reserve with that of the Paper Currency Reserve. Perhaps he imagines that, in case of an adverse balance, people may return paper money in India to get gold in London. We may leave Sir Basil Blackett to work out the consequences of his imaginary hypothesis. During the same session (January 1925), Sir Basil Blackett urged that if India uses more paper money, the funds—the precious metals thus released—can be made available for capital expenditure within the country. This is true, and if it be so, where on earth is the necessity for sterling investments from the Paper Currency Reserve in London ? [1]

India loses the advantages of the use of paper currency owing to the reasons indicated above. The Government of India has the monopoly of the issue of paper money ; the paper currency has consequently become inelastic, as the Government of India cannot be in such close touch with traders and merchants as are the banks, and cannot therefore respond to the needs of these classes as sympathetically and spontaneously as banks would do. If the management of the paper currency is entrusted to a bank, it is likely to acquire greater

[1] " The transfer of a portion of the Reserve to London is a measure which is not calculated to improve the credit of the note issue, and is therefore undesirable. For the same reason I am unable to approve of the proposal to employ in London a portion of the Reserve in temporary investments " (Note by Sir James Begbie (para. 20) to the Chamberlain Commission Report). Even as early as September 1900, the then Finance Member, Sir Edward Law, observed : " When the funds in the Paper Currency Reserve were diverted from their original purposes and taken as providing security for the maintenance of a steady exchange, a radical and perhaps uncontemplated change was introduced, and at the risk of being considered somewhat conservative I would venture to suggest that it would be more prudent to revert, as far as possible, to original conditions as regards the treatment of these funds. The original conditions are that all funds in the Currency Reserve must primarily be held with the object and for the purpose of securing the prompt conversion of notes into such coins as the public may legitimately require."

elasticity. It is desirable that the management of the paper currency should be transferred to the Imperial Bank of India, under legal safeguards. This contention is accepted by the Finance Member, Sir Basil Blackett. Speaking before the Indian Merchants' Chamber at Bombay in July 1924, he declared: "I do not think that the Finance Member of any Government, and I would go further and say that any Government, is the right authority to manage the currency. . . . I confess to a very strong personal preference in favour of handing over to the Imperial Bank at the earliest possible opportunity the management of the paper currency. I do not believe in the Finance Member and still less in the Government managing the currency. Provided that right conditions obtain, the Imperial Bank would be a better agent for its management."

We have 22 crores' worth of gold in the Paper Currency Reserve in cash, and the gold should not be replaced by silver. Any such transformation would mean the final death-blow to the possibility, vague as it is to-day, of restoring an effective gold standard in India. Far from parting with the gold in the Paper Currency Reserve, the £20,000,000 worth of securities in the fiduciary portion of the Reserve should be sold, and the liquid gold thus obtained be added to the already accumulated 22 crores. With a favourable balance of trade, it would not be difficult for the Government of India gradually to convert the whole metallic reserve which serves as the backing to notes into a Gold Reserve, making the notes convertible into gold instead of silver. If, with the growing demands of trade, additional paper currency becomes necessary, it should be covered by gold only, and rupees should be gradually eliminated from the Paper Currency Reserve. The rupee securities should be expressed in terms of gold, and the management of the paper currency should be handed over to the Imperial Bank of India.[1] The

[1] The criticism made by Van Den Berg in 1884 still holds good. "The paper currency established by the Indian legislature fully answers

adoption of these simple measures would facilitate the introduction of an effective gold standard, which, as we have endeavoured to show elsewhere, is the only statesman-like policy that can solve our currency difficulties and further the economic development of the country.

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the purpose so far as business requires an easier means of exchange than gold or silver coin ; but no connection whatever exists between the issue of the fiduciary currency and the wants of the public to have their bills or other commodities converted into a current medium of exchange" (*The Money Market and Paper Currency of British India*, p. 3).

CHAPTER XXX

THE IMPERIAL BANK OF INDIA

The Money Market in India

Modern economic organisation is based on large-scale production involving specialisation. This specialisation is not merely confined to what we familiarly define as division of labour; it extends to capital and land, and the process is facilitated by the development of communications, of the means and facilities for making payments, that is to say, by the provision of facilities for effecting those kinds of payment by which capital is transferred from the control of one party to another. The introduction of the railway and the steamship, the discovery of the telegraph and the telephone, the use of the motor-car and the aeroplane, have made the world one for commercial purposes, and have created a single market for the purchase and sale of staple commodities. The processes of production, which are not complete till the goods are delivered, involve a time element, and every device which extends the use of credit, and transfers capital from the hands of people who can make no use of it themselves to others who can use it to the best advantage, furthers the growth of production and the consolidation of a world market. The special organisation by which the work of supplying credit and capital is carried out is known as the Money Market, which consists of a nucleus of specialised institutions, including the banks, the market for negotiable securities, the discount houses and bill brokers, institutions like the

investment banks in America, agricultural banks, and co-operative credit societies. The money market in every country performs two essential functions—it supplies a stock of money and facilitates the transport of capital. The efficiency of the money market primarily depends on the degree of success which it attains in supplying an efficient currency, and in regulating this supply in such a manner as to secure the relative stability of the purchasing power of the monetary unit. Briefly, the efficiency of the money market depends on providing a currency capable of being adjusted to the requirements of industry and trade. Secondly, the efficiency of the money market depends on the extent to which it can mobilise the surplus resources of the community, and transfer these resources into the hands of those who can use them most effectively, thus increasing the productive capacity of the nation and swelling the national dividend.[1]

We may briefly survey the money market in India under the following heads:

THE BANKING ORGANISATION OF INDIA

A. 1. The Imperial Bank of India.
2. The Exchange Banks.
3. The joint-stock banks.
4. The savings banks.
5. The co-operative banks.
6. Insurance companies.
7. Stock Exchanges and markets for negotiable securities.

B. Indigenous banking, including the Mahajans, Shroffs, Sowkars, Marwaris.

HISTORY OF THE PRESIDENCY BANKS

The Presidency Bank of Bengal was opened in 1806, that of Bombay in 1840, and that of Madras in 1843, under special charters. The prospects of changing the

[1] See F. Lavington, *The English Capital Market*, chaps. i. and ii.

Bank of Bengal into an All-India Bank entertained in the early decades of the last century were ended by the establishment of the two other Presidency Banks. Originally the bank had a semi-official character, and the East India Company contributed a portion of the capital and appointed some of the directors, as well as the Secretary and Treasurer. Down to 1862 the Presidency Banks enjoyed the right of note-issue [1]; in 1862, however, this privilege was taken away from the banks and became the monopoly of the Government of India. By way of compensation, Government agreed to keep its balances with the banks. Owing to the failure of the Bank of Bombay, and for other reasons, Government relinquished its portion of the share capital of the bank, and with it its right of appointing directors. Further, on account of difficulties encountered in 1878 in getting back promptly their balances from the bank, Government devised a separate Treasury system and agreed to keep with the banks a stipulated minimum reserve, and whenever the balances fell below this minimum to pay interest on the deficiency.[2]

The constitution, operation, and functions of the Presidency Banks were governed by the Presidency Bank

[1] The Bank of Bengal had the power of issuing currency notes to the extent of two crores, subject to the proviso that it should keep coin in its vaults to the amount of one-fourth of all claims outstanding, payable on demand.

[2] Cf. Sir James Westland's minute dated October 1, 1898. As regards the Government balances at the Presidency Banks, "a maximum and a minimum limit are fixed, both very much in excess of the minimum stipulated in the contract with the banks; and the rule is laid down that, when the balance is above the maximum, the responsible account officer withdraws a certain amount into the reserve treasury; when it falls to or below the minimum he passes money into it from the reserve treasury. This rule is departed from only (1) when we are raising a loan, and in order to let it fall easily on the market, allow the Presidency Banks to retain a nominally excessive treasury balance; (2) when our general balance is so severely depleted that for the time we cannot spare funds from the district treasuries to maintain the usual standard of cash balance in the Presidency towns" (*Indian Currency Committee Report* (1891), App. I. p. 27).

Act of 1876, and they had to work under strict and rigid conditions from the very beginning. To encourage the growth of banking on sound and healthy lines in a conservative country like India, to do work on conservative principles, to safeguard semi-official institutions, to save the banks from speculative business, and to incorporate the experience and practice of English banking—these were the leading considerations underlying the rigid provisions of the Act and the restrictions imposed upon the operations and functions of the banks. Briefly stated, the provisions of the Act of 1876 prevented the Presidency Banks from conducting foreign exchange business, from borrowing or receiving deposits payable out of India, and from lending for a longer period than six months, or upon mortgage, or upon the security of immovable property, or upon promissory notes bearing less than two independent names, or upon goods, unless the goods or the title to them were deposited with the bank as security.

The banks were to transact general business for the Government at their head offices and certain branches; they were to receive specified remuneration, and the Government, though not bound to retain at the banks any particular sum, agreed that, if its balance at the head office of any of the three banks fell below a specified minimum, it would pay interest at "the lowest rate chargeable on such day by the same bank to the public for loans recoverable on demand".[1]

[1] The agreement provided as follows:

	Remuneration per Annum.	Amount of Balance below which Interest became payable.
Bank of Bengal . . .	£2900	£233,300
Bank of Madras . . .	800	120,000
Bank of Bombay . . .	800	133,000

In actual practice the Government of India kept at the head offices of the three banks the following amounts:

Bank of Bengal . .	£467,000 to £533,000
Bank of Madras . .	Over £133,000
Bank of Bombay . .	£267,000 to £333,000

(See *Chamberlain Commission Report*, Appendices, vol. i. p. 2.)

The question of establishing a Central Bank in India is as old as the beginning of the Presidency Banks. It was seriously discussed at various times in 1836, 1859, 1867, and 1870.[1] In 1898–99 Mr. Hambro called attention in a note appended to the Fowler Committee Report to the advantages which would accrue from the establishment of a strong Central Bank. This note gave rise to correspondence between the Secretary of State and the Government of India; both were favourable to the idea of a Central Bank, but the scheme was dropped as inopportune at the time. The proposal was again discussed by the Chamberlain Commission, but the question was left open with a suggestion that a Special Committee might be asked to examine it. Two carefully prepared memoranda were submitted to the Chamberlain Commission, one by Sir Lionel Abrahams and the other by Mr. J. M. Keynes in collaboration with Sir Ernest Cable.[2]

[1] In 1867, when the Bank of Bombay was known to have lost a large part of its capital, the directors of the Bank of Bengal submitted to Government a scheme for the amalgamation of the three Presidency Banks into a Central Bank for all India, with a paid-up capital of five crores of rupees and an unpaid capital of the same amount. The Secretary and Treasurer of the Bank of Bengal summed up the advantages of the amalgamation as follows: "With such a large capital actually provided, and liable to further calls in case of need, with an adequate reserve fund in the event of unforeseen losses, I submit that the proposed united bank would be equal at all times and under all circumstances not only to meet the legitimate requirements of commerce, but by unity of action and under the eye of the supreme Government to control those recurring monetary crises which, although hitherto more felt in the Bombay Presidency, yet very closely and intimately affect the interests and position of all. Government would have an absolute guarantee for the unvarying management of their treasuries under one controlling power, a certainty of greater economy in the use and distribution of their balances throughout India, uniform management of the public debt under the same safeguard, but with enlarged security, and a powerful agent in aiding them in all their financial measures."

[2] Cf. *Chamberlain Commission Report*, para. 221: "A study of these two memoranda makes much clearer the nature of the question at issue, and the schemes proposed in them present *prima facie* several attractive features. But most of the witnesses whom we have examined have not been in a position to consider or pronounce upon the specific proposals therein contained. It was not possible for us, therefore, to

The jealousies of the Provincial Banks may to a certain extent have been responsible for the lack of enthusiasm and interest in the question. The Government of India in 1907 was obliged to recognise the presence of "provincial and personal jealousies". The Industrial Commission 1916–18 recommended the appointment of a Committee to examine the subject. At the same time the events connected with the war made the Government realise the necessity for a Central Bank. The nature and character of the work done by the three Presidency Banks was almost identical, and this work could not possibly give rise to conflict as between the banks. The benefits that would accrue from amalgamation were realised by the Presidency Banks during the war. They rendered ungrudging service to the Government in floating its War Loans and Treasury Bills. The sense of the valuable services which the banks rendered during the war was too vivid to disappear in the years that followed. Government was anxious to continue the co-operation and the more intimate relations which the war had established between itself and the banks. There was, moreover, the larger question of providing adequate facilities for banking in the country. It was realised that a Central State Bank would win public confidence amongst investors; that it would more readily and easily draw money in the shape of deposits; and that it would be possible for such an institution to extend its activities by opening branches in every part of India, and thus ensure the flow of capital in directions where it was most needed. It was also felt that the financial resources of the Government might be made more readily available to commercial and business circles through a

submit these schemes to a sufficiently searching examination without much delay in the presentation of our Report. We recognised further that such an examination would probably involve a visit to India, a careful study of the conditions on the spot, and we came to the conclusion that we were not fitted as a body to undertake this task. We do not feel ourselves, therefore, in a position to make recommendations one way or the other on the question of a State Bank."

Central Bank than through the existing Presidency Banks. There was some fear that London banking interests might enter the field as rivals to the Presidency Banks, and it was suggested that the Presidency Banks could protect themselves only by a project of consolidation.

Negotiations were accordingly opened, and agreement was reached between the banks themselves and between the banks and Government. The results were embodied in the Imperial Bank of India Act which came into operation on January 27, 1921. It was one of the last measures sanctioned by the old Legislature which passed away with the advent of the Reform Constitution. It has been suggested that the measure was rushed through lest the new legislative bodies, with a majority of elected representatives, might successfully oppose the proposed amalgamation.

The Imperial Bank of India Act

The Imperial Bank of India has been brought into existence by the amalgamation of the three Presidency Banks, their undertakings vesting in it, and the shares of the existing holders being exchanged for shares of the new Bank. The authorised capital of the Imperial Bank is fixed at Rs. 11,25,00,000, of which Rs. 5,62,50,000 represent paid-up capital and Rs. 3,75,00,000 represent reserves. Of the total authorised capital, Rs. 3,75,00,000 consist of fully-paid shares of Rs. 500 each, and the balance consists of quarter-paid shares of Rs. 500. These latter were offered in the first instance at par to existing shareholders of the Banks of Bengal and Bombay, and at a premium of Rs. 100 to shareholders of the Bank of Madras. The Bank's position at its inception in 1921 may be summed up as follows:

	In Lakhs of Rupees.
Authorised capital	11,25
Fully-paid capital	3,75
Partly-paid capital	1,87.5
Total capital paid up	5,62.5
Reserves	3,75
Reserve liability of shareholders	5,62.5

It is clear from these figures that the Bank can call Rs. 5,62,50,000 to increase its operations without changing the Imperial Bank Act. There is ample scope for extension of its activities under the existing constitution.

The Governing Body of the Bank is the Central Board, which is to " exercise such powers and do all such acts and things as may be exercised or done by the Bank and are not by the Act expressly directed or required to be done in general meeting ". Its functions are defined by by-laws. It deals only with matters of general policy, such as the movements of funds from one part of the country to another, the fixing of the Bank rate, and the issue of the weekly statement. Local Boards at the three Presidency towns are constituted with fairly wide powers of managing local business, but they are under the general control of the Central Board. Disputes between the Local Boards are adjusted by the Central Board. The Central Board is composed of the presidents and vice-presidents of the Local Boards representing the shareholders, the Controller of Currency representing the Government of India, four Governors nominated by Government to secure representation of the interests of the Indian community in general, the Secretaries of the Local Boards, and two Managing Governors (there may even be one) appointed by the Government of India on the recommendation of the Central Board, holding office for such period as the Government of India directs. The four Governors, while they are entitled to attend all meetings of the Central Board and to take part in its deliberations, are not entitled to vote on any question arising at any meeting. Owing to the difficulty of calling meetings of the Central Board, the work of the Central Board is delegated to a small Managing Committee, including the two Managing Governors, the Controller of Currency, and the representatives of the Local Board of the place where the meeting is held. The Committee meets regularly and exercises full administrative powers. In the past, provincial jealousies had long proved an

impediment in the way of amalgamation, and even to-day those jealousies manifest themselves in relation to the location of the Central Board. The Central Board has no fixed and permanent location. It sits alternately in Calcutta and Bombay, meetings being held at fixed intervals and additional meetings being summoned whenever necessary.

The Bank acts as banker to the Government of India and transacts all business of the Government. It acts as sole banker to Government; it is the custodian of public funds and Government cash balances, central and local, and also of the Secretary of State's balances through the newly constituted London office. Apart from this work, the business of the Bank is regulated by the provisions of the Act, which lay down clearly the nature of the business that the Bank can transact and the business that it cannot transact. The provisions are both positive and negative, and are based on the provisions of the Presidency Banks Act with some modifications. The schedule of the Imperial Bank of India Act, Part I., defines the business which the Bank is authorised to carry on. Part II. defines the business which the Bank is not authorised to carry on. Briefly stated, the kinds of business that the Bank can transact are :

(*a*) Advancing money on the security of—

1. Stocks, etc., in which a trustee is authorised by the Act to invest trust moneys.
2. Securities issued by State-aided railways notified by the Governor-General in Council.
3. Debentures or other securities issued under the Act by or on behalf of a district board.
4. Goods, or documents of title thereto, deposited with or assigned to the Bank.
5. Accepted bills of exchange or promissory notes.
6. Fully-paid-up debentures or shares of companies with limited liability, or immovable property or documents of title relating thereto as collateral

security where the original security is one of those specified in 1, 2, 3, 4, and if authorised by the Central Board.

(*b*) With the sanction of the local Government, advancing money to Courts of Wards upon security of estates in their charge.

(*c*) Drawing, accepting, discounting, buying, and selling bills of exchange and other negotiable securities payable in India and Ceylon, and, subject to the directions of the Governor-General in Council, the discounting, buying, and selling of bills of exchange, payable outside India, for and from or to such banks as may be approved.

(*d*) Investing the Bank's funds in the securities referred to (*a*) 1, 2, 3.

(*e*) Making, issuing, and circulating Bank-post-bills and letters of credit payable in India and Ceylon.

(*f*) Buying and selling gold and silver.

(*g*) Receiving deposits.

(*h*) Receiving securities for safe custody.

(*i*) Selling such properties as may come into the Bank's possession in satisfaction of claims.

(*j*) Acting as administrator and winding up estates.

(*k*) Drawing bills of exchange and granting letters of credit payable out of India, for the use of principals in connection with (*g*), and also for private constituents for *bona fide* personal needs.

(*l*) Buying for the purpose of meeting such bills, etc., bills of exchange payable out of India, at any usance not exceeding six months.

(*m*) Borrowing money in India.

(*n*) Borrowing money in England upon the security of the assets of the Bank, but not otherwise.

The restrictions placed on the business of the Bank are :

(*a*) It shall not make any loan or advance—

1. for a longer period than six months ;
2. upon the security of stock or shares of the Bank ;
3. save in cases specified in Part I. (Courts of Ward)

upon mortgage or security of immovable property or documents of title relating thereto.

(*b*) The amount which may be advanced to any individual or partnership is limited.

(*c*) Discounts cannot be made, nor advances on personal security given, unless such discounts or advances carry with them the several responsibilities of at least two persons or firms unconnected with each other in general partnership.

CHAPTER XXXI

THE IMPERIAL BANK OF INDIA (*continued*)

LIMITATION OF FUNCTIONS

THE nature of the functions which the Imperial Bank performs to-day may be gathered by a brief reference to the balance-sheet as it stood on December 31, 1924.

LIABILITIES.	In Thousands of Rupees.	ASSETS.	In Thousands of Rupees.
Subscribed capital .	11,25,00	Government securities .	15,14,18
Capital paid up . .	5,62,50	Other authorised securities under the Act .	1,21,96
Reserve . . .	4,67,50	Loans . . .	15,79,05
Public deposits . .	7,50,20	Cash credits . .	33,34,19
Other deposits . .	76,71,22	Inland bills discounted and purchased. .	11,58,98
Loans against securities *per contra* . .	...	Foreign bills discounted and purchased. .	67,69
Loans from the Government of India under Sect. 20 of the Paper Currency Act against inland bills discounted and purchased *per contra* . . .	2,00,00	Dead stock . .	2,63,09
Sundries . . .	42,42	Liability of constituents for contingent liabilities *per contra* . .	...
		Sundries . . .	44,99
		Balance with other banks	49,03
			81,33,65
		Cash	15,60,25
	96,93,90		96,93,90

The above balance-sheet includes :

Deposits in London	£1,243,409
Advances in London	929,344
Cash and balances at other banks in London .	369,437

A glance at the balance-sheet will show that the largest item on the side of the assets is the cash credits. The

next two items in order of importance are loans and inland bills. The transactions of the Bank to which these items refer are limited to six months. Very many of the loans and credits are of shorter duration, though in some cases they may be renewed. The service which the Bank renders to the country is confined to granting loans and credit to business men engaged in trade and commerce and requiring short-term loans. The Imperial Bank is thus primarily and mainly a commercial bank. The amalgamation which took place in 1920–21 removed many of the limitations which handicapped the Presidency Banks as separate concerns with regard to the granting of loans and business in exchange, and facilitated economies of administration. But the relaxation of restrictions which was made possible by the Act was confined to the restrictions on commercial banking. Not even the official advisers of the Government of India in the annexe to the Chamberlain Commission Report could, in their vision of a State Bank, think of realising for the country other advantages than those accruing to the commercial community by the elasticity of the credit system, by the introduction of a re-discount market and a definite Bank rate policy.[1]

Again, the Bank is debarred from extending its operations beyond India and Ceylon. The business in London through its London branch is to be of a special character, and the Bank is strictly prohibited from entering into any foreign exchange business, though it is the sole banker to Government. The Secretary of State and the Government of India still carry on a large amount of banking business by the operations of the sale and purchase of Council Bills and sterling. It may be that the Imperial Bank is debarred from the exchange business as a concession to the vested interests of the Exchange

[1] The annexe to the Chamberlain Commission Report makes a grudging admission that the great increase of branches in country districts may lead to the State Bank's playing an important part in the development of co-operative banking amongst agriculturists.

Banks, which enjoy almost a monopoly of financing India's foreign trade, amounting to 600 crores of rupees.[1] Exchange business is represented as being somewhat precarious and speculative. It may be so under a monetary system like that which India possesses to-day, a system that has been lacking in a precise, definite, consistent policy, that sought to stabilise exchanges at one time, professes to stabilise prices, and let the exchanges alone and then again to fix the rate of exchange at 1s. 6d.[2] But under an effective gold standard there is no reason why business in the exchanges should be speculative. What is more remarkable, however, is that this very speculative business is carried on to-day to a large extent by the Government of India, with the result that its Budget calculations are frequently over-

[1] In 1900, when the project of a new Bank formed by the amalgamation of the three Presidency Banks was being discussed between the Government of India and the Secretary of State, the Exchange Banks of Calcutta addressed a memorial to the Viceroy insisting on the desirability of restricting the operations of the projected Bank and debarring it from the exchange business, as it would expose them to dangerous competition, not of a rival institution, but of an institution "with all its contemplated resources and privileges and prestige as a State Bank". The Exchange Banks would practically be swept out of the field and effaced, and "all the well-known objections to the State competing with its subjects in matters relating to private enterprise would in that case become applicable". We confess it would be difficult to understand reasoning like that of the Exchange Banks, which prefers State management of the sterling exchanges directly by the Secretary of State to State management through a central banking institution controlled by Government.

[2] There is nothing more pathetic in this connection than the admission of Sir Basil Blackett in his Budget speech in March 1923: "Whatever system of currency had been in force in India during the Great War, it would have been profoundly disturbed by the events of 1914–18. In so far as India had a choice and was not swept along in the maelstrom of world events, India's choice was necessarily between an attempt to keep the exchange value of the rupee more or less stable and an attempt to keep rupee prices more or less stable. As a matter of fact, India's first choice was the former, but then the rise in the price of silver introduced a new complication and upset the Indian currency system. I need say no more of the attempt that was made to stabilise the rupee at a new, or rather at the old, fixed rate of two shillings gold in 1920 except that it failed."

thrown, ending every year in surprises in the shape either of windfalls or of deficits. If the Imperial Bank of India ought not to gamble in the exchanges, the Government of India has still less reason to do so, and the only way out of the muddle seems to be the adoption of a gold standard with gold in circulation, which would reintroduce an element of stability in the exchanges and permit an institution like the Imperial Bank of India to control the movements of the precious metals, and regulate the supply of credit, by the predominant position given to it by its resources.

Moreover, as the Imperial Bank cannot borrow or receive deposits outside India, or maintain a branch for this or similar purposes, the Bank is virtually prevented from raising money in London or other centres for use in India. Now, before the outbreak of the war, wherever in Europe a strongly centralised banking system was adopted, the Central Bank, whether a State bank or a central institution like the Bank of England, indirectly controlled by the State, has been vested with powers to raise money in any part of the world. Its resources have never been crippled by a prohibition to borrow outside the country. The strongest banks in any country require at times to pledge their securities in order to raise funds to meet unusual requirements. Even the Bank of England often borrows large sums from abroad to meet its own requirements. As early as 1877, in a memorial addressed to the Secretary of State, the Presidency Banks drew attention to the desirability of extending their powers so as to enable them to borrow in England, but their request was turned down. The question was revived in 1899, but once again the Secretary of State decided otherwise in 1905, and even after the amalgamation of the three banks the prohibitory clauses were incorporated in the new Act, with this exception, that the Bank can now borrow on its assets in times of emergency. Perhaps here too the attitude of the Government of India and the Secretary of State may

have been influenced by the pressure of the exchange banks.

And yet, in pleading for greater freedom in borrowing in London than what is permissible under the Act, the issue seems to be open to no doubt. A bank whose powers are so restricted as to give it no elasticity in respect to its funds—and we shall notice other causes that account for this want of elasticity besides the restrictions on the power of borrowing—fails to fulfil its functions as a Central Bank, and can never adequately control the money market. In times of financial stringency or extraordinary trade demands, as with the Presidency Banks in the past, if the Imperial Bank of to-day requires to raise money, no other institution in India is likely to be in a position to lend, and since Government can give only a limited undertaking to do so,[1] the power given to the Imperial Bank to borrow in India is practically of no avail, although it may hold first-class securities which it can offer as security for loans. Trade may thus be hampered and industries starved when money might easily be obtained if the Bank had the power to borrow in London. The objections raised by the Government of India in 1899 refer, in the first place, to conditions which no longer obtain to-day. Borrowing in the London market, it asserted, "would involve the Bank in dealings in foreign exchanges, a class of business which the Bank of England does not transact, and which is not banking but speculative commercial business". It was of opinion "that the position of the banks should be strengthened by an increase of capital before they could safely be allowed to resort to the London market", and that while "access to London might be given to one amalgamated Bank, it could not be given conveniently to three separate banks". But these objections definitely refer to conditions which were removed in 1921; the banks were then

[1] The Paper Currency Amendment Act, as we shall notice later, enables the Imperial Bank of India to borrow money to the extent of 12 crores of rupees.

amalgamated into a single institution, and the position of the amalgamated Bank was strengthened by an increase of capital. Moreover, it was not accurate to suggest that the Bank of England offered an analogy which the Government of India desired to follow. The Bank of England may not as a matter of policy deal in foreign exchanges, but it is not prevented by law from doing so. If it is objectionable for a bank to deal in foreign exchanges, because it is a speculative business, it ought to be still more objectionable for the Secretary of State and the Government of India to indulge in such speculative business. With an effective gold standard, dealing in foreign exchanges would cease to be speculative ; and even with a Gold-Exchange Standard under normal conditions dealing in foreign exchanges is no more speculative than dealing in bills backed by the transit of goods from one part of the country to another.[1]

But it was suggested that permission to borrow in London would involve the possibility of the banks locking up a portion of their capital at so great a distance as to render it practically unavailable in the case of any emergency arising in India. The only way in which a bank can lock up any part of its capital is by investment in securities which are not liquid. The mere act of borrowing could not lock up a bank's funds, and so long as the Imperial Bank's powers to invest in English securities are not further extended, the objection to borrowing in London cannot stand.

There is another function that a Central Bank can efficiently perform in regulating the volume of currency to the requirements of the community—one which is being performed to-day by the Central Banks in all countries in the West—namely, the issue of notes. In India since 1862 the issue of notes has been the monopoly of Govern-

[1] The directors of the Bank of Madras, in their reply, aptly remarked : " It is now an easy matter to avoid any exchange risk by the simple expedient of fixing the rate both ways at the time the transaction is entered into " (Letter dated April 2, 1907).

ment. The transfer of the Government balances and the management of the Public Debt Office to the Imperial Bank may be important privileges ; but so long as the Government keeps to itself the right of issuing notes, it deprives the country of the benefits of a monetary circulation capable of easy expansion, such as all other countries enjoy, and which, though it may be of comparatively smaller importance in the West, where the use of money is so largely superseded by bank cheques and transfers, is of supreme importance to a country like India, where the variations in the demand for money are sudden and excessive. The Government of India in January 1900 was candid enough to confess that " there is nothing in the peculiar circumstances of India to prevent the note issue being transferred to a Bank. We are, moreover, disposed to believe that it is through the agency of a Bank that the note issue may have a larger development in India." But though the amalgamation of the Presidency Banks in 1920 afforded an opportunity of reorganising the machinery for the issue of notes, the Government retained its monopoly.

Lack of Organisation in the Market for Money

The result of these restrictions of the functions and privileges of the Imperial Bank is that India's monetary organisation has no driving force behind it which can secure a consistent national policy, directed to the fostering of its trade and industry. The issue of notes being the monopoly of Government, the volume of currency does not always respond to the requirements of commerce. Government is not in as intimate touch with the business world in this country as a banking organisation would be ; the automatic forces that operate under a gold standard with a free and open mint are lacking under the present system ; and the country is left to the tender mercies of people not always vigilant and alive to its monetary needs. The Imperial Bank can undoubtedly

affect the volume of purchasing power within definite limits by such resources as it can command ; but here, too, it is dependent on the policy of the Government, which keeps its balances with the Bank.

Under these circumstances, it is not surprising to find in India the strange phenomenon of a favourable trade balance combined with a high Bank rate. The Bank is dependent on the Government for its resources ; it has no hold over the note issue, which is a Government monopoly, and its rate is determined by Government policy rather than by the conditions of trade and the money market. Now the policy of Government in the past has been determined by two objectives—either the need for raising a loan or the desire to maintain a definite rate of exchange. Even to-day, if Government for the time being has abandoned stability of exchanges in favour of securing stability of internal prices, it is only an *ad interim* attitude which Government itself acknowledges it will give up in favour of the old policy as soon as circumstances permit. We thus find repeated instances in which, when Government is floating a loan, the Bank rate is lowered, and when the rate of exchange is showing a downward tendency, the Bank rate rises. The regulation of the Bank rate in India does not depend on the conditions of the money market, nor can the Bank rate effectively control the trend of prices by adjusting the supply of the volume of money to the requirements of trade. The management of India's currency and exchange by a Government that forces up the Bank rate to prevent the exchange from falling, and enters the money market as a large borrower from year to year, can only have the result of starving the country of its legitimate requirements in the shape of money, credit, and capital for the development of its trade and industries.

To meet the seasonal requirements of trade, the Paper Currency Act has been amended, enabling the Imperial Bank of India to borrow money on inland bills to the extent of 12 crores of rupees when the Bank rate is not

below 6 per cent. Not more than 4 crores are to be issued when the rate is below 7 per cent, a further 4 crores when it is 7 per cent, and the final 4 crores when it is 8 per cent. The Act has been further amended recently, enabling the Bank to borrow 4 crores when the rate is 6 per cent, and the remaining 8 crores when it is 7 per cent, and without any specific limit when it rises beyond 7 per cent. Under the unusual conditions of monetary stringency prevailing in 1923 and 1924, this power was fully exercised by the Bank. When we remember that the separate treasury system is now abolished, that the cash balances of the Government are available to the Bank, and that the balance of trade is in favour of India, it is difficult to account for the monetary stringency of the last two years, except on the supposition that the money market in India is controlled by Government for purposes other than the normal purposes of fostering production and trade. The following table is instructive:

TABLE SHOWING THE CAPITAL RESERVE, DEPOSITS, AND CASH BALANCES OF THE THREE PRESIDENCY BANKS REGARDED AS ONE BANK, UP TO 1920, AND OF THE IMPERIAL BANK OF INDIA.

In Thousands of Rupees.

December 31.	Capital Reserve and Rest.	Public Deposits.	Private Deposits.	Cash Balances.	Percentage of Cash to Total Liability.	Bank Rate.	
						Half-Year, June 30.	Half-Year, December 31.*
1913	7,48,07	5,88,66	36,48,50	15,37,75	36	7·23	5·16
1914	7,64,17	5,61,52	40,04,08	20,83,92	46	6·03	5·13
1915	7,47,50	4,88,67	38,61,19	14,65,24	34	5·85	5·46
1916	7,35,99	5,20,55	44,70,87	17,27,25	35	7·38	6·15
1917	7,42,52	7,71,28	67,71,74	33,77,31	45	7·13	5·8
1918	7,19,58	8,64,28	50,97,75	17,07,62	29	6·16	5·68
1919	7,32,81	7,72,24	68,21,37	23,62,93	31	6·61	5·3
1920	7,52,79	9,02,63	78,01,90	26,03,34	30	6·52	5·9
1921	9,76,78	6,80,01	65,77,99	13,60,23	19	6·0	5·1
1922	9,95,57	14,15,73	57,00,57	15,07,47	21	7·13	4·5
1923	10,07,50	8,56,94	74,19,50	15,01,34	17	7·41	5·3
1924 June 30	10,20,00	22,08,22	76,62,44	21,95,37	20·11	8·05	..

* To the end of 1920 we have averaged the half-yearly averages of the Bengal, Bombay, and Madras Bank rates.

In spite of the fact that the power to borrow from the paper currency was exercised to the fullest extent, first up to 5 crores,[1] then up to 12 crores, the money market suffered from all the evils of a high Bank rate during the past two years. The maximum and minimum Bank rates of the Imperial Bank for 1921–24 have been as follows :

	1921–22.	1922–23.	1923–24.
Maximum . . .	8	8	9
Minimum . . .	5	4	4
Average . . .	5·57	5·87	..

The Government of India has had to face the situation, and it has further modified the Paper Currency Act, which enables it to increase the fiduciary portion from 85 crores to 100 crores ; the additional 15 crores may be invested in sterling securities. All these measures, and the new practice of purchasing sterling, are intended to ease the money market. It is interesting to observe the official explanation of this monetary stringency, which is acknowledged to be harmful. Replying to a question in the Legislative Assembly, in September 1924, the Finance Member stated : "Until the economic disturbances caused by the war, when India's currency was greatly expanded, have receded further into the background, and until new earnings annually available for capital investment in India become more nearly equal to the demand, some stringency is probably un-

[1] "The Bank rate was raised to 9 per cent from the 24th February 1924. From then till the end of the year the rate for call money stood at no less than 9 per cent, and the short-deposit rate at 8 to 8½ per cent. There was no material improvement in the money position either towards the close of the year under report (1923–24) or in the opening months of the current year. On the other hand, the return of cash to the Bank was very slow, and the withdrawal of 12 crores of emergency currency issued during the busy season proved to be a slow and difficult process and prolonged the period of stringency, the Bank's cash having fallen again to 12 crores of rupees on the 18th April, and the percentage as low as 11·65. The last occasion when the Bank rate reached 9 per cent in both Calcutta and Bombay was as far back as 1908, though the rate rose to that level in Bombay for a short time in 1920" (*Report of the Controller of Currency for the Year 1923–24*, p. 34).

avoidable. During the very busy season in India a rise in Bank rate may exercise a salutary check on speculation, but every high rate long continued must hamper legitimate trade." It is undoubtedly true that in a country where the majority of the people live on a bare minimum of subsistence, there is not room for considerable saving; and that owing to this lack of capital, money will continue to be dear in India. Nevertheless, the monetary stringency with which the country has been faced for the last two or three years is not a stringency arising out of a lack of capital resources; it is the result of a defective currency system which is manipulated with a view to maintaining a high rate of exchange. The Finance Member was evidently mixing up two different issues which are more or less connected, but which admit of being distinguished; namely, lack of capital and lack of currency for meeting expansion of trade and seasonal demands. The Government of India has repeatedly and expressly told us that its currency policy to-day is directed to maintaining a stable level of prices, by keeping the volume of money steady, though with a favourable balance of trade the country naturally requires an increase in the volume of currency. We have also indicated our grounds for believing that underlying these currency measures of the last few years is the desire to attain and maintain a higher rate of exchange than 1s. 4d. It is a policy of dear money and high exchange. To raise the exchange value of the rupee, Government has embarked on a policy which has resulted in limitation of the supply of loanable capital.[1] To maintain the

[1] The Finance Member of the Government of India had a clearer view of the facts connected with stringency when, anticipating what has actually happened, in the course of a speech on the Indian Coinage Amendment Bill on August 31, 1920, he said: "What is the Bank rate? If that is any indication at all of the money market, there is at present no stringency. I maintain, further, that if the crisis that he (Mr. Tata) anticipates were to ensue, it would not be as the result of any statutory change of the legal ratio; it would be because of steps undertaken subsequently by Government, not necessarily as part of

high exchange rate, Government remitted £42,000,000 to London in 1924–25 though the budgeted provision for the Home Charges was only £27,000,000, thus transferring from the Indian money market 15 crores of rupees and investing the amount in London. The provision for emergency currency is futile when we consider what the Government of India is simultaneously doing to prop up exchange. Popular clamour may be silenced by the professed anxiety of the Government to provide emergency currency, whilst the country may continue to be denuded of its available monetary resources by manipulations under the Gold-Exchange Standard.

The only way out of the difficulties is to establish an effective gold standard which will obviate the necessity for interfering with the exchanges, and, secondly, to hand over to the Imperial Bank of India, under legislative safeguards, the right to issue notes and to deal in foreign exchange. The ebb and flow of industrial activity in different seasons in every country give rise to fluctuations in the demands for currency. The most marked variations in the demand occur in connection with the marketing of crops ; and in a country like India, where the use of cheques is unknown except in urban areas, and only familiar to a limited extent even there, the seasonal fluctuations in the demand for money are greater than elsewhere. The demand for money is a demand for coin and notes, and in the towns it is a demand for deposit currency. With a proper system of banking, the shifting requirements of trade can be adequately met by the issue of notes through the Bank's branches all over the country, and through the provisional increase of deposit currency. The money market conditions of Canada have a certain resemblance to those obtaining in India. In Canada, as in India, the demand for money is not

this legislation, but steps in connection with deflation, or steps in connection with the maintenance of a particular ratio of exchange. It would be in connection with those steps . . . that a stringency might supervene."

steady. There is a sudden big rise in the demand for currency in autumn, and a sudden decline in the spring. The system in force in Canada is sufficiently flexible to meet these varying demands without causing serious inflation.[1] The circulating currency consists of Dominion notes issued by the Government and notes issued by the Chartered Banks. The power of the banks to issue notes is subject to the conditions that the total amount must not exceed the aggregate of the paid-up capital plus the amount of the Dominion notes and gold coin held on the issuing bank's behalf in the Central Gold Reserve, and that to facilitate crop movements additional notes may be issued up to 15 per cent of the combined paid-up capital and reserve fund, the Bank paying interest at a rate not exceeding 5 per cent. This system broadly meets the fluctuating seasonal demands for money in Canada, and the seasonal demands for money in India may well be met by the Imperial Bank of India, if it is empowered to issue notes subject to legislative restrictions under a gold standard. With a Government interested in maintaining a particular rate of exchange, and retaining a monopoly of note issue in its hands, the money market in India will continue to manifest the lack of organisation and method which during the past two years has exerted such a benumbing influence on the country's trade and industries.

[1] See Banking Supplement to the *Economist*, October 20, 1923, p. 121.

CHAPTER XXXII

GOVERNMENT AND THE BANK

Potentialities of the Bank as a National Asset

The observations of the Government of India made in its despatch forwarding the scheme for amalgamation to the Secretary of State summarise the benefits which the amalgamation was to bring to the country.

The Presidency Banks have now undertaken, as part of the present amalgamation scheme, to establish 100 new branches within five years ; and we have every reason to hope that the progressive policy thus initiated will be continued until at least in every district, and eventually at every town of importance, a branch of the Imperial Bank is established. We do not claim that this widespread extension of branches will work a sudden miracle or will immediately prove itself the long-sought talisman to charm the wealth of India from its hoards. We do not look for rapid or dramatic results. But a beginning must be made, and we think that the mere appearance in the district of a bank which conducts Government's treasury and public debt business, as to whose stability there can be no question, and from which local traders and dealers in produce can obtain advances on reasonable terms, must in due course inevitably have an appreciable effect upon the local mental attitude towards banking in general ; and in course of time we shall expect to see the new branches of the Imperial Bank attract a large amount of deposits from the general public in such localities.

There are, moreover, other results which may reasonably be looked for from the large increase in the number of branches now contemplated. In those places in which they are already established, the Presidency Banks usually act as bankers of the other local banks. They keep most of the latter's cash, and it is to the Presidency Bank that a local bank turns when it is in difficulties, or when, in a period of tight money, it desires to pledge Government or other gilt-edged securities. The position of the Presidency Bank as the " bankers' bank "

has noticeably grown during recent years, and on many occasions have the Presidency Banks rendered valuable assistance in quelling an incipient panic, or in coming to the relief of a local bank which, through no fault of its own, was in temporary difficulties. It cannot be expected that the number of banks in up-country districts can be largely increased, or can be placed on a satisfactory footing, unless there is at their door a powerful bank to which a sound institution can turn in time of trouble and to which it can look for guidance in its general financial policy. Many of such banks would, of course, engage in business from which a Presidency Bank or its successor must necessarily be debarred, but it is, we think, of great importance that they should have behind them an institution on which they can rely for assistance, and which will form the solid background necessary for the healthy development of the various forms of banking—agricultural, industrial, and ordinary joint-stock—of which this country is admittedly in need. For such development, moreover, an equal necessity is a sufficient supply of men trained in modern methods of banking. The mere staffing of a large number of new branches of the amalgamated bank will necessarily involve the training and employment of Indian agency to a very much greater extent than at present, and the demand for and training of such men by the Imperial Bank should have a valuable influence in stimulating their supply for other banking institutions.

A further and almost equally important result which we anticipate will follow from the establishment of the new Bank and from the multiplication of its branches is substantial increase in the assistance given by it to the internal trade of the country through its relations with the indigenous banking system. The extent to which the Presidency Banks already help to finance the internal trade of India by their purchases and rediscounting of internal bills of exchange, known generally as *hundis*, at their head offices and branches, is not perhaps always realised. The shroffs, the mahajans, chettis, and others, who either directly or by their relations with smaller "bankers" of the same kind, largely finance the movement of produce and of important articles of commerce such as piece-goods in the up-country markets, rely to a very great extent upon assistance from the Presidency Banks when, in a season of active trade, their own capital is fully employed. On some occasions, for example, the amount of *hundis* held by the Banks of Bengal and Bombay has exceeded a third of their total advances, and during the busy season the proportion is rarely less than a quarter. The connection of the Presidency Banks with up-country trade is thus very close and intimate.

By the rates which they charge on the discount of *hundis*, and by their willingness or refusal to extend their commitments in that direction, they can profoundly influence the provision of credit and money rates in the up-country bazaars. It is clear that by the ramification of its operations through a largely increased number of branches, and by its ability to employ more funds in the discount of *hundis* and similar bills, the amalgamated Bank will be able to irrigate the channels of internal trade to a substantially larger extent than is at present possible.

Such, in brief, were the expectations entertained by the Government of India at the time of the amalgamation: the amalgamation would secure the mobilisation of banking resources in India; would lead through the extension of the Bank's branches throughout the country to a concentration of savings in the banks by inspiring confidence; would enable the Bank thus formed to serve as a bankers' bank; would afford opportunities for the training of Indians; and would ease the Indian money market by placing the surplus funds of Government at the disposal of trade. It is too early as yet to judge about the working of the Imperial Bank of India, but we may be permitted to make a few observations on what has been and what might be done for the country with the help of a semi-Government institution like the Imperial Bank.

One of the objects of the amalgamation was, as we have already seen, the encouragement of banking in India with a view to mobilising savings. If banking habits were to be popularised, it was necessary to open new branches on a large scale. The Imperial Bank of India undertook within five years of the commencement of the Act to establish and maintain not less than 100 new branches, of which at least one-fourth were to be established at such places as the Government of India would direct. In return for its undertaking this obligation, the Government agreed not to charge interest on the Government balances with the Bank for the first ten years. Before the amalgamation the Presidency Banks had 69 branches in all; 64 new branches were opened between the passing of the Act and March 31, 1924. The

progress has undoubtedly been satisfactory, but the question has often been raised whether the sacrifice in the shape of interest which the Government of India has made is proportionate to the advantage obtained, and whether it can be regarded as a justifiable compensation for such risks as the Bank may have incurred. It has been argued that in opening new branches the Bank would incur loss for some time, that the possession of additional funds from Government would involve additional responsibilities in the shape of adequate reserves, and that the Bank was no longer to enjoy the advantage of fixed minimum balances. On the other hand, it is obviously to the Bank's advantage to open new branches ; the disappearance of the fixed minimum balance clause makes no practical difference to the Bank's position as custodian of Government balances ; and as for its increased responsibilities, they are responsibilities imposed by general considerations of sound banking which necessarily accompany the possession of additional resources.

The extent of the loss incurred by Government in giving up all claim to interest will be rendered vivid by the following table, which shows the total cash balances of the Imperial Bank of India and the Government balances on the last day of every month.

In Lakhs of Rupees.

Last Day of	1921–22.		1922–23.		1923–24.	
	Total Cash Balances.	Government Balances.	Total Cash Balances.	Government Balances.	Total Cash Balances.	Government Balances.
April . .	28,16	14,08	18,04	15,19	16,53	14,83
May . .	26,41	13,34	19,40	16,85	17,66	12,38
June . .	30,45	22,14	33,92	16,65	28,40	12,54
July . .	35,73	25,87	43,23	32,95	36,28	29,49
August .	33,06	11,63	44,98	26,87	39,57	23,12
September	29,71	8,47	36,73	13,62	39,40	15,76
October .	29,24	8,97	33,46	13,18	36,34	7,72
November	24,68	11,55	27,03	13,25	24,58	8,46
December	13,56	6,80	15,48	14,16	17,04	8,92
January .	16,91	11,02	12,61	18,20	16,15	16,99
February .	15,98	12,98	14,50	17,62	15,01	22,63
March. .	20,48	20,08	14,44	20,52	18,20	26,94
Average .	26,20	13,91	26,15	18,25	25,43	16,61

Thus in 1921–22, 50 per cent of the average cash balances of the Imperial Bank of India were made up of Government cash balances, while in 1922–23 and 1923–24 the ratio of Government balances to the total cash balances of the Bank rose to 65 per cent. There were months in which the Bank's total cash balances fell below the amount of the Government balances with the Bank.[1] The strength and prestige of the Imperial Bank are largely dependent on its connection with the Government, and its profits also depend on the credit superstructure it can raise with the help of the public deposits. Official statements do not allow us to gauge accurately from year to year the proportions of private deposits to public deposits, apart from the deposits which the Bank creates by its lending operations; but there can be no doubt about the fact that the profits of the Imperial Bank of India, to a much greater extent than the profits of the Presidency Banks before 1921, are due to the strengthening of the Bank's resources by the Government balances and by its more intimate relations to the Government. The Imperial Bank of India is for all practical purposes a national institution, and the nation as a whole is entitled to par-

[1] For the purposes of comparison we give a table showing the total cash balances of the three Presidency Banks and the total Government balances in the three banks for the period 1912–22 on December 31 of each year.

In Lakhs of Rupees.

	Government Balance.	Total Cash Balance.	Percentage of Government Balances to Total Cash Balances.
1912	4,27	11,77	36
1913	5,88	15,37	38
1914	5,61	20,83	26
1915	4,88	14,65	33
1916	5,20	17,27	30
1917	7,71	33,77	22
1918	8,64	17,07	50
1919	7,72	23,62	32
1920	9,02	26,03	34
1921	6,80	13,60	50
1922	14,15	15,07	93

ticipate in the profits that the Bank makes through its national prestige. The shareholders of the Bank have been earning a dividend of 16 per cent on their shares for the last few years. It should not, however, be forgotten that the Bank exists primarily, not for earning dividends, but for developing the country's banking habits and fostering trade and industries by mobilising savings ; and the Government of India might have been justified from the very date of the amalgamation in stipulating either for interest on its balances, when they exceeded a fixed minimum, or for a share in the profits after payment to the shareholders of a definite proportionate rate of dividend.[1]

The Government of India had also looked forward to the opportunities for training which the Imperial Bank might afford through its branches to the youth of the country. This has remained to a considerable extent a pious hope. During the debate on the Act, it was promised that Indians should be recruited as probationers to occupy the posts of assistant managers, and some Indians have been so recruited. But it might well have been pointed out that there are very few banking experts in this country, and still fewer facilities for their proper training. An express stipulation at the time of the passing of the Act that the surplus profits of the Bank, after giving the shareholders a definite rate of dividend, should be ear-marked for expenditure, amongst other things on sending students abroad for training in banking, would have secured for the country a benefit to which it was entitled, and of which it has so far been deprived. Japan solved the same problem by a similar method to that we suggest. The Govern-

[1] " The concession (*i.e.* the use of Government funds and other privileges granted to the Bank) is obviously a valuable one, and it might be argued that there was justification for participation by the State in the profits of the Bank, as, for example, by the payment to the former of interest upon the average amount of Government deposits above some specified sum, or by a definite share of the profits after a certain dividend has been realised" (H. F. Howard, " The Imperial Bank of India ", *Economic Journal*, June 1921).

ment of India, while giving the strength of its credit, its prestige, and its financial resources to the Bank, might well have provided specifically for the training of students and for sending them abroad at the expense of the Bank.

When we realise that the Imperial Bank of India is to-day the arch on which the whole banking system of India rests, we can only regret the opportunities that have been lost to the country by the arrangements made in 1921. The Bank might, in the first place, have relieved the Secretary of State and the Government of India of a large amount of remittance and banking business, which could be more appropriately transacted by a Central Bank. The Act debars the Bank from this business. In the next place, a Central Bank would have relieved the Government of India of the management of the paper currency, a work which, though carried on efficiently by the Government, might be more efficiently executed by a Central Bank under legislative safeguards. The Act, however, perpetuates management of the paper currency by Government. The Imperial Bank of India to-day is confined to commercial banking. What the country needs at the present juncture is capital for industrial development, and a Central Bank confined to short-term loans can never help industries, which require loans for long periods. We cannot develop our industries without industrial banking, and in 1921 the opportunity was lost of incorporating into the Act a provision which would have made it possible for the Imperial Bank of India to finance industries, either directly through its own network of branches or indirectly by acting as banker for industrial banks.[1] A Central Bank like the

[1] Cf. *Industrial Commission Report*, para. 287: "Where industrial enterprise is in a healthy state, opinions seem to be crystallised in the evidence tendered to us by the Bombay Advisory Committee, who state: 'We favour the establishment of a Central Industrial Bank or similar organisation with a large capital and numerous branches designed to afford financial support to industries for longer periods and on less restricted security than is within the power or practice of existing banks. Such a bank would probably require a measure of Government support, but should not be brought under rigid Government control.'"

Imperial Bank of India might also have been used to finance agriculture by empowering it to place part of its aggregate resources at the disposal of agricultural and co-operative banks, for the purposes of lending the cultivators capital for intensive farming, relieving them from the incubus of debt, bringing close to the cultivators' doors an institution that can command their confidence and attract their savings. All these opportunities were lost in 1921, and we can only hope that when in the future the question of reconstructing the Imperial Bank comes up again, Government as well as our leaders will bear in mind the desirability of organising a Central Bank to act as a bankers' bank, entrusted with the power of issuing notes, strong enough to control the money market and affect the exchanges by the operations of its discount rate, to serve as the basis and background for agricultural and industrial banks, and to mobilise the scattered savings of the people for the purposes of fostering their productive resources, encouraging their industrial development, and facilitating their trade and commerce. For a country like India, it is futile to trust to the spontaneous growth of banking institutions through private enterprise ; the only alternative is to create and establish these institutions, on a basis carefully and intelligently determined, by means of the corporate efforts and resources of the Government. We have reached a stage in human evolution when we can control social events and mould the environment for the better or the worse.[1]

[1] " Theoretically, perhaps, it can be argued that in the development of banking it is desirable to rely on spontaneous growth as the result of private enterprise. It must be confessed, however, that under this policy of non-interference, advance in India has been but tardy and confined within very narrow limits. It is, of course, possible to attribute the fact to the proclivity of the people of India for holding their savings in the form of coin or bullion. But it would be possible to exaggerate the conservatism of the Indian people in this respect. . . . As the Government of India have pointed out, however, it would not be altogether correct to ascribe the existing state of affairs solely to the ingrained habits of the people, their ignorance, their conservatism, and

their suspicion, which can only be removed by the process of education. That the spread of education will work a steady and substantial change in the mental attitude of the people in this matter is practically certain, but it is useless to educate people into civilised habits as regards keeping their money, if there are not at hand banking facilities for them to do so. Progress in these two respects must go hand-in-hand. Even, however, in the present stage of educational development, there is undoubted room for a much larger supply of banking facilities. . . . In short, it is evident that the first essential of any scheme for improving the banking machinery in India was that it should contribute towards the solution of the problem here disclosed" (H. F. Howard in the *Economic Journal*, June 1921).

CHAPTER XXXIII

THE EXCHANGE BANKS AND THE JOINT-STOCK BANKS

The Exchange Banks

The Exchange Banks form an important part of the banking organisation in India. We have already seen that the Imperial Bank of India is debarred from dealing in foreign exchanges. Its activities are strictly confined to the financing of India's internal trade and commerce. Thus the work of financing India's foreign and sea-borne trade, which amounts to nearly 600 crores of rupees per year, falls to the Exchange Banks, which are institutions of a highly specialised character. The Exchange Banks have their head offices located outside of India, and deal mainly in exchange business. There were 18 Exchange Banks doing business in India in 1922.[1] They are divided into two groups: (1) banks doing a considerable portion of their business in India, numbering five, and (2) banks which are agencies of large banking corporations doing a major portion of their business abroad, numbering thirteen.

A good deal of the business of these banks is on the

[1] (1) Chartered Bank of India, Australia, and China, (2) Cox & Co., (3) Eastern Bank, Ltd., (4) Imperial Bank of Persia, (5) Mercantile Bank of India, Ltd., (6) National Bank of India, Ltd., (7) National Bank of South Africa, (8) Netherlands Indische Handelsbank, (9) Banco Nacional Ultramarino, (10) American Express Co., Incorporated, (11) P. and O. Banking Corporation, (12) Nederlandsche Handel Maatschappij, (13) Hongkong and Shanghai Banking Corporation, (14) International Banking Corporation, (15) Comptoir National d'Escompte de Paris, (16) Bank of Taiwan, Ltd., (17) Sumitomo Bank, (18) Yokohama Specie Bank, Ltd.

same lines as that of other banks. The Exchange Banks, in addition to their capital and reserve, secure funds by receiving deposits from the public both in London and in India. They try to tap India's capital resources, and receive as much as they can obtain by offering better terms than those offered by the Imperial Bank of India. They allow a slightly higher rate of interest for fixed deposits. While the Imperial Bank does not offer any interest on current accounts, the Exchange Banks allow 2 per cent on balances exceeding a definite limit. These funds are used mostly for financing India's foreign trade, but a certain portion is employed in advancing loans either in India or outside of India. They finance the foreign trade of the country by the purchase or discounting of bills of exchange. For the settlement of India's balance of accounts there are always bills drawn on India and bills drawn on London. These bills are bought by the banks and negotiated both in London and in India. The majority are bought in India, drawn on London, and cash is received for them either at maturity or through rediscount. The banks are also always in possession of funds in London, and obtain funds in India by the purchase of Council Bills. They are thus in a position to balance their accounts. They buy bills drawn on London in India and send them to London, where they get cash on maturity ; but if they want money immediately, they get it by discounting them in London and purchasing Council Bills, which enable them to get funds in India. When there is an urgent need for funds in India, they buy telegraphic transfers, and this is also done when money is dear in India. These bills are met from the funds of the bank, either capital reserve or deposits.[1]

[1] Cf. L. G. Dunbar's evidence before the Chamberlain Commission (1913) : " The actual money to finance the crop is found by the Presidency Banks, who, having no access to London, have no means of getting Council Bills. When the crops come to the seaports, then the Exchange Banks come in, and the bills are offered to them ; then they wire home to London, saying, perhaps, ' Send twenty lakhs extra of Councils ' " (Question No. 8094).

I. TABLE SHOWING CAPITAL, RESERVE, DEPOSITS, AND CASH BALANCES OF THE EXCHANGE BANKS ON THE 31ST DECEMBER EACH YEAR

Year.	No. of Banks.	Capital and Reserve.			Deposits.		Cash Balances.	
		Paid-up Capital.	Reserve and Rest.	Total.	Out of India.	In India.	Out of India.	In India.
		£000.	£000.	£000.	£000.	Rs.000.	£000.	Rs.000.
1913	12	23,640	14,185	37,825	181,138	31,03,54	25,688	5,88,24
1914	11	22,885	14,157	37,042	164,970	30,14,76	40,694	8,39,37
1915	11	22,681	14,112	36,793	179,948	33,54,56	45,111	7,60,13
1916	10	22,836	15,095	37,931	208,232	38,03,88	41,367	10,14,01
1917	9	18,384	14,298	32,682	228,001	53,37,53	54,765	33,74,37
1918	10	22,269	17,180	39,449	305,937	61,85,60	57,981	15,17,55
1919	11	31,931	21,139	53,070	433,001	74,35,90	63,571	29,98,32
1920	15	54,198	36,019	90,217	513,671	74,80,71	84,197	25,17,53
1921	17	66,369	45,263	111,632	526,473	76,19,61	82,318	23,56,74
1922	18	66,541	45,680	112,221	527,348	73,38,44	81,654	16,17,63

II. TABLE SHOWING THE PROPORTION PER CENT OF CASH TO LIABILITIES ON DEPOSITS OF THE EXCHANGE BANKS *

	1913.	1914.	1915.	1916.	1917.	1918.	1919.	1920.	1921.	1922.
Banks doing considerable portion of their business in India .	19	28	19	25	40	20	35	30	28	19
Banks which are merely agencies of large banking corporations doing a major portion of their business abroad	17	26	41	35	160	44	67	58	43	33

* The percentages have been calculated on their deposits and cash balances in India only.

III. TABLE SHOWING THE PROPORTION PER CENT OF CASH TO LIABILITIES ON DEPOSITS OF THE EXCHANGE BANKS BOTH IN INDIA AND OUTSIDE INDIA IN 1922

	In India.	Outside India.
Banks doing considerable portion of their business in India	19	16
Banks which are merely agencies of large banking corporations doing a major portion of their business abroad	33	15

We find from the first of these tables that the deposits these Exchange Banks attract in India have rapidly increased during the last ten years. In 1913 the total deposits in India amounted to 31 crores; in 1922 they stood at 73 crores of rupees.[1] But whilst the Exchange Banks thus draw upon the Indian money market for their business, the proportion of the cash balances to the deposits does not show any considerable increase. In 1913 the proportion percentage was 19 for banks doing a good deal of their business in India; it was also 19 in 1922. In the case of banks doing a good deal of their business abroad, the percentage shows an increase from 17 in 1913 to 33 in 1922. The proportion of the cash balances to the liabilities on deposits in India may give legitimate cause for alarm to those conversant with banking operations in India. A proportion which may be considered adequate in a country like England, with a highly developed banking organisation and accustomed to the use of cheques, may be regarded as inadequate in a country like India. It is true the Exchange Banks may rely on their London resources coming to their help in a time of crisis, and they may expect relief by the purchase of telegraphic transfers, but these hopes may often prove futile. In the case of a crisis or of a sudden monetary stringency in India, the Government of India itself may not be in a position to meet telegraphic transfers. It is necessary for the safety and stability of Indian banking, and in the interests of the Indian money market, that the Exchange Banks should be compelled by law to maintain a fixed minimum proportion percentage of cash balance to their total deposits in India; and they should not be allowed to disturb the statutory proportion by events affecting their position outside of India.[2] The publication by the Exchange

[1] The figures of the total deposits in India of the Exchange Banks were Rs. 11,83,00,000 in 1907, and Rs. 24,31,00,000 in 1910.

[2] Can we suggest 30 per cent as a safe statutory minimum for the Exchange Banks? Cf. J. M. Keynes: "An Indian Reserve, such as they appear to keep, of from 18 to 20 per cent would be respectable,

Banks, under statutory regulations, of weekly statements showing their assets and liabilities in India is also desirable in the general interests of the country.[1]

The proportion of cash balances to deposits in 1922 stood at 16 per cent for banks doing a good deal of their business in India, and at 15 per cent for banks doing a good deal of their business abroad. The Exchange Banks may have some source of strength in their capital and reserves, but their liquid assets outside of India are limited, and at any rate cannot immediately be utilised by the banks in the case of a crisis in India. In a banking crisis, moreover, when everybody would be drawing upon the Imperial Bank of India, the Imperial Bank would not be able to meet everybody's requirements. Under the circumstances the only alternative seems to be a statutory provision for a fixed minimum percentage of cash to liabilities.

The Exchange Banks have in all 62 branches in the country. Their business is profitable, and they are able to declare large dividends. It is not too much to assert that they have a monopoly of exchange business, and it has been found very difficult for any new banks to obtain a share in it. Under the peculiar currency system that obtains in India, the Exchange Banks, with their head offices or main branches in London, find themselves in a position of advantage. They are not purely Indian banks. The cream of their business is not local business. It may very often suit them better to transfer funds from India at a time when a purely Indian bank would strive to draw money to India. In a time of monetary stringency, the Exchange Banks may send money out of India instead of keeping it in India, to take

for example, in England. But in such a country as India, where banking is ill-established and hoarding more than a memory, the proportion held in reserve seems somewhat lower than perhaps it ought to be. Possibly Exchange Banks have already been in smooth waters longer than is for their good" (*Indian Currency and Finance*, p. 216).

[1] This would only apply to the Indian portion of the business of the Exchange Banks, and would necessitate a separation of accounts.

advantage of a tight market in other places. We have often been told by representatives of the Exchange Banks that a high Bank rate does not mean that banking facilities in India are insufficient, that for many months money is a drug in the market, that swollen balances are a nightmare to bankers, and that temporary borrowers must be prepared to pay a high rate for their finances in the busy season. That the Exchange Banks find no use for their money in the slack season is but the natural consequence of a compartmental system of banking institutions, which makes it possible for the Exchange Banks to specialise in financing the foreign trade of India. It is regrettable that the increasing deposits in India which the Exchange Banks are now in a position to attract should be used only, or mainly, for financing the sea-borne trade, so depriving the country to some extent of the use of funds which might otherwise be employed in financing internal trade and developing industries. It has even been suggested that the Exchange Banks carry away Indian balances to England and other foreign countries for investment or otherwise. To talk of temporary borrowers being prepared to pay a high rate for financial services is to lose sight of the fact that ultimately it is the cultivator who is affected, being deprived of the prices he might otherwise obtain with an easy money market—and that India is even to-day a predominantly agricultural country.

When the Bank rate is abnormally high, as it has been in the busy season for the last three years, rates in the districts are usually higher still. Money is generally drained away to the port towns in the very months when it is urgently needed in the districts for produce. At such a time the banks show a not unnatural disposition to do as little business as they can at the branches, so as to have the bulk of their funds available at the seaport towns. Thus a high rate in the busy season means for all practical purposes the paralysing of internal trade, and forces the cultivator to part with his produce for whatever price the man with money chooses to offer. Whatever

be the causes that bring about a high rate in India, one thing is clear—that the Exchange Banks are not likely to come to the help of the money market and relieve monetary stringency. The balance sheets of some of the more important of them for 1922 and 1923 show that they concentrate on foreign trade, and that when trade is slackening they prefer to strengthen their investments rather than scatter their resources over other fields. The Chartered Bank of India, Australia, and China had in December 1923 investments amounting to 28 per cent of their total liabilities, as against 9 per cent in 1913 and 14 per cent in 1915.[1] So also the investments of the Mercantile Bank of India for the year ending December 1923 amounted to 30·5 per cent of the total liabilities, as against 4·2 in 1913 and 12·2 in 1915. The percentage of the investments of the National Bank of India for 1923 was 32·6, as against 4·1 in 1913 and 10·2 in 1915.

Finally, every one who is interested in the growth of banking in India is faced with the fact that, whereas countries like Japan and Holland, whose total volume of foreign trade is considerably smaller than that of India, have a network of banks with branches in all parts of the world to finance their trade, this country has no branches

[1] The following table of percentages of investments of the Chartered Bank of India, Australia, and China, the Mercantile Bank of India, and the National Bank is significant.

GOVERNMENT AND OTHER SECURITIES IN PERCENTAGES OF TOTAL LIABILITIES OR ASSETS

	Chartered Bank.	Mercantile Bank of India.	National Bank of India.
1913	9·9	4·2	4·1
1915	14·6	12·2	10·2
1916	12·1	7·3	8·1
1917	12·0	8·0	7·3
1918	8·9	9·0	8·3
1919	9·4	7·3	8·2
1920	6·9	7·4	6·4
1921	17·8	12·8	12·0
1922	23·7	20·3	21·4
1923	27·9	30·5	32·6

of its own banks abroad, at any rate in London, with which it is so intimately connected. The Imperial Bank of India to-day has a branch in London, but it is prevented from dealing in the foreign exchanges. For the financing of her foreign trade, India has to be dependent on the mercies of the Exchange Banks, which are exceedingly jealous of their monopoly; and whilst Japanese and French and English bankers are actively busy in India, the country must wait an indefinite time before Indian bankers can establish their business in London or Rome or Kobe.

The Indian Joint-Stock Banks

The third constituent of the Indian banking system comprises the Indian Joint-Stock Banks. There are 68 of them, each with a minimum paid-up capital and reserve of one lakh of rupees. They have over 300 branches scattered throughout the country. These banks are divided into two classes: (1) those with a paid-up capital and reserve of five lakhs of rupees and over; (2) the smaller banks with a paid-up capital and reserve between one lakh and less than five lakhs of rupees. The aggregate paid-up capital and reserves of these 68 banks in 1922 amounted to Rs. 11,75,00,000; the deposits amounted to Rs. 65,02,00,000 and the cash balances to Rs. 12,60,00,000.

The deposits of joint-stock banks increased from 24 crores in 1913 to 65 crores in 1922. But the percentage of cash balances to liabilities on deposits was 20 in the case of banks included in Class I., and 17 in the case of those included in Class II. In the case of banks of Class I., it went down to 16 per cent in 1923.

The first bank of this type, the Bank of Hindustan, was founded as early as 1770. The Bengal Bank was in existence between 1790 and 1800. A number of agencies and financial houses flourished for some time in Calcutta; but many of them disappeared between 1829 and 1832. Between 1840 and 1850 there was a development of

Statistical Table relating to Indian Joint-Stock Banks, 1913–23

In Lakhs of Rupees

Year.	Class I.					Class II.				
	No. of Banks.	Capital and Reserve.	Deposits.	Cash Balances.	Percentage of Cash Balances to Liabilities on Deposits.	No. of Banks.	Capital and Reserves.	Deposits.	Cash Balances.	Percentage of Cash Balances to Liabilities on Deposits.
1913	18	364	2259	400	18	23	50	151	25	16
1914	17	393	1711	353	21	25	55	126	28	22
1915	20	438	1787	399	22	25	55	91	20	22
1916	20	461	2417	603	24	28	63	101	17	17
1917	18	467	3117	765	25	25	54	99	20	21
1918	19	602	4059	941	23	28	63	155	37	24
1919	18	763	5899	1217	21	29	75	228	54	24
1920	25	1092	7115	1631	23	33	82	233	42	18
1921	27	1240	7690	1566	20	38	100	326	44	13
1922	27	1064	6164	1204	20	41	111	338	56	17
1923	26	973	4443	737	16·5	43	111	326	61	18

joint-stock banking mostly under European management. Between 1870 and 1894 a number of banks were founded. It was after 1904, however, that banking activity became remarkable, and new banks came into existence mostly as a result of the Swadeshi movement. The Bank of Burma was founded in 1904; it failed in 1911. Most of the Indian joint-stock banks, with the exception of the Allahabad Bank (now incorporated with the P. and O. Banking Corporation), the Alliance Bank of Simla (in liquidation), and the Oudh Commercial Bank, are of recent growth. The spread of the Swadeshi movement, the growth of canal colonies in Punjab, and the expansion of trade led to the establishment of a large number of joint-stock banks after 1906. Most of them were managed by persons ignorant of banking principles, and were run on unsound lines, with the result that in the banking crisis of 1913–14 no fewer than 54 Indian joint-stock banks went into liquidation. The failures of 1913–14 gave a set-back to Indian banking; the cases of the People's Bank in the Punjab and the Specie Bank in Bombay in particular made people suspicious of Indian joint-stock banking enterprise. The causes that led to these failures were various and complex: (1) most of these banks carried a cash reserve dangerously low in relation to their liabilities; (2) many of them undertook transactions that could not fitly be characterised as banking transactions;[1] (3) the banks were controlled and managed by persons untrained in the technique and ignorant of the principles of banking; (4) the directors were equally incompetent for their work; (5) the desire to satisfy the shareholders by large dividends involved a sacrifice of the larger interests of banking; (6) the European banks looked askance upon the Indian enterprise and were reluctant

[1] Compare the evidence of Mr. Thomas Smith before the Chamberlain Commission: "The mushroom banks invest in all sorts of things such as coachbuilding. They will take a part of their money and erect a soap factory, or a coachbuilding business for repairing carriages, and so on. . . . They become traders with the money which is given to them as bankers" (Questions 8666, 8667).

to co-operate, even less inclined to help the banking fraternity in times of difficulty.

The following table may be of some interest.

Year.	No. of Banks that failed.	Capital in Lakhs of Rupees.		
		Authorised.	Subscribed.	Paid up.
1913	12	274	165	35
1914	42	710	245	109
1915	11	56	8	5
1916	13	231	21	4
1917	9	76	35	25
1918	7	209	5	1
1919	4	52	6	4
1920	3	10	8	7
1921	7	70	6	1
1922	15	1015	27	3
1923	20	2086	992	465

These failures have affected the growth of Indian banking, and it is increasingly recognised that banking legislation on sound lines is necessary to avoid similar disasters.

These banks do ordinary banking business and mostly help the financing of India's internal trade and commerce. They facilitate the movements of crops in busy seasons. They do not enter into the business of foreign exchange, though recently some of them have entered on that business to a small extent. One institution amongst these joint-stock banks requires special notice — the Central Bank of India. It is entirely an Indian institution in the strict sense of the expression, being managed and controlled by Indians, and its deposits show a steady growth. There may be behind this growth the sentiment that an Indian joint-stock bank of this type should be especially patronised by Indians. Its position has been recently strengthened by the amalgamation with it of the Tata Industrial Bank, and it has been opening a number of branches in different parts of the country. The joint-stock banks receive deposits both for fixed periods and on current account. They pay a higher rate of interest on the fixed deposits than the Imperial Bank of India,

and they allow 2 to 2½ per cent on current accounts on sums exceeding a definite limit.

The joint-stock banks keep some portion of their cash balances with the Imperial Bank of India. The proportion of their cash balances to their total liabilities is dangerously low, when one remembers that the Indian banking system is not a single-reserve system. Their position is unsound, and the necessity for legislation in the case of the joint-stock banks, prescribing a definite minimum percentage of cash reserve to liabilities, is greater than in the case of the Exchange Banks. The publication of weekly statements is more feasible in the case of the Indian banks than in the case of the Exchange Banks, and statutory provision for such publication is eminently desirable in the interests of the depositors, whose resources may be limited, and whose ignorance and illiteracy need special protection.

Besides the joint-stock banks, there are a large number of institutions registered as banks under the Indian Companies Act, but they have insufficient capital, and their activities are of such various kinds that they are not usually included in the class of Indian joint-stock banks. The relevant and available statistics regarding these are given in the following table.

Year ending March 31.	No. of Banks.	Paid-up Capital in Lakhs of Rupees.
1900–1	398	300
1911–12	454	779
1912–13	477	820
1913–14	513	776
1914–15	436	780
1915–16	422	815
1916–17	422	849
1917–18	447	1000
1918–19	456	826
1919–20	517	893
1920–21	648	1832

Statistics of their deposits are not available. It is clear, however, that their capital has increased by rapid

strides between 1900 and 1921, and it is necessary that banking legislation should bring within its scope the operations of these smaller companies.

In a country like India, there is an enormous scope for the development of joint-stock banking which would bring facilities for saving within the reach of the average depositor in the smaller towns, and which would link up the Shroff, the Sowkar, and the Mahajan with the larger banking institutions of the capital towns. But the success of such banking enterprise will depend upon the fulfilment of conditions which, while they are not difficult to put into practice, may yet be resisted either as unnecessarily restrictive or fantastically novel. In spite of the amalgamation of the Presidency Banks, the country to-day suffers as much as in the past from a general lack of direction in banking policy. "It is no one's business to look at the matter as a whole, to know the position of the market's component units, or to enforce prudence when it is needed." The result is that though in theory we have a multiple-reserve system of banking, in practice the majority of the banks work with low cash reserves and "every one is reckoning, in a crisis, upon every one else".[1] In the first instance, then, we require legislation insisting upon minimum percentage of cash reserves, upon the publication of weekly statements, even on a compulsory deposit for every new bank that comes into existence. The banking depositor in India—we are not talking of the few wealthy men in the towns who may have alternative avenues of investment—is usually a poor illiterate man, who looks round for an outlet for his savings, and who may be attracted by a bank that tempts him by offering a high rate of interest, and may put his all into the bank. When disaster overtakes any institution, he can scarcely discriminate between sound and unsound concerns, but will hasten to get his money back from whatever bank it is in, and the flow of deposit available for financing the country's trade and industries may be

[1] J. M. Keynes, *Indian Currency and Finance*, pp. 236-237.

needlessly and seriously retarded. Both in the interests of the depositors and in the general interests of trade and economic development, we need banking legislation.

There is another condition, equally vital, on which the future of Indian banking largely depends. The available sources of Indian capital have not been, and never will be, successfully tapped till the bank in the district familiarises the people with the use of cheques in the vernacular. The masses cannot be reached so long as the cheque remains an instrument written in a mysterious and foreign script which cannot be easily read and understood. The simplification of banking business and the use of vernaculars in drawing cheques may in the future open up a large field for deposit banking.

CHAPTER XXXIV

POST OFFICE SAVINGS BANKS AND CASH CERTIFICATES

Post Office Savings Banks

No discussion of the Indian banking system can leave out of account the Post Office Savings Banks. Government Savings Banks were established in the Presidency towns between 1833 and 1835. In 1870 District Savings Banks were instituted in connection with selected District Treasuries. The Post Office Savings Banks opened in 1882 absorbed the District Savings Banks' business in 1886, and that of the Presidency Savings Banks in 1896. It may be noted that the whole of the business of the Savings Banks is a branch of postal administration. A moderate rate of interest—namely 3 per cent—is allowed on all deposits from 4 annas to Rs. 2000, and any sum can be withdrawn. These banks have attracted the deposits of the middle classes who have small savings and want investment without risk though on low interest. It is interesting to find that in the list of their depositors there is a fairly large number of Government servants earning moderate salaries. The amount of deposits has steadily grown, and it is an indication of the saving habits of the people. We reproduce on the following page the relevant statistics.

Taking the figures for 1920–21, the amount per head of the depositors was Rs. 120, whilst the amount per head of the population in British India was only Rs. 0-14-10 or less than a rupee. In 1922–23 the amount per head of depositors fell to Rs. 113. The amount of deposits in 1924 rose to 24,79 crores of rupees, and in 1925 to 25,9 crores

Year.	Number of Banks at the End of the Year.	Number of Depositors.	Deposits (inclusive of Interest) at the End of the Year.	Withdrawals each Year.	Balance of Deposits inclusive of Interest.	Interest.
			In Lakhs of Rupees.			
1911–12	9,502	1,500,834	879	681	1890	51
1912–13	9,460	1,566,860	971	799	2161	56
1913–14	9,824	1,638,725	1160	905	2367	62
1914–15	10,161	1,644,074	961	1780	1489	54
1915–16	10,386	1,660,424	816	773	1532	43
1916–17	10,421	1,647,419	938	811	1660	45
1917–18	10,975	1,637,600	1016	1018	1658	44
1918–19	10,587	1,677,407	1345	1121	1862	47
1919–20	10,670	1,760,442	1775	1522	2135	56
1920–21	10,713	1,877,957	1885	1733	2286	62
1921–22	10,758	1,958,503	2139	2200	2226	61
1922–23	10,730	2,043,502	2078	1984	2319	63

of rupees. It will be noticed that the figures of new deposits and annual withdrawals show a close correspondence. The abnormal figure of withdrawal for 1914 can be accounted for when we remember that it was the first year of the war, which brought fear and created a panic; but confidence was soon restored, and the total deposits stood in 1920–21 at 23 crores, and in 1925 at 26 crores of rupees. It is true there will always be withdrawals, but it is also true that there will always be new deposits on a larger scale. The Government of India does not maintain any specific reserve against these deposits. They are treated as unfunded debt, and used for capital expenditure and often for ordinary expenditure.

The Post Office Savings Banks are not only meant to encourage thrift among the people, and especially among the middle classes; they constitute an important part of the financial organisation. Everything possible should be done to encourage thrift and to provide facilities and opportunities for the investment of small savings. It is well recognised that on the whole a high rate of interest induces people to save more than they do at a low rate of interest; and for the middle classes there can be no more effective inducement to save than a fairly reasonable rate of interest.[1] At present the rate of interest allowed by the Post Office Savings Banks is only 3 per cent, which is low in view of the rates for money ruling in the Indian money market during recent years. It is urged that the banks have to maintain a fairly large reserve to meet the current demands of the depositors, who are entitled to withdraw their money at any moment—hence that they cannot afford a high rate of interest. It is true that they

[1] It is interesting to note that in the course of a debate in the House of Commons in 1838, it was pointed out by the then Chancellor of the Exchequer that Government was prepared, even at a sacrifice, to maintain a high rate of interest on savings banks' deposits, in view of the effects of a reduction in the rate of interest. In the commercial panic of 1835, he stated the total amount withdrawn was £361,000; in the political panic of 1832, £550,000; in 1828, when the interest was reduced by 14s. per cent, no less a sum than £1,500,000 was withdrawn (Lewins, *History of Banks for Savings*, p. 77).

have to keep a reasonable amount in liquid form, but unless there are abnormal circumstances like those of 1914, there is no danger of a rush on the part of the depositors. Even so, the current balances of the Government are fairly large. If, moreover, we look at the statistics, we find that with the exception of the years of panic, 1914–15–16, the total deposits have not fallen below 18 crores of rupees in spite of all the withdrawals ; and even in those particular years they did not fall below 15 crores. We can safely look upon 18 crores of rupees as of the nature of fixed deposits. As a matter of fact, in 1925 the total amount of deposits has risen to 25 crores of rupees. Even the Imperial Bank of India allows 4 per cent interest on savings deposits. There is no reason why the Post Office Savings Banks' deposits should not earn 4 or $4\frac{1}{2}$ per cent interest. We should not forget the fact that the persons who put their savings in the savings banks are persons who desire to provide for their families and against a rainy day ; they have no desire to withdraw their money immediately. The best method of encouraging thrifty habits and tapping the savings of the middle classes is that of allowing a fairly high rate of interest ; and one can only regret that opportunities for attracting savings such as exist in the country should be to a considerable extent lost by a conservative policy that refuses to look beyond the trodden ways. The Post Office Savings Banks are alive to the need for providing facilities for the small investor. A working man in a small town may as readily take his four or eight annas to the savings bank as the wealthier man takes his hundreds of rupees to the bank with which he has dealings. But if the Post Office Savings Banks have for their object the encouragement of thrift and the mobilisation of small savings, we cannot quite understand why the total amount of deposits for any one account should be limited to Rs. 5000.[1] The benefits of the savings banks are not

[1] A depositor is allowed to raise the amount to his credit to Rs. 10,000 by investments in Government securities.

confined even in theory to any one class. To the poorer classes the restriction forms a kind of barrier to saving habits ; with regard to other classes, one might as well think of restricting investments in Government securities, which yield a higher rate of interest, as of restricting deposits in savings banks. The larger the amount of deposits on the part of an individual depositor, it might be thought, the greater is the risk of sudden withdrawal. What should be remembered, however, is that the class of people who deal with savings banks are a class not likely to withdraw their money except for grave reasons and in abnormal circumstances ; and that the larger the amount of savings thus deposited in savings banks, the greater the stability of the institutions with the help of which the social organism grows, as also the greater the stake which the masses have in their preservation. There is one other anomalous phenomenon in connection with the Post Office Savings Banks' deposits that calls for notice. These deposits, now amounting to nearly 25 crores of rupees, are treated by the Government as unfunded debt ; they are used to meet Council Bills, and are sometimes transferred to London for maintaining the exchange. These deposits represent the savings of the people, and might well be used for the development and extension of education and sanitation, and for other national objects. That Indian public opinion should tolerate the use of Post Office Savings Banks' deposits for the maintenance of the exchange—in other words, for an object that is characterised as a convenience to the foreign trader—whilst such needs as those of education and sanitation are starved for want of funds, is an indication of how far the public is from enlightenment as to the real facts of the situation.

Post Office Cash Certificates

Side by side with the Post Office Savings Banks has developed during recent years the practice of attracting

savings by means of the system of five-years' Post Office Cash Certificates. These certificates were introduced during the war for the first time as an extraordinary measure to obtain funds for war purposes. Though the scheme met with success for some time, their use subsequently declined. When Sir Basil Blackett entered on office as Finance Member of the Government of India in 1923–24, he was impressed by the fact that the cash certificates had not been sufficiently popularised, and that there was scope for attracting funds by extending their use. In his first Budget speech (1923–24) he observed : " I have been making some inquiries as to the progress of the Post Office cash certificates. The change from thriftlessness to thrifty habits which has taken place among sections of the English people has been described as a revolution. National Savings Certificates to the value of nearly £360,000,000 are now held by the small investor in the United Kingdom. When I contrast the sales of the Post Office cash certificates, which were not inconsiderable during the war when they were first started, but have since declined, I cannot help thinking that there must be great possibilities of development in this system. What a great improvement in our financial outlook would result if, by development of the Post Office cash certificate system, a considerable part, if not the whole, of the money required for provincial capital expenditure could be found out of the proceeds of cash certificates. It is my earnest hope that before long means may be found for taking up this subject in earnest." Soon after this pronouncement the cash certificates were largely advertised. In order to meet the convenience of all kinds of investors, certificates of various denominations from Rs. 10 to Rs. 1000 were issued, and the procedure for their purchase was simplified. The purchaser has to pay Rs. 7-8-0 for a five-years' cash certificate of Rs. 10, and Rs. 750 for one of Rs. 1000. He is entitled to withdraw his money at any time, but if he does so on the completion of a year he gets a lower rate of interest, but not less than 4½ per cent. If he waits for

five years he gets the full amount of Rs. 10 or Rs. 1000 as the case may be. The respective amounts realisable for the various denominations are certified on the back of the certificate, and no one can hold certificates of a larger amount than Rs. 10,000.

The scheme met with success in the very first year. It afforded opportunities for safe and sound investment at a reasonable rate of interest to persons with small and moderate savings, at the very time when people were losing confidence in industrial concerns, which had had a brief career of success during the abnormal war-time conditions. Added to this was the mistrust of Indian banking enterprise prevalent amongst those who had dealings with the banks ; wild rumours of all kinds were rife about the soundness of the Indian joint-stock banks. It is not surprising, then, that the Post Office cash certificates became popular. In the very first year the net receipts from the cash certificates were Rs. 5,29,00,000 ; in the first two months they amounted to Rs. 80,00,000. Reviewing the working of the scheme on July 12, 1924, Sir Basil Blackett said : " The Government have been doing what they can to provide special facilities for the small investor, alike through the co-operative movement, through the Post Office Savings Banks, and through the Post Office cash certificates. Statistics of the latter are very interesting. In the twelve months ending March 31, 1924, the net receipts from Post Office cash certificates were Rs. 5,29 lakhs, and in the two months, April and May 1924, were 77 lakhs, which compares with the figure of 80 lakhs in the corresponding period of the previous year. It will be seen from this that the stimulus given to those certificates by the attractions added to them on April 1, 1923, has not lost its strength. Although the rate of interest for those who hold the cash certificates for the full period of five years is 6 per cent, and therefore somewhat higher than the rate which the Government of India now have to pay for their rupee loans, it is not proposed at

present to reduce the attractions of the Post Office cash certificates. It would be a pity to disturb the growing popularity of these certificates, and the benefits to be obtained by an increase in the number of people who invest in them, and in the amount of capital saved by their means, outweigh the extra cost of continuing the higher rate for the present." [1] The continued popularity of the cash certificates is evidenced by the figures of the net receipts arising from their sales, estimated at 4,60 lakhs of rupees for 1924–25. Between April 1923 and March 1925 the total receipts from the sale of cash certificates were 9,87 lakhs or nearly 10 crores of rupees. All these need not be assumed to be new savings, and they may not entirely belong to the middle classes. The number of holders of these certificates, and the amounts held by them, are not available to the public. It is quite possible that persons who already had savings bank accounts may have withdrawn their deposits for investment in cash certificates, and also that the class of people who have investments in industrial concerns may have resorted to cash certificates as a safer form of investment. However that may be, the sale of Post Office cash certificates opens up a large field for the mobilisation of savings and the encouragement of thrift, a field which has as yet been very incompletely covered.

Sir Basil Blackett has rendered valuable service in reorganising and popularising these cash certificates, but it is not difficult to extend and increase their use immensely by measures that do not make any demands on the resources or imaginative powers of the Government of India. The number of Post Offices doing the business of Savings Banks and handling Post Office cash certificates (all Savings Banks do not handle cash certificates) was 10,713 in 1921, while in the same year the total number of villages in British India was nearly 499,000. Now it

[1] Would not the same considerations govern a somewhat higher rate of interest on the Post Office Savings Banks' deposits than the 3 per cent at present allowed ?

may not be possible to open a post office in every village, but every village has a Patel and an accountant, who collect the land revenue, and they might conveniently undertake the business of these cash certificates. It is only by such a method that the cash certificates may be brought to the knowledge of the small investor in the villages. Moreover, a scheme like this is the easiest and the most convenient method, not only of encouraging thrift, but of popularising the use of credit instruments. The cultivator who buys the cash certificates can easily get them cashed at the nearest post office, when he is asked to pay in his land revenue. He may even find it convenient to pay the land revenue in the form of cash certificates at their realisable value, if he so desires. It must be remembered that the total amount paid in the shape of land revenue and rates in 1921 came to 34 crores of rupees; and this huge sum is mostly paid—in the Rayatwari areas almost wholly paid—in cash or in notes. A large part of the total amount is practically so much unproductive cash held by the cultivator, money hoarded in the absence of banking facilities. What often happens to-day is that if the cultivator has, say, Rs. 100 in cash in April or May of any year, and his land revenue is due in January of the following year, he has to keep the money by him, lying idle, and loses the interest on it. If he is given an opportunity to earn interest by investing in the cash certificates, and at the same time knows that these certificates will be accepted in payment of land revenue, he will readily invest all his savings in that form. We assume, of course, that the present rule about interest will have to be modified for such purposes, making it possible to obtain interest on cash certificates if they are not sold by the investor within six months. The cash certificates will be a form of cheque, and the savings represented by them will be of the nature of deposits earning interest. The more complex mechanism of banking of the modern type may be difficult to introduce into rural areas, and the people may not readily realise the

advantages of deposit banking, but in the scheme we are suggesting we have a simple method of familiarising the rural population with the use of credit instruments, something which they can easily understand and adopt. There are vast potentialities here of gathering and centralising the savings of the poorer classes, to be used for national purposes. The working out of the scheme will not involve any cost in the shape of an addition to the administrative cadre, and it does not involve any element of novelty or violent departure from the general principles of economics, such as may invite opposition from a bureaucracy temperamentally conservative.

Here again we cannot help raising a note of warning with regard to the use to be made of the resources made available to Government by the extension of the sale of cash certificates. They represent essentially the savings of the poorer classes and the classes above them in rural or urban areas ; and such savings, if they are to be used, should be used primarily for the extension of education and sanitation, for the multiplication of dispensaries and hospitals, or for supporting co-operative credit to cultivators. Sir Basil Blackett himself expressed a desire to obtain sufficient funds for provincial capital expenditure from the receipts of the cash certificates. The Government of India obtained 10 crores of rupees from this source in two years, and it has been used for swelling the Government balances which have been remitted to London. The Government remitted £42,000,000 in 1924–25, though the budgeted provision was only for £27,000,000. These remittances were effected by the sale of Council Bills and the purchase of sterling, all the obligations being correspondingly met from the Indian balances. As we were told by the Finance Member in March 1925, " There has been a strong and continuous demand for rupee exchange throughout the year, and we anticipate that our total remittances during 1924–25 will amount to £42,000,000. We have already remitted about £40,000,000, of which about £33,000,000 have

been obtained by the purchase of sterling in India. It has been necessary, in view of the general cash position in India, to transfer the equivalent of £6,000,000 from the Paper Currency Reserve in India to our treasury balances against a corresponding transfer in London." In no other country have we seen it even suggested that the savings of the people thus mobilised by Government might be used for the ordinary purposes of public expenditure, much less for maintaining stability of foreign exchange.[1]

[1] It is interesting to note, for example, that under the Postal Savings Bank system of the United States the funds received by the banks are to be deposited in national and State banks. The minimum rate of interest paid by the banks to the Government on the Postal deposits is 2½ per cent. Not over 30 per cent of the amount of such funds may be withdrawn by the trustees for investment in United States Bonds. The residue of the funds, amounting to 65 per cent, is to remain on deposit in the banks in each State and territory willing to receive the same, but may be withdrawn for investment in bonds under the direction of the President when in his judgment "the general welfare and interest of the United States so requires". The Post Office Savings Banks' funds, in other words, fertilise the credit recourses of the United States and play their part in the building up of national wealth.

CHAPTER XXXV

THE CO-OPERATIVE BANKS, INSURANCE COMPANIES, AND STOCK EXCHANGES

The Co-operative Banks [1]

Another component of the Indian Banking organisation is the institution of co-operative banks. The problem of agrarian indebtedness has attracted the attention of the Government of India ever since 1880, and various palliative measures have been adopted, including the institution of Takavi loans and loans for land improvement. The question of land banks was seriously raised for the first time by Sir William Wedderburn, who, with the help of Justice Ranade, prepared a scheme for establishing agricultural banks, to be started in the first instance in a single district; but the proposal was negatived by the Secretary of State. During the closing year of the last century, the Madras Government sent Sir Frederick Nicholson to Europe to study and report upon the desirability of establishing agricultural banks in the Madras Presidency. He made comprehensive recommendations, but no immediate action was taken on them. The famine of 1900 forced the question again upon the attention of the Government of India, and Lord Curzon appointed a Committee with Sir E. F. Law, the then Finance Member, as Chairman. From the report of this Committee resulted the Co-operative Credit Societies Act of 1904. The inquiries of the various Famine Commissions had already

[1] For a full and critical discussion of the subject see *The Wealth of India*, by P. A. Wadia and G. N. Joshi, chapter xvi.

revealed the fact that the peasantry of India was not only sunk in poverty but was deep in indebtedness. On the recommendation of the Law Committee it was thought desirable that Government should undertake to finance agricultural production on a co-operative basis, and to supply credit on much cheaper terms than the cultivator could obtain from the Sowkar. The problem before the Government was twofold—(1) the removal of indebtedness and (2) the provision of cheap credit on reasonable terms. The co-operative movement, it was believed, would not only solve the problem, but would by its educative influences remove the causes that had led to agrarian indebtedness in the past. In an explanatory memorandum appended to the Bill of 1904, Sir Denzil Ibbetson observed that the object of the Act was " to encourage thrift, self-help, and co-operation among agriculturists, artisans and persons of limited means ". A number of co-operative credit societies were started under the Act of 1904. Owing to the increasing demand for co-operative credit a new Act was passed in 1912. This Act provided for the establishment of Central Banks formed by a union of primary societies or by a union of primary societies and individuals. The chief functions of these banks were: (1) the attraction of deposits from non-agriculturists; (2) the use of excess funds of some societies temporarily to make up for shortage in others; and (3) to supervise and guide the affiliated societies.

The primary societies are of the same character as any joint-stock bank. Their main function is that of lending money to villagers on easier terms. Much of their work is done through agencies of an honorary character. In the early days the Government helped them at the outset with deposits, but the patronage was withdrawn later on, and they are left to carry on their work on the basis of self-help. The Central Bank now takes the place of Government. In June 1914 the Government of India issued a resolution surveying the progress of the co-operative movement in the preceding ten years. It was

optimistic in its tone, but emphasised the need for financial organisation. In the same year the Maclagan Committee was appointed to examine whether the movement was progressing on sound lines, especially in its financial aspects and in its higher stages, and to make recommendations. It examined the whole question and made a comprehensive report. The Government has disclaimed all responsibility as regards direct financial assistance in order to allow the movement to progress on true co-operative lines. With regard to the difficulties in connection with the discounting of the promissory notes of the banks, the Committee suggested that this business should be transacted through the Presidency Banks. It recommended the establishment of a State co-operative apex bank. " It may perhaps be possible for some arrangement to be entered into with the Presidency Banks under which they will undertake the duty of rediscounting agricultural paper for Provincial Co-operative Banks. Failing this, according to the European precedent, the only alternative solution appears to lie in the establishment of a State co-operative apex bank. There are, of course, other advantages besides the provision of the requisite financial stability which would accrue to co-operation from the foundation of such a bank." On this recommendation a Central Co-operative Bank was established in Bombay, and action on similar lines was also taken in other Provinces.

The accompanying tables give the relevant statistics.

It will be seen from Table I. that the paid-up share capital of co-operative societies in 1920–21 amounted to Rs. 3,54,00,000, the deposits by members to Rs. 1,51,00,000, and the reserve to Rs. 1,99,00,000, whilst the loans issued to members and other societies amounted to nearly 15 crores of rupees. In Table II. the co-operative banks are subdivided into two classes, Class A representing banks with a paid-up capital of 5 lakhs of rupees and over, and Class B consisting of banks with a paid-up capital between one

TABLE I. CO-OPERATIVE SOCIETIES

Year.	No. of Societies.	No. of Members.	Loans from Private Persons, other Societies, and Banks.	Share Capital.	Deposits by Members.	State.	Reserve.	Loans issued to Members and other Societies.
			In Lakhs of Rupees.					
1911–12	8,177	403,318	199	51	65	9	10	270
1912–13	11,792	543,388	324	79	91	9	16	415
1913–14	14,881	695,998	477	110	115	9	33	504
1914–15	16,296	761,935	543	131	115	11	50	392
1915–16	18,552	842,959	672	157	61	13	76	481
1916–17	21,737	945,545	793	186	72	14	88	671
1917–18	24,393	1,048,290	914	211	80	19	109	677
1918–19	29,800	1,234,930	1104	244	99	26	142	863
1919–20	37,254	1,520,376	1359	243	123	25	169	1211
1920–21	43,366	1,756,925	1702	354	151	35	199	1494

TABLE II. CO-OPERATIVE BANKS

(In Thousands of Rupees.)

Year.	Class A.			Class B.		
	No.	Capital and Reserve.	Deposits and Loans Received.	No.	Capital and Reserve.	Deposit and Loans Received.
1914–15	2	6,56	14,57	15	17,03	92,23
1915–16	2	8,36	19,46	18	22,46	1,14,71
1916–17	2	11,11	25,03	21	27,75	1,49,45
1917–18	3	18,32	52,29	24	30,49	1,52,34
1918–19	4	24,67	1,35,44	29	40,60	1,57,37
1919–20	2	14,42	96,34	44	72,84	3,12,65
1920–21	5	36,56	2,29,38	49	79,00	2,95,26
1921–22	5	39,76	2,82,68	55	1,02,28	3,95,87
1922–23	5	43.60	3,41,05	65	1,30,11	5,09,54
1923–24	7	57,18	4,03,21	72	1,54,65	5,95,10

and five lakhs of rupees. The total deposits of the banks belonging to both classes in 1923–24 amounted to nearly 10 crores of rupees. The co-operative movement has undoubtedly been gathering strength as the years rolled on, but when one remembers that the total indebtedness of the agricultural population in India at the most moderate estimate amounts to Rs. 3,50,00,00,000 one cannot help remarking how inadequate the loans of a mere 15 crores of rupees are to the solution of the problem of indebtedness,

much more so if these 15 crores are to be directed not only to the relief of indebtedness, but also to the supply of credit for agricultural production. At the present rate of progress it may probably take a century before the resources of agricultural banks and co-operative societies can fully respond to the needs of the country. The problem can only be solved with the help of a Central Bank with its sub-offices in the Provinces and a network of branches all over the country, working with such ample resources in the shape of funds as the Government alone can afford. There can be no better use, for example, of the funds attracted by the Post Office Savings Banks, and realised through the sale of cash certificates, than in the relief of agricultural indebtedness and the financing of agricultural produce. It is true that the funds thus available to Government are at present limited; but with a higher rate of interest, and with greater facilities offered to the rural depositors, such resources might be multiplied several times; and the closer association of the savings banks with the co-operative societies and the co-operative banks involves possibilities of rural construction in India undreamt of by the present co-operative societies.

Insurance Companies

No discussion of the money market in India can omit a reference to the work of insurance companies. Insurance is still in its infancy in India. In other civilised countries enormous amounts are saved in the form of premiums every year, and what is achieved by the savings banks directly is achieved by insurance companies indirectly. It is saving in another form, with additional advantages. In the West, the growing importance of insurance in all its different phases is amply evidenced by the amount of premiums of all kinds obtained by insurance companies. In Illinois, only one of the forty-eight States that make up the United States of America, the fire insurance

premiums collected in 1914 amounted to $27,000,000, and the life insurance premiums to $66,000,000. In the same year, in the whole United States, the total insurance premiums collected reached the figure of $1,485,000,000. Or to take just one more illustration, the total income from premiums of a single company like the Canada Life Assurance Company amounted to £2,558,000 in the year 1922. It has been observed that the present vast and complicated industrial and commercial organisation of the West could not long be sustained in the absence of insurance in all its phases. Insurance to-day furnishes a method by means of which reasonable security of the means of livelihood can be guaranteed for the masses of the people under modern industrial conditions, where the great majority of the workers are wage-earners, and do not own the instruments of production. There are thoughtful men who see in a scheme of universal insurance the only potent instrument for fighting against the radical revolutionaries who challenge the present economic order. We are told that our present-day civilisation has practically reached its limits under present economic conditions, that social progress has come to a standstill, and that the only condition which makes further progress possible or conceivable is the adoption of a scheme of universal social insurance, which alone can furnish economic security for every worker.[1]

The huge premiums earned by insurance companies steadily from year to year represent savings of the people available for investment in a mobilised form. The companies constitute an important factor in the money market, very often helping on the trade and industrial enterprise of the country, their vast resources placing them in a position to offer facilities for new investments. In India only the statistics of life insurance companies are available ; and

[1] See *Addresses and Papers on Insurance*, by R. M. Potts (Illinois, 1917), pp. 18 and following ; pp. 95 and following. " Welfare insurance is a plan whereby all, through the operation of the law of average, help without hardship to bear the heavy burdens from misfortune that befall the few."

of these only the statistics of Indian companies, which are estimated to do no more than a third of the total business in life insurance. No statistics are published of the work of fire and marine insurance companies, the latter business being entirely monopolised by foreign companies. The work in sickness and accident insurance, in burglary insurance, and in unemployment insurance, may be regarded as totally negligible, if existent. In 1923 there were fifty-two Indian life insurance companies subject to the operation of the Indian Life Assurance Companies Act. There were, in the same year, twenty-three British, Colonial, and foreign life insurance companies having a place of business in India. Of the Indian companies, the Oriental, founded in 1874, is the oldest doing ordinary life insurance business.

The following table gives us some indication of the growth of business among the Indian companies:

Year.	No. of Companies.	Funds at End of Year.	Increase to Life Funds.	Total Income.
		Rs.	Rs.	Rs.
1913	36	5,82,85,415	44,86,671	1,26,69,000
1914	39	6,36,21,700	53,36,285	1,34,80,000
1915	40	6,77,11,530	41,42,262	1,40,72,000
1916	43	6,85,90,280	7,80,137	1,37,13,000
1917	43	7,20,08,049	34,12,153	1,44,22,000
1918	43	7,36,01,466	15,93,417	1,53,90,000
1919	42	7,87,11,011	51,14,524	1,69,01,000
1920	43	8,46,54,346	59,43,335	1,90,41,000
1921	45	8,62,42,570	7,71,592	2,18,83,000
1922	48	8,36,92,550	82,75,242	2,36,45,000
1923	45	10,29,65,200	96,62,348	2,48,97,000

Since 1912 the total income and the total life insurance funds of the Indian companies have almost doubled in amount. About a crore of rupees is available every year for investment in public funds and trust securities from the income of the Indian life insurance companies. Assuming that the work of the foreign life offices is about three times as large, not an over-estimate under any circumstances, we find that the net available funds lost to this

country for the purposes of investment in the Indian money market amount to three crores. The amount of holdings in Indian securities of these foreign companies is very limited. We have also to take into account the net premiums available for investment of fire and marine insurance business, which is being almost exclusively done by foreign companies, for which we have no figures, and which we estimate as a conjecture at four crores every year at the lowest. Thus about seven crores of rupees which would otherwise be available for investment and for productive capital expenditure in this country, for the development of railways and irrigation, are lost to the country. They represent savings in as full a sense as the money drawn in by the Post Office Savings Banks ; and though undoubtedly it may be objected that these premiums represent the earnings of the foreign companies legitimately obtained for services rendered, the fact remains that some portion of them is savings of the people, which, if they remained within the country, would help its economic development by building up its capital resources.

The following table will give a comparative view of the changes in investments of British and Indian insurance companies in different periods, expressed in percentages of the total assets :

British Insurance Companies in Great Britain.			Indian Life Insurance Companies.		
	Percentage of Total in 1892.	Percentage of Total in 1921.		Percentage of Total in 1914.	Percentage of Total in 1923.
Mortgages	39·3	9 6	Indian Government securities, Municipal Debentures, etc.	78	72
Loans on policies	4 4	2·6	Mortgage on property in India	2·2	·2
Loans on rates	10·7	4·1	Loans on policies within surrender value and loans on personal security.	6·6	9·5
British Government securities	3	35·2	Land and house property	5·8	6·3
Indian and Colonial securities	6·1	5·2			
Foreign securities	1·7	5·8			
Debentures	11	11·5			
Stocks and shares	6·5	6·3			
Land and house property and ground rents	7·5	6·4			

The remarkable change in the holding of British securities by British insurance companies as between 1892 and 1921 can be partly explained by the more remunerative character of investments in Government securities in war-time and in the post-war period. In the case of Indian companies, on the other hand, it is but necessary that the pioneer work of spreading insurance business should aim at inspiring confidence amongst the people and attracting savings, by investing the greater portion of their assets in securities recognised by the Trust Act. The increase in the loans on policies and on personal security in the case of the Indian companies may be welcomed, not only because, so far as the loans on policies within surrender value are concerned, the security is absolute, but also because the loans on personal security popularise insurance, and afford a profitable source of investment under strict rules of management.

Growth of Banking Habits

The growth of banking habits in India and the stimulus given to it during the war are amply demonstrated by the following table :

Table showing the Growth of Capital Reserve and Deposits of the Imperial Bank of India, the Exchange Banks, and the Indian Joint-Stock Banks

In Crores of Rupees

Year.	Imperial Bank of India.		Exchange Banks.		Joint-Stock Banks.		Total of all Banks.	
	Capital Reserve.	Deposits.	Capital Reserve.	Deposits.	Capital Reserve.	Deposits.	Capital Reserve.	Deposits.
1913	7	42	38	31	4	24	49	97
1920	7	87	90	75	12	73	109	235
1921	10	73	112	75	13	80	135	228
1922	10	71	112	74	12	65	134	210
1923	10	82	140	68	11	47	161	197

The total deposits in all three classes of banks in India increased from 97 crores of rupees in 1913 to 197 crores in 1923 ; the aggregate paid-up capital and reserve from

49 crores in 1913 to 161 crores in 1923. To these figures we may add 6 crores of rupees in the shape of deposits in the co-operative banks, 23 crores of rupees in the Post Office Savings Banks (the deposits in the Savings Banks reached 26 crores in 1925), and 13 crores of Post Office cash certificates in 1925. The increase of banking business in India is further evidenced by the expansion of work done by the clearing-houses through the use of cheques. To the extent that cheques are employed in the settlement of transactions, the use of cash is economised; cheques may be regarded as bank deposits in active use, and the proportion of cheques to deposits indicates the rapidity of circulation of bank deposits. The clearing-house enables the banks in important towns to settle a large amount of mutual indebtedness through transfer of entries in bank accounts. The increase in the work of clearing-houses in India is indicated by the following figures:

In Lakhs of Rupees

Year.	Calcutta.	Bombay.	Madras.	Karachi.	Rangoon.	Cawnpore.	Lahore.	Total.
1914–15	2,66,95	1,57,83	18,81	11,62	43,12	..	..	4,98,33
1915–16	3,52,36	1,77,18	20,21	14,09	39,50	..	..	6,03,34
1916–17	4,92,89	2,62,28	25,29	17,36	50,68	..	..	8,48,50
1917–18	5,24,90	3,83,53	23,01	22,17	52,86	..	..	10,06,47
1918–19	7,41,13	5,79,46	25,45	22,30	73,85	..	..	14,32,19
1919–20	10,55,76	8,33,02	33,95	23,13	34,74	..	..	20,90,60
1920–21	14,39,93	13,15,93	75,79	33,42	1,04,84	6,63	..	29,76,54
1921–22	9,05,01	9,06,73	39,54	36,73	1,22,02	9,01	5,86	20,24,90
1922–23	9,80,26	8,58,73	46,13	33,58	1,25,96	7,93	8,49	20,60,08
1923–24	85,03	7,07,98	55,41	41,52	1,32,82	6,38	5,85	18,03,01

The amount of money work done through the clearing-houses has thus increased by 400 per cent in ten years, from 498 crores of rupees in 1914–15 to 1803 crores in 1923–24. The opening of clearing-houses in more centres would quickly demonstrate that there are untold potentialities in the system.

The amount of remittances through the post offices may also be considered when we are noticing the development of the Indian money market. The use of money orders renders the use of cash unnecessary; they may

almost be regarded as postal bills of exchange. The following table gives us an indication of their steady growth:

In Lakhs of Rupees

	1911–12.	1912–13.	1913–14.	1914–15.	1915–16.	1916–17.
Total of inland and foreign money orders issued .	45,34	48,45	52,29	52,64	55,07	58,72
Total of inland and foreign money orders paid .	47,57	51,17	55,21	55,05	57,38	61,44
	1917–18.	1918–19.	1919–20.	1920–21.	1921–22.	1922–23.
Total of inland and foreign money orders issued .	63,98	71,89	80,22	94,91	79,53	79,40
Total of inland and foreign money orders paid .	73,45	77,03	84,12	86,31	84,36	82,52

The Stock Exchanges

To complete our description of the Indian money market so far as it is run on Western lines, we must make a brief mention of the market for negotiable securities. We have Stock Exchanges in most of the important industrial centres of India, but two of them require special notice, those of Bombay and Calcutta. All Government securities and the stocks and shares of important industrial, railway, and other large-scale concerns are quoted in these markets, and a fairly large amount of work is done from day to day. Stock Exchanges are important concomitants of industrial development on modern lines, and India also has benefited to some extent by their appearance and growth. In Bombay the bulk of the business centres round cotton-mill shares, in Calcutta round jute-mill shares. But the shares of all kinds of industrial concerns, including some located as far away as Burma, are also quoted in these markets. Statistics of the actual work done are not available.

Speculation in the share market is not unknown to India. As the result of the conditions created by the war, all kinds of new companies were floated, their shares

were often over-subscribed, and the values of the shares of existing companies went up in the period of inflation. Large numbers of people engaged in other occupations were attracted to the Stock Exchange in the belief that fortunes could be easily made. When the turn in the tide came, many of the newly floated concerns went into liquidation. There were big failures in Bombay, which led to the appointment of the Stock Exchange Committee. The Committee made its report in the beginning of 1924, and the public attention which the inquiry aroused has indirectly exercised a healthy influence on those who control the Exchange.

The stock and share market is to-day a vital factor in the economic organisation of every progressive country, and can substantially further industrial expansion by the facilities it can offer for financing securities. The establishment of a Stock Exchange in every important centre of trade and commercial activity in India may prove as important for the economic advance of the country as the general spread of banking habits.

There are as yet no finance houses or trust companies at the service of Indian industries, though there are some individual financiers in a city like Bombay, as well as financial firms, who accommodate the needy at a somewhat higher rate of interest. The system of underwriting is also in its infancy, and has every prospect of developing with the growth of banking.

CHAPTER XXXVI

INDIGENOUS BANKING

We have hitherto dealt with one type of banking and money-market operations in India, namely, the banking and other transactions carried on on Western lines and for the most part in English. But a very considerable part of the financing of internal commerce, trade, and agriculture is done through native agencies. We have no statistical information about the total volume of this business, but when we remember that the internal trade of India is estimated to be about fifteen times as great in volume as her foreign trade, we can form some idea of the work done through indigenous agencies. Even taking the volume of internal trade to be only ten times that of the external trade, its total volume would amount to 6000 crores of rupees. It is not necessary, and it would be misleading, to assume the whole of this work to be done through the medium of cash. Part of it is done by the Imperial Bank of India through the Shroffs, and by the joint-stock banks; but only part, if we can judge from the total deposits of these banks in relation to the volume of trade. The rest is done by indigenous methods of banking and on a credit basis. Large transactions are settled by *hundis* (internal bills of exchange) of various kinds. In spite of the development of modern banking, even in cities like Bombay and Calcutta, we find native merchants settling their transactions by means of *hundis* at rates definitely higher than the Bank rate. It is also to be remembered that a portion of the financing is done by book credits, though we have no statistical information

which can give us any idea, however vague, of the relative amount. The financing of the agricultural industry both for cultivation and for sale—with the exception of the rather unambitious activities of the co-operative societies—is entirely effected through the medium of the Shroffs, Banias, and Marwaris. "The agriculturist, the rural artisan, and the small trader are financed by the Mahajan, who does not confine his dealing to money, but is often also a purchaser of local products and a dealer in imported articles. He either operates with his own capital or is helped by a bigger man of his own class, and the latter often has dealings with banks on a considerable scale. The Mahajan charges high interest; landed security is good but not easily or rapidly realisable; debtors are uneducated and have no idea of business or of punctuality in meeting their obligations; their income is often precarious, depending as it does on the nature of the season; and partly in self-protection the Mahajan charges a rate of interest which local custom easily tolerates. The larger Mahajans, who finance landowners or regular traders, often lend money on cheaper terms." [1]

In the rural areas, and even in the smaller towns, transfers of money for settling transactions are in many cases personal transactions between debtors and creditors. The loanable capital available to the Mahajans is limited; it is therefore dear, and available only to a few. The result is that, when it comes to financing agricultural produce in the busy season, there is always considerable stringency of money. The fatal weakness of Indian banking is that it makes no provision for the financing of the one great industry of the country—agriculture. The Presidency and the Exchange Banks offer convenience to the foreign trader, but the great majority of the population, the men without whom neither the trader, nor the banker, nor the Government could exist, are left to the tender mercies of the small money-lender. The cultivator, when he wants to borrow—and he experiences this want

[1] *Industrial Commission Report*, para. 281.

every year, either when he has to pay his assessment to Government or for the oft-recurring emergencies of human life—has no security to offer except his land or his ungrown crops. He may be practically insolvent before the harvest is gathered, and he has to pay for his finance whatever price his creditor may choose to ask. Trade cannot flourish unless production goes on constantly increasing, and production largely depends on what the producer is able to get in the way of return for his exertions. "If the producer has to pay anything from 25 to 100 per cent for his finance, the inducement to produce is wanting; for it means that all he makes over and above his bare living goes to his creditors. The secret of successful industry is to buy your finance cheap and to sell your produce dear. The Indian buys his finance dear and sells his produce cheap. His creditor generally fixes the price of both. The ryot feeds the financier in the fat years; and the Government feeds the ryot in the lean. Trade flourishes on the labour of the bankrupt people, for three-fourths of the people of India are unable to pay their debts." [1]

The need for providing credit and banking facilities for agriculture is one of the great problems that face the Government. The Imperial Bank of India may multiply its branches as it is required to do under the Act, but with their Western methods of working and the use of English in their transactions, these branches can never come into direct touch with the individual cultivators in the villages. Perhaps the need can be met by the extension of the co-operative societies movement, and by the organisation of co-operative banks in every district. These banks might be able to mobilise the scattered capital of the districts, and lend money to agriculturists as well as traders. The vast amount of work now done by the Mahajans can be easily, cheaply, and intelligently done by the co-operative banks and their branches.

[1] Note of evidence submitted by Sir Daniel Hamilton to the Chamberlain Commission, Appendices, vol. ii. p. 524.

After the Mahajans, we have the Shroffs. Native bankers and Shroffs have flourished since times immemorial. We have already seen that under present conditions the bank can never hope to be able to get into sufficiently close touch with the affairs and business of the vast trading community, to enable it to grant accommodation to every trader who needs it. This deficiency is made good by the Shroff, who renders great service in his capacity as a middleman. He is the connecting link between the bank and the traders. It is in his capacity as a middleman that he brings a good deal of business to the Imperial Bank, and enables the Imperial Bank to give accommodation to a number of trades which would otherwise be deprived of such assistance. The traders and shopkeepers who require more money than they possess, approach the Shroffs for accommodation either for trade or goods. After careful inquiry into the position of the shopkeeper or trader, and after the Shroff is satisfied that the business is safe, the accommodation is arranged through a *hundi* broker, who approaches some Shroffs for the whole sum. These *hundis* are usually drawn for two months. The trader or shopkeeper has to pay a higher rate of interest, and also commission to the *hundi* broker. But in the busy season the resources of the Shroffs are sometimes strained, and they then seek the help of the banks. The following description gives us some idea of the nature and manner of the business :

The people with whom the banks deal directly are for the most part large shroffs of good standing in the principal cities. These men operate with their own capital, and, generally speaking, it is only when they have laid out all their available capital in purchasing the *hundis* of other (and usually smaller) shroffs that they come to the Presidency Bank (now the Imperial Bank of India). The shroffs whose *hundis* the larger shroffs have purchased have probably also similarly financed other and still smaller shroffs or mahajans, and so on, until we get down to the smallest flea of all, namely, the village bania or grain-dealer or goldsmith. For instance, shroff A at Amritsar may purchase a bill drawn by a larger shroff at Lahore, who sells it to the Presidency Bank, which

sends it to their Bombay Agency for collection, or the bill may be a pure finance bill, generally known as a hand bill as opposed to a " trade " bill drawn against produce.

Speaking very generally, it may be said that the bank's real security in the matter of purchasing or rediscounting bills is the personal standing of the drawee or endorser or acceptor; and the bank has an elaborate and very efficient system of limits whereby the amount of bills discounted for each shroff is watched. Put very briefly, the system is as follows: Shroff A is given in the bank's register a limit of, say, 20 lakhs, and at the time the names of the drawers of the bills purchased from him by the bank are watched. The bank may have purchased from A, say, 15 lakhs of bills, the drawers of which are B, C, D, E, etc. If it is observed that shroff A has been purchasing rather too many bills from shroff B, who is of comparatively small standing, or about whom not much is known, A will be liable to be turned down, or if the fact has been noticed by the head office, the branch will at once be told to go slow.

As already mentioned, *hundis* are of two kinds, pure finance bills, known as hand bills, and trade bills. The banks are much more particular as to the amount of the former that they discount for a shroff than the latter. This is not because they receive any documents on account of trade bills (their direct security is just as personal as in the case of hand bills), but because they know that somewhere or other produce or goods exist against the credit so created, that such goods must have been hypothecated to one or other of the shroffs whose names are on the bill, and that if anything goes wrong such shroff will be able to realise on the goods, and so to reimburse the subsequent holders of the bill to whom he is liable. In the case of hand bills, on the other hand, it is impossible to say definitely how far these represent a genuine trade demand or not.

It may be said broadly that the *hundi* rate rises and falls with the Bank rate proper, though somewhat in advance of it, and naturally so, for one is a discount rate and the other a rate for day-to-day loans. Thus at the beginning of the busy season the *hundi* rate would usually be higher than the Bank rate, the reverse being the case when the slack season is about to begin, so that the *hundi* rate may be said to be a sort of long-distance signal. When the bank finds that it is not getting enough *hundis*, and its money is lying unemployed, it puts down the *hundi* rate. When on the other hand it feels that it has already got too much money in the bazaar, or for some reason or other wishes to consolidate and conserve its recourses, it puts up the *hundi* rate and may

even go to the length of refusing to buy new *hundis*. No cases have come to official notice of a Presidency Bank making a wholesale refusal to renew *hundis*, although it may charge a rate considerably higher than that at which the original *hundi* was discounted. On special occasions, when the bank is very hard pressed for money, it may impose a prohibitive rate on the bazaar so as to enforce shroffs to endeavour to raise money elsewhere rather than to renew their *hundis* with the bank.[1]

The note from which the above extracts are taken describes the amount of this kind of business done by the banks for a number of years ; and it is shown that on some occasions over a third of the bank's total advances have been represented by the purchase of *hundis* and proceeds.

[1] Appendices to *Report of the Babington-Smith Committee*, pp. 13-14.

CHAPTER XXXVII

INDIAN BANKING: GENERAL FEATURES AND DEFECTS

THE description of Indian banking institutions that has been attempted in these pages bears ample witness to the fact that there is a distinct lack of organisation and development about the money market in India. Our country has to face a world possessing highly organised and efficiently developed money markets with its own extremely rudimentary and undeveloped banking institutions. It is a truism that lack of adequate provision of capital is largely responsible for the absence of industrial development as well as for low agricultural productivity in this country; and this cause is itself the effect of the absence of an adequate banking organisation and a properly organised money market.

When we examine the banking system as a whole, one feature thrusts itself at once upon our attention, which is that banks in India are marked off into different types, each doing a definite and distinct kind of business. In practice, there is undoubtedly overlapping of work as between the various types of banks, but in the main the differentiation of functions is too well marked to escape notice. The Imperial Bank of India acts as a banker to the Government of India and transacts the business of the Government. It holds Government balances without payment of interest. The Imperial Bank also finances the internal trade and commerce of the country to a certain extent, and this part of its activities is likely to grow with the opening of new branches

all over the country. The Imperial Bank also acts to a limited extent as a bankers' bank; with its large liquid resources and its favourable position as holder of Government balances, the Imperial Bank in co-operation with the Government controls the money market in India through the Bank rate. It is, however, shut out, if not by regulations, at any rate in actual practice, from foreign exchange business, of which the Exchange Banks have a virtual monopoly. The business of financing the foreign trade of India is in the hands of these banks, which are protected by established and not easily assailable advantages, and Indian joint-stock banks have found it difficult to break the monopoly.[1] The joint-stock banks mostly confine themselves to internal trade and commerce, like the Imperial Bank of India, though some of them deal in foreign exchange to a limited extent. The Imperial Bank and the joint-stock banks transact business through the medium of English. The internal trade of India is largely financed by the indigenous bankers and the joint-stock banks. The co-operative societies and banks give credit to the agriculturists to a limited extent. The deposits attracted by the Post Office Savings Banks are made available to Government, whilst the premiums of insurance companies, which are mostly foreign, are available as deposits to the Exchange Banks or are transferred abroad. The majority of the agricultural population, as well as artisans and labourers in need of money, are financed by the village Sowkars and Marwaris.

It is thus sufficiently clear that the Indian banking organisation is a decentralised organisation. It is divided into watertight compartments. There is too much specialisation and too little co-ordination. As Lord Curzon observed as early as 1899, " In respect of banking

[1] Cf. Keynes: " It is probable, however, that it would be exceedingly difficult to start a new Exchange Bank at the present time, except under the ægis of some important financial house already established in a strong position in India" (*Indian Currency and Finance*, p. 208).

it seems that we are behind the times. We are like some old-fashioned sailing ship, divided by solid wooden bulkheads into separate and cumbrous compartments." [1] There is no fluidity in the money market. There is no one reservoir into which all streams can flow, and from which all the waters can be let out, to fertilise trade and commerce and industry. We have instead a banking system in which the waters of each stream are limited to its own narrow and not very extensive channel; each bank has to keep a reasonable amount of till money and reserve, and in the result all the banks lock up a considerable amount of money which would otherwise circulate in the shape of credit, irrigating large areas of hitherto undeveloped productive resources.[2] The amount of till money and reserve locked up in this way must in theory be at any rate greater in proportion to the total liabilities, in a country like India, than in other countries with a more highly developed system of banking and less liable to frequent moods of distrust and panic on the part of depositors. What we want in India, as in other countries, is a centralised single reserve system of banking, with the Imperial Bank of India as a bankers' bank. The cash reserve of the Imperial Bank might serve as a central reservoir from which all other banking institutions might be supplied with cash or credit, and to which all the surpluses of the banks might flow. Such a co-ordinated system might secure other advantages. The Imperial Bank, through its dominant position, might exercise some kind of control over all other credit institutions when these were inclined to extravagance, and might even stimulate them when they were sluggish.

[1] Speech made while presiding over the Imperial Legislative Assembly, September 1, 1899.

[2] "There is a multiple reserve system in theory but hardly an adequate one in fact; and a danger exists that every one is reckoning, in a crisis, upon every one else" (*Indian Currency and Finance*, p. 237).

Lack of Banking Habits, and the Practice of Hoarding

Banking in India, in the strict sense of the expression, has not yet reached the masses. When we inquire into the conditions that account for the lack of banking habits we have first to realise the absence of facilities for banking.

India has an area of 1,802,657 square miles, and it contains 2253 towns with 29,748,228 inhabitants, and 720,342 villages with a population of 285,406,168. On December 31, 1917, the total number of banking offices in India was only 402, and many of them overlapped in the larger towns. In fact, on that date there were in the whole of India only 165 towns which had bank offices. The United Kingdom, with a population of 48,000,000, had 9138 banking offices. Canada, with a population of 8,460,000, has about 4000 bank branches. Furthermore, there are 294,875,000 illiterate people in India, and out of the 18,539,578 literates there are only 1,670,387 literate in English.

The vast and scattered population of India has thus modern banking facilities at 165 stations only, and consequently the financial power of India is insufficiently mobilised. Money lies dormant in endless small hoards. . . . It will be seen that there is a vast virgin field for the development and expansion of banking, and for the collection into bank reserves of the innumerable stores of money lying idle throughout the country, which could be utilised for the benefit of the holders and for the good of trade and of the State.[1]

[1] Babington-Smith Committee (Currency and Exchange), 1919, Minority Report by D. M. Dalal, paras. 75-77. Since 1917, to which Sir Dadiba Dalal's figures refer, the number of banking offices has increased to 566 in 1923, and the number of towns with banking offices has increased from 165 to 206 in 1923. "There are thousands of commercial centres in India where no stable banking institutions exist, and where, lacking sound places of deposit, the Indian with small capital at his disposal must either keep it in the form of notes, gold, silver, or ornaments, or entrust it to the local money-lender" (Sir Stanley Reed's Memorandum submitted to the Babington-Smith Committee, Appendices, p. 130). Sir Stanley Reed's evidence is more forcible than his written statement: "I was talking to the chief minister of one of the important cotton states in India, and he told me he could take me in his small capital into a score of houses in not one of which would there be less than from two thousand to three thousand coined rupees. There is in that town absolutely no bank, no credit institution, no stable

The lack of banking facilities in this country may also be indicated by the fact that the deposits per head in British India in 1923 came to only Rs. 6-3-0, as compared with the £58-6-0 per head of the population of England and Wales in 1921.

The problem of the supply of capital in India has two aspects : (1) There is the question of mobilising available savings, and economising and utilising these savings for national purposes, for the development of her agriculture and industries ; this includes measures for encouraging thrift and habits of investment and banking. (2) There is the question of increasing the amount of available capital by affecting those who are in a position to save and by increasing the national dividend. The capital available for investment depends upon these two factors. The second of them opens up the larger question of increasing the national dividend by measures securing the development of India's potential resources. Nobody suggests that capital can be accumulated, and the accumulations made to go on increasing, by the simple device of opening more bank branches in various centres and offering more banking facilities. Where a large majority live on less than the bare minimum necessary for physical efficiency, such savings as are possible would be absorbed in raising the standard of living and in procuring the decencies of life ; and the provision of greater facilities will not of itself increase the accumulation of capital. But whilst we readily recognise the impossibility of adding substantially to the savings of the people by a mere extension of banking facilities, we must also recognise the possibility of effectively mobilising such small and scattered savings as do exist by means of the development

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credit organisation, in which one of these men can put one of his rupees. In a single cotton district in the Bombay Presidency in 1917, an additional four crores of rupees was moved in order to finance the cotton crop ; and in that district there was no branch of a bank. Much of this large mass of inert currency must come out for investment if proper banking facilities are given for its deposit." (Question No. 4217.)

of banking.[1] This can partly be achieved through the extension of the Post Office Savings Banks.[2] It could also be achieved by the agency of the village accountants, whose services might be profitably used for the sale of interest-bearing certificates for five years, or even shorter-dated, if the procedure for their sale is simplified.

Sir Stanley Reed was perhaps a little too optimistic and was preoccupied with the industrial boom conditions of war-time, when he observed that there was no shortage of capital in India, and that the supply of capital in India was in excess of the opportunities of conservative investment.[3] None the less, there is no doubt that the potentialities of the small-account system in banking have not yet been recognised in this country, and that bankers have not yet realised the need for catering for the small man.[4]

In the second place, we must remember the illiteracy of the vast majority of the people. Where only a million and a half out of the total of 300 million people under-

[1] " India is full of money and self-contained enough to supply all funds necessary for the expansion of its railways and irrigation systems and for the development of industries. We are of opinion that year after year India will be able to spare increasing sums of money for the building of railways, canals, and industries, and for provincial developments. Unfortunately the money power of India is not properly mobilised " (*Report of the Bombay Committee of Inquiry into the Rehabilitation of Government Securities* (1919), paras. 28 and 29).

[2] " Savings banks are attached to certain post offices only. I could not give you accurate data, but I am quite certain that in many cases a man would have to walk 12 or 15 miles to a savings bank to deposit his money, and walk an equal distance back again; that is to say, he would have to make a journey of perhaps 30 miles in order to bank his money, which he is not likely to do " (Evidence of J. Campbell, D.C.S., before the Chamberlain Commission. Question No. 3745).

[3] Question No. 4227.

[4] " If we cater for the small man, I believe we can develop Indian banking to a degree which may now seem almost inconceivable. As I go round England, I see branches of the great joint-stock banks in all the small towns and even at many of the great military camps. In India one of the Presidency Banks talked for years about opening a branch at one of our greatest military centres. I do not know if that branch has been opened even yet " (Sir Stanley Reed's evidence, Question No. 4218).

stand English, the need for using the vernacular for all banking transactions, including the drawing of cheques and keeping of accounts, is of supreme urgency if we aim at bringing about the spread of banking habits among the mass of the population.

Monetary Policy and Locking Up of India's Gold

Still more potent is another factor, which is apt to escape notice because it is psychological in its operation, and which is conveniently overlooked or likely to be overlooked by those whose minds are obsessed by the idea that the monetary policy of the Government has contributed substantially to the economic welfare of India. To deposit one's savings in a bank argues confidence in the institution, and also confidence in the stability of the purchasing power of the monetary unit. It is paradoxical that the monetary system of India, which is alleged to have been devised for economising the precious metals and strengthening and mobilising the money power of the country—a system which its advocates claim to be " scientific ", and a revelation to a bewildered Europe of a successful method of escape from its perplexities—should have resulted in a total dislocation of her monetary resources, and, by shaking confidence in the stability of the unit of value, should have accentuated the process of hoarding ; nevertheless, it is undeniable. We cannot have a sound and highly developed banking organisation without a sound monetary system. Banking and credit go together ; they are rooted in psychological conditions, and they presuppose confidence. The legal definition of the monetary unit is one of those sacred and inviolable traditions which enter into the very fabric of civilised life ; and a Government which tampers with those traditions, which alters from time to time the meaning of the monetary standard, shakes the very foundation of the social economy. The light-hearted

methods of experimentation which mark the currency measures of the Government have been responsible for the slow development of banking habits, and have deprived India of the benefits, not only of the gold reserves that stand to her credit in London, but of the vast amounts of gold that she absorbs every year as the result of a favourable trade balance.[1] For the alleged purpose of stabilising the exchanges, no less than £40,000,000 belonging to the Gold Standard Reserve are located and invested in London. Similarly, about £20,000,000 belonging to the Paper Currency Reserve are locked up in investments in London. Admittedly, India earns interest on these investments, but the same amount of money can obviously earn a much higher rate of interest if invested in the Indian money market. What is more, the earning of interest is a small matter compared to the immense benefits that India would obtain if this huge amount of gold centralised in the hands of the Government were made available to the banking world for the financing of Indian industries, the development of her agriculture, and the fostering of her trade and commerce.

Internal Absorption of Gold

More important than the loss arising to the country from this external hoarding of gold is the loss from the annual absorption of vast quantities of gold that disappear

[1] " It is sometimes said that a greater development of banking would cure the currency trouble. That seems to me to be putting the cart before the horse. The first essential to a great extension of modern banking is a currency system which inspires the public with absolute confidence. A credit system cannot overcome the difficulties arising from a system of money which is liable to violent changes in the valuation of the different forms of money of which it is composed, such as the present alteration of the ratio of rupees to the sovereign. No credit system could cure that fault in the money on which it rests. On the contrary, unsound money would imperil the credit system. Hence, in my opinion, the need for making the money system in India a specially sound and strong one if the money resources of India are ever to be mobilised in a great banking system" (D. M. Dalal, *Minority Report on Indian Currency and Exchange* (1919), para. 78).

from circulation and are not available, as they otherwise would be, for the development of her economic resources. This is largely the result, as we have already indicated, of the monetary policy of our rulers. Now the annual absorption of gold for non-monetary purposes—and it is not quite easy to distinguish between the use of gold in the arts and the simple hoarding of gold—is not by itself so economically harmful as people sometimes imagine.[1] It becomes harmful to the economic interest of a nation only if, with an unfavourable balance of trade, banking institutions are not able to draw the gold from the hoards and from its use in the industrial arts. The hoarding of the precious metals is not a peculiarly Indian vice; they are absorbed by the Western nations with as much greed and readiness as by the Eastern. With a population constituting 19 per cent of the total population of the world, the consumption of 20 per cent of the world's production of gold is neither unnatural nor sufficiently large to justify the imputation of a harmful and vicious habit. This was the average consumption of India during the five years immediately preceding the war. "Between the years 1890 and 1910 the United Kingdom, the United States of America, Germany, France, Italy, and India absorbed among them £809,100,000, of which India accounted for £126,000,000. It may be interesting to note that whereas the net addition to the banking reserves of the five European countries came to £306,610,000, during the same period their absorption for 'other purposes' reached the high figure of £465,839,000. In other words, the most civilised European Powers, who have no 'insane' desire for the precious metals, are in

[1] We confess that it is somewhat difficult for us to reconcile the view that gold is a barbarous relic of a primitive age, and thoroughly useless for monetary purposes, with the view that India is a bottomless sink of the precious metals and is responsible for the waste of enormous quantities of gold that disappear from circulation. There is no harm in hoarding a useless substance. If, however, hoarding is so harmful, it is evidently because the substance thus hoarded is far from being a "barbarous relic".

the habit of absorbing for other purposes 50 per cent more than they do for bank reserves." [1]

The absorption of gold by India is not disproportionately large in view of her population.[2] Being, like the United States of America, a creditor country, she has naturally drawn the precious metals in final adjustment of her trade balances. The United States absorbed nearly £500,000,000 worth of gold from 1915 to 1923. But the difference between the United States and India in the matter of gold absorption is well marked. The gold absorbed by the United States is partly centralised in Government banking reserves, and it is always available for export in times of need. In the case of India, with her unfortunately contrived monetary system, the gold absorbed is diffused; no attempt is made in the general interests of the country to centralise the annual imports of the precious metal, even in part, and those who come into possession of it are unwilling to relinquish it simply because they feel that they will not get it back when they want it. "For a country which takes gold in great quantities, an extensive token currency is most unsuitable. It has the usual effect of driving gold out of circulation. It has the still greater disadvantage that it keeps the gold out of useful employment. People who value gold so highly as to store and hold it to the extent witnessed in India are not likely to invest or make other profitable use of it, so long as they have to take the risk of being repaid in token coins when they realise their investments. The token currency not only prevents the holders of the gold from utilising it to some advantage, but the country as a whole loses the benefit that should accrue to it from the possession of great wealth. While, therefore, the process of education in the use of economical

[1] Memorandum of evidence by S. K. Sarma submitted to the Chamberlain Commission (Appendices, pp. 122-23).

[2] See *Report on Indian Currency and Exchange* (1919), para. 63: "We do not therefore consider that the quantity of gold taken by India for all purposes in the period before the war was disproportionately large in relation to her economic condition".

forms of currency is proceeding, the probabilities are that the people will none the less continue to amass their growing wealth in solid gold. . . . It seems to me that it is not to the interest of India to have its rapidly accumulating wealth diverted into idle hoards by the token currency policy." [1]

Banking development, currency measures, and the general monetary policy are closely interdependent, and where the monetary policy is directed towards the stabilisation of exchanges for the convenience of one section of the people, we cannot hope to see banking facilities extended, or the industries and trade of the country fostered by a sensitive, elastic, and responsive money market.

Industrial Banking and Finance in India

Our present Indian banking organisation is exclusively a system of commercial banking. We have already referred to the fact that the Imperial Bank of India is debarred by law from lending for more than six months, and in actual practice it lends for still shorter periods. The Exchange Banks, by the very nature of their dealings, never lend for more than six months, and the Indian joint-stock banks follow the same policy. The only institution worth naming in the field of industrial banking was the Tata Industrial Bank, which was never industrial in the strict sense of the term, and which was finally amalgamated with the Central Bank of India. During its brief existence it suffered either from too close an association in the directorate of men directly connected with the flotation of large enterprises in the boom period, or from the lack of expert local advice in lending to small concerns. It is regrettable that a vast country like India, with such potentialities for industrial growth, should not have even one great industrial or investment bank. As

[1] Sir James Begbie's note appended to the *Chamberlain Commission Report* (1919), paras. 6 and 10.

in other matters, so also in banking, India has under the influence of British rule reproduced in her banking organisation the characteristics of the English system, without the slightest reference to her own requirements. India's banking needs are like those of Germany.[1] Like her, she is called upon to replace her old productive apparatus and technology by a new up-to-date technology, requiring an amount of capital which is not easily available. The problem of Germany and Japan after 1860 was of a similar character, and it was solved in a satisfactory manner by the development of both commercial and industrial banking side by side. These two countries owe their economic and industrial development *inter alia* to the presence of an efficient and highly organised and developed system of industrial banking.[2] It is banking that fosters

[1] " If some day sufficient constructive energy is stirred into activity to undertake the task, let the framers of the new Bank's constitution put far from their minds all thoughts of the Bank of England. It is in the State Banks of Europe, especially in that of Germany, or in those, perhaps, of Holland or Russia, that the proper model is to be found" (J. M. Keynes, *Indian Currency and Finance*, p. 239).

[2] The period following the foundation of the German Empire witnessed a vigorous development of German industry. At the same time German foreign commerce kept on steadily increasing. Under such conditions, the economic policy of the banks of placing the funds entrusted to them at the service of the new development must be regarded as perfectly proper. The banks furthered this development by forming stock companies, granting long-term credit, assuming shares and bonds, placing the new industrials on the stock market, and selling them to the public. There is no doubt that but for their policy of furthering industry the economic development of Germany would have taken considerably longer. To obtain the means for granting industrial credit, and to dispose of the enormous amounts of newly created industrial securities, it was and is necessary to attract in as large a measure as possible the surplus funds of the community available for capital investments. For this purpose the joint-stock banks spread a network of deposit branches destined to serve as reservoirs for the inflow of available funds, and at the same time as distributors for the industrial securities created. It cannot be said that the banks created our industries. It is true, however, that the creative power which in a comparatively short time placed German industry in its present commanding position took its origin in the men who put to practical use, and in the interest of economic progress of the nation, the achievements and inventions in the domains of science and technique. It is the

international commerce ; high finance has to-day assumed a dominant place in economic civilisation. The bankers control the machinery which makes production on a large scale possible, as well as the exchange and distribution of this huge production. Economic development on modern lines is almost an impossibility without an adequate and well-organised system of industrial banking, which can make the surplus resources of a nation available for long terms, and for productive industrial enterprise. Industrial banking in India is still unknown ; it has yet to be evolved, and it is a pity that the one bank which was started for this purpose should have come to so rapid an end because it neglected its proper functions, even dabbled in exchange, and got involved in obligations incurred for lack of reasonable caution. It is equally regrettable to find the chairman of the bank urging in justification of the discontinuance of the work for which it was brought into existence, that " industrial banking is premature in India ".[1] If there is one country in the world where the field for industrial banking is virgin and hopeful, it is India. The need for industrial banks has been felt for a number of years. The Industrial Commission recommended their establishment. A resolution was moved in the Legislature not long ago, and the Industries Advisory Board recommended that they should come into being. But the wheels of Government move slowly, and the country will have to wait till hope is translated into actuality.[2]

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undisputed merit of the persons at the head of the banks that they supported those endeavours by advancing the requisite capital, often incurring great risks for the banks (abbreviated from Phillips, *Money and Banking*, pp. 533-34).

[1] The Tata Industrial Bank dealt in commercial banking business from a very early stage of its existence.

[2] Cf. Findlay Shirras' Memorandum submitted to the Indian Industrial Commission (*Minutes of Evidence*, vol. v. pp. 814-15) : " After the war Indian industry will require financial assistance in a fairly large way because (1) new schemes for the development of industries will demand and receive more encouragement than hitherto, (2) old industries will require to be renovated or overhauled, and (3) in order to enjoy the economies of large-scale production, such industries

In the absence of industrial banking, the existing banks, which are purely commercial banks, find themselves gradually involved in a type of work meant exclusively for industrial banks, with the result that the commercial banks and the industries financed by these banks alike suffer. Industrial development in this country has to depend on the deposits of commercial banks which

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will have to be conducted on a much larger scale. This means that the organised aid of banking, especially in the higher direction of Indian industry, will be advantageous if not essential. The problem before us is to discover whether the undoubted merits of the German system of co-ordination of industry with finance can be secured, due allowance being made on account of dissimilarity in local conditions, whether, in short, the example of the German credit banks (Grossbanken), which undertake the responsibility for industrial issues, could not be followed in the development of industrial financing in this country. Indian banks do not accept any responsibility to the public as regards issues of any sort. The German credit or commercial banks, on the other hand, undertake the responsibility for industrial issues, and this is the keystone of their close relations with German industry. In the so-called 'heavy' industries and in the light industries these banks have been not only financial advisers, but in some cases even controllers of industrial concerns. They carry through the organisation and the promotion of industrial concerns; they examine and nurse new schemes until they are ripe for public investment. In Berlin all the bankers are members of the Stock Exchange, and it is part of a German bank's business to act the part of a stockbroker. These banks encourage new undertakings and allow acceptances and acceptance credit to be freely used. The Grossbanken are, as it were, the General Staff of German industry, the brains of the industrial army. . . . It is true that Indian banks are, so far as strictly banking and temporary assistance to industry are concerned, fairly liberal; these are deposit banks, the watchword of which must be safety and liquidity. . . . There are two other advantages of industrial banks on the Grossbanken model; the first of these being that the company promoter is not left, as in India, with new schemes. The company promoter is concerned mainly with the success of the issue and is often regardless of the future welfare of the business. The expression 'company promoter' has sometimes a sinister significance to the investing public, and he does not always bear the imprimatur of an institution which would guarantee that the business has been thoroughly investigated and will be looked after when the issue has been made. The other advantage is that, if financial assistance to industry on the part of Government is deemed to be necessary, industrial banks are convenient media through which such assistance can be most safely given."

can lend out money for short terms only. Deposit banking is meant mainly for financing commerce; it can supply working capital for short terms to finance trade; industries, on the other hand, require long-term loans. The commercial banks find themselves drawn into lending to industrial concerns, and whilst the genuine and growing commercial needs of the country are to this extent starved, the banks, having neither the inclination nor the time nor the knowledge to scrutinise the value of lands and buildings, machinery and raw materials, either refuse to accommodate the industrialist on such security as he offers, or find themselves involved in transactions of an imprudent character from the point of view of commercial banking. It is thus a characteristic weakness of our money market that, whilst the needs of the commercial section of the population are not met, the industries are also starved for want of sufficient long-term accommodation; and added to this is the risk to the commercial banks of lending their money on securities which cannot be easily converted into cash. There is a still more vicious practice into which circumstances have forced industrial concerns in India. In the absence of industrial banking, much of the working capital, if not the fixed capital, of these concerns (as in the case of the textile industry in Bombay and elsewhere) was obtained in the past by the short-term deposits of people who treated these concerns as banks and placed their money with them on interest. The events of the last few years have violently shaken public confidence in these concerns, with the natural consequence that one great source of accommodation has now been practically lost to industrial enterprises. Not that the continuance of this system was healthy in itself; but that at times when even commercial accommodation is difficult to obtain, the industrial concerns could not draw upon the savings of the middle classes, and mobilise them, as they were accustomed to do in the past. This aspect of the question is sufficiently emphasised by the Finance Member in a recent speech: "Far too large a

proportion of the capital used by industrial concerns in India is obtained on short deposit. This leads to many evils. An industrial concern ought not to be in the position of being liable to have to repay to the lender on demand or at short notice any part of its capital, which it has locked up in bricks and mortar and plant, or which it requires for the purpose of day-to-day working capital. So long as it runs the risk of a sudden demand to repay deposits, an industrial concern, however well managed, and however adequate its rates of profits, may be forced to close down by some unforeseen monetary development leading to a general demand on the part of depositors for the return of their money. The habit of using short deposits to provide capital for industrial concerns has the further disadvantage, that it restricts the supply of good industrial securities—shares, preference shares, debentures —available for the ordinary investor, and unduly narrows the market for such investments. Further, the deposit habit is, to my mind, injurious also to the growth of banking in India. An industrial concern which is taking considerable sums on deposit is really doing banking business of a kind for which it is not equipped and in which it is not experienced. At the same time the banks, who are the natural middlemen for the management of money on short deposit, and ought to be skilled in the problems of maintaining liquid resources, and judiciously making short-term loans, find their natural business unduly restricted. Finally, the losses which must occur in a crisis or a panic owing to money lent on short deposit being locked up in fixed capital assets, must tend to frighten many Indians, both from investing in industrial shares and from putting their money on deposit with a bank or any one else at all. If the machinery of industrial finance is to keep pace with the demands of modern times in India, this habit which is sanctified by long years of practice will have to be modified." [1]

[1] Sir Basil Blackett's speech on opening the Calcutta branch of the Central Bank of India, July 24, 1924.

The one great weakness about this practice of borrowing on the part of industrial concerns is the precariousness of their finances. In a country like India a slight rumour about any concern ends in a rush ; and whereas a bank may be able to withstand a rush of this kind with the help of the credit of other banks, an industrial concern has no liquid assets, and can only go into liquidation even though it may otherwise be sound. This practice of borrowing by short-term deposit has grown up by reason of the absence of adequate banking facilities, and also because people prefer to entrust their savings to an industrial concern they know rather than to a bank whose transactions are carried on in English, and whose methods of working are strange and unfamiliar. The only way out of the difficulties created by this practice is for industrial concerns to give it up and to borrow money from commercial—and preferably industrial—banks. Deposits in banks run on sound principles are safe investments, and banks can meet sudden demands more readily than industrial concerns. The old practice is already being gradually abandoned, and its total abandonment will mean greater stability for industries, greater security for private depositors, and to some degree an extension of banking habits.

India is on the threshold of industrial development ; it is to her interest to accomplish the transition to industrialism in as short a time as possible. But all her efforts will be futile so long as there is no adequate supply of industrial and working capital. We may build a tariff wall as high as we please, and clamour for Government purchase of Indian stores, but measures like these may at the best direct attention away from the main issue, at the worst react unfavourably on the general interests of the country. At present there is no adequate provision for industrial capital, and one of our urgent needs to-day is the development of industrial banking, with a view to increasing the capital available for industrial purposes, and for the adequate mobilisation of her capital resources.

The industrial development of India depends, in the first instance, on the availability of Indian capital; if this is found inadequate after all resources have been tapped, the country may legitimately borrow foreign capital on its own terms.

CHAPTER XXXVIII

ADEQUACY OF THE MONEY MARKET IN INDIA

FACTORS THAT RETARD INDUSTRIAL DEVELOPMENT

1. *Shortcomings of Indian Enterprise*

WHILST we plead for the necessity of developing industrial finance, we must not leave out of account a few factors that have complicated the situation and made industrial development difficult and slow. Amongst these factors we must include the lack of foresight and insight on the part of those who are responsible for the organisation of Indian industries themselves. The history of the cotton textile industry in the Bombay Presidency bears ample evidence of what one might call the total lack of organisation and brain-power on the part of those who control it. The textile industry in India possesses to-day all the advantages, natural and acquired, that an industry is capable of enjoying—and if, after sixty years of existence, it complains piteously of competition from Japan and Lancashire, there must be something radically wrong with its management and organisation. There is no common national purpose behind the management, no such steady vision of a growing national industry as can inspire a readiness to sacrifice immediate advantages to the larger but less tangible advantages of a rather distant future. There is the amazingly unwise system of appointing managing agents who charge a heavy commission, not on profits, but on the out-turn. The war brought with it opportunities such as can occur only once in a lifetime. The immense profits earned by the industry

were foolishly frittered away in the payment of dividends to shareholders, in some cases in amounts equivalent to the total capital subscribed. No attempt was made to renew the machinery or provide for repairs. The managers and directors behaved in a manner which can be understood only on the assumption that they believed that the profits obtained in war-time would be continued for ever. The years of depression that have followed have reacted terribly on the investing public, and those who have invested in textile concerns now find that they do not even receive such interest as gilt-edged securities can afford.

A number of industrial and commercial concerns were started in India during the war, some of them of questionable soundness. Very many of them went into voluntary liquidation before starting work, and the unwary shareholders asked to subscribe the capital in advance found themselves without a legal remedy. If rapid and successful industrialisation is to be achieved in India, we want a body of directors, promoters, and entrepreneurs of joint-stock concerns who would realise their responsibilities, not merely to the small body of shareholders, but to the larger public, who would understand that they are trustees of the national savings which they have been able to mobilise through the machinery of the financial market, who would inspire confidence by their foresight and by their vision of a great national purpose.[1] Otherwise the result can only be such a shaking of public confidence in industrial concerns as we have already beheld, a loss of confidence manifested by the rapidity with which Government loans have been over-subscribed, and by the increasing sales of Post Office cash certificates.

[1] Cf. *Capital*, February 12, 1925: "They" (the members of the Legislative Assembly) "seemingly cannot and will not open their eyes to the fact that the vast majority of Indian financiers are gamblers or usurers for whom a slow and small-profit-producing investment, even gilt-edged, has few charms; secondly, that Indians have still much to learn in many processes of manufacture, and also, let it be said, in efficient and honest management".

It does not bode well for the success of Indian industries in the immediate future that a firm like the Tatas, which had inspired confidence by its enterprise and foresight, should have lost that confidence within the last few years, partly through entanglements it might have avoided, mainly because of that lack of a sense of responsibility to the country at large which made it rush into the floating of concerns of a questionable character. In a country like India, which is about to enter on an era of industrialism and large-scale production with every prospect of success, and where one of the fundamental obstacles in the way is the lack of capital, it is of the first importance that those who are responsible for the handling of industrial capital should understand that they are trustees of money that comes out of the savings of the small investor, and that on the right use of this capital depends, not merely the amount of dividends to be earned by a relatively small class of shareholders, but the future of Indian industrialism itself. And if private enterprise and capital do not rise to the occasion and become alive to the great national interests at stake, it is better that the Government, it may be an alien Government, should mobilise the capital resources of the country and undertake the working of big national industries, with the general interests of the country in view, than that private capitalists and entrepreneurs should waste in their individual efforts the slender capital resources of the country, guided by no broad vision or national purpose and following the old discredited paths towards the sole objective of earning large dividends for a small class of shareholders.

2. *Government Borrowing.*

The problem of industrial finance in India is further complicated by the fact that the Government of India is the greatest borrower in the Indian money market. This borrowing is partly for ordinary revenue purposes, but mostly for capital expenditure. In the words used by the Finance Member in his Budget speech in 1924 :

"India is a country where, as it seems to me, there is an almost unlimited field for new capital expenditure on new development. Every one admits, however, that India is only at the beginning of her industrial development, and it is out of her capital resources, *i.e.* out of her accumulated savings and her new savings, that capital to develop India industrially must be found. We have borrowed all that we could borrow in India and in England during the last few years for capital expenditure purposes. Yet we have spent 100 crores out of capital in the last five years in financing deficits, thereby diminishing to a corresponding extent the resources available for developing India. If recourse to inflation is ruled out . . . the money to meet the annual expenditure of India, whether on capital or on revenue account, must come out of the savings of the country. The only exception to this statement is that some of the capital may be borrowed abroad. . . . But the amount that India can borrow abroad is limited both by the amount available abroad . . . and by the capacity of the borrower to meet the annual charges for interest. These annual charges for interest are in effect a claim on the future resources of India, and ultimately come out of the same pocket as the money required to meet the rest of India's expenditure, *i.e.* out of the savings of the people. To sum up, the deficits of the last few years have brought in their train a certain amount of taxation by inflation, a heavy annual charge on the present and future budgets of India, a deterioration in India's credit, an increase in the costs of borrowing, and a depletion of the resources available for desirable capital development."

The amount of surplus capital available for investment from year to year in India is limited, and when the Government itself enters the field as a borrower on a large scale at a reasonable rate of interest, investors will naturally prefer Government loans to loans of industrial concerns in which they have no confidence.[1] Not only has the

[1] "When the Government is the greatest borrower at a tempting rate of interest, it is but natural that the few who could invest would

Government of India borrowed heavily during recent years for unproductive purposes—to meet deficits on the ordinary revenue accounts—but it proposes to borrow large sums in the immediate future. The Finance Member has recently informed us that the sums required for development, including loans to Provincial Governments, in the five years 1925–26 to 1929–30 inclusive, would amount to an annual average of 20 crores for the Provinces and 25 crores for railways. If to these sums were added the 19 crores required for meeting maturing loans, then the total of 300 crores of rupees, or 60 crores annually, would be necessary during the next five years to meet their requirements. The bulk of this amount would have to be borrowed or reborrowed. The Finance Member estimated that about 20 crores of rupees on an average would have to be borrowed in the open market every year. He emphasised that this was an average, and he saw no reason why from her annual savings India should not be able to finance this annual loan. If this amount was not forthcoming, then the alternatives were either to slow down development, which would be a short-sighted policy, or to borrow abroad. There was no harm in moderate borrowing externally for productive purposes, but they must not unduly strain India's capacity for payments abroad. It was, however, always better to construct railways or canals by capital raised in India.[1]

This is the declared policy of the Government of India. It is to be a heavy borrower for years, and the borrowing is to be for purposes of railway development and the construction of canals. It has been asserted over and over again that the total national dividend of India is comparatively low, and the available annual surplus capital which constitutes the savings of the people is a

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not invest in industrial concerns. Where the masses are so conservative they prefer a low but safe and present rate of interest to an uncertain higher and future rate of interest" (Wadia and Joshi, *The Wealth of India*, pp. 115-116).

[1] Proceedings of the Legislative Assembly, January 1925.

definitely limited amount, not exceeding, say, from 12 to 15 crores of rupees on the most favourable estimate—apart, of course, from the gold absorbed by the people, which is not available for productive purposes, partly owing to the customs of the people, but mostly owing to the lack of banking facilities and to the defective currency system. If under these circumstances the Government stands out as the largest borrower at a reasonably high rate of interest, people whose confidence in industrial concerns has been so violently shaken during the recent depression will prefer investing their money in Government loans to investing in private joint-stock concerns. It is a commonplace in economics that the industrial development of a country is limited by the supply of capital, meaning by that expression not merely the surplus cash annually available from the savings of the people, but also the credit that may be raised by sound banking. In India the creation of industrial credit is, as we have already indicated, difficult if not impossible under the existing banking and monetary organisation; and the cash capital which is available through the savings of the people is to be absorbed by the Government of India.[1] What scope or opportunity can there be for the play of private enterprise in the field of industry under these conditions? Where private enterprise and the Government are competitors for capital within a money market where the total capital available for investment is limited and the investors are timid and conservative, private enterprise has not the remotest chance against its rival.[2]

[1] Sir Basil Blackett thinks that the annual savings available for investment in Government securities amount to more than 12 crores of rupees. In his Budget speech (1925–26) he said: "In India I anticipate that the maximum amount of new money that we shall require to raise by a rupee loan in the open market will be twelve crores, a figure which is well within the amount of annual savings of India available for investment in Government securities". It is a pity Sir Basil does not tell us what sum would be available from the annual savings of the people for investments other than Government securities.

[2] Sir Stanley Reed, in his evidence before the Babington-Smith Committee, observed: "We have for years in India been talking about

So also, with dear money throughout the year, with a discount rate of 7 and 8 per cent, it is extremely difficult for Indian industries to find working capital. The shortage and dearness of working capital has been intensely and bitterly realised during the last three years; and this stringency of money for private enterprise is accentuated by the exchange policy of the Government, bent on attaining and maintaining a higher rate of exchange than 1s. 4d., despite the evil effects we have shown such a policy to have upon the economic life of the people. In conditions like these it is not difficult to realise why private enterprise in industry cannot flourish. Our legislators in the Assembly may play with protective tariffs and bounties, and spend themselves in petty squabbles about Provincial contributions; all this will do nothing to help industrial development. No industry, however well established, can flourish in a country where the available surplus capital is absorbed by Government borrowing, and where the exchange policy of the Government creates an artificial stringency of money by drying up the channels of the country's economic life-blood.[1]

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the timidity and inadequacy of her supplies of capital. I believe that proposition is totally unsustainable. I would go so far as to say that even for years before the war, the amount of capital in India available for investment was in excess of the facility for safe and conservative investment, and I would prove that up to the hilt by reference to the price of any first-class securities quoted in the share market of Bombay. Before the war Bombay industrial securities were sold on the basis of an average dividend of six per cent. Is that conceivable in a country where there was a shortage of capital? Five per cent feeder railways invariably went from 15 to 20 per cent premium on the day of their launching. Is that consistent with a shortage of capital?" (Q. Nos. 4227 and 4228). Sir Stanley Reed was in the first place influenced by the phenomena of superfluous money in war-time, and as for the pre-war days, the industrial securities on whose prices Sir Stanley based his remark were either bank or textile shares which commanded public confidence, and for which there was a ready market in Bombay. One need not be harsh in judging a friend of India who in so many ways saw more clearly through currency complications than his contemporaries.

[1] Whilst closing this part of our discussion we cannot help referring to one more practice of the Government of India, that of issuing Treasury Bills of three or six months' duration, generally offered to the

It is extremely remarkable that a country with a favourable balance of nearly 103½ crores in ten months should experience a discount rate as high as 9 per cent, and that this discount rate should be raised from 5 to 6 and 7 per cent as the balance in favour of the country increases. In other countries, a high Bank rate follows on an unfavourable balance of trade, and the rate increases with every increase in the amount of the adverse balance. In India the rate of discount is raised with every rise in the balance in favour of India. It has been pointed out that "it would be truer to say that the object with which the Bank of England raises its rates is to protect its cash balance by checking the demand for, and increasing the supply of, immediately loanable funds, thereby setting up a tendency towards a fall in commodity prices, and an increase in the exchange value of sterling. The final result may frequently be, when sterling has a stable ratio to gold, the attraction of gold from abroad. This, however, is a symptom of the successful attainment of purposes with which the Bank rate was raised, rather than an object in itself. If the position is carefully analysed, it will be found that movements in the Bank rate in India have very much the same general purpose as in England." [1] As a matter of fact, when the trade balance is in India's favour, and when the country naturally wants more money for financing its trade and meeting its commercial requirements, it is refused its legitimate demands because the rate of exchange has to be maintained; and the Bank rate is only a symptom of the monetary disease.

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public at a discount, at a reasonably high rate of interest. This practice came into vogue during the war, and has been continued since then. Where the investors are naturally conservative, and where faith in industrial concerns is temporarily shaken, Treasury Bills offer an irresistible attraction. There is no reason to-day for the continuance of this practice, and the only effect it can have is that of absorbing savings which might otherwise be available to industries through the banks.

[1] Finance Department's Reply to the Letter of the Bengal Chamber of Commerce, July 16, 1924.

One of the urgent needs of the country to-day is the entire reconstruction of the monetary system with a view to concentrating and mobilising its capital resources for its economic development.[1] The monetary system, the issue of paper currency, and the organisation of banking should all be inspired by a common purpose, that of meeting the country's monetary and credit requirements, providing an elastic currency, and economising and strengthening to the utmost our meagre capital resources. What we need and would welcome is a conscious control over the whole Indian money market, exercised in the general economic interests of the country. This control could be exercised through the manipulations of the currency, through the paper currency and banking. " After all, the financing of industry and trade should be the main business of banking, using that term in its broader sense. It is the banking system which collects and concentrates the savings of the community: it should be its chief care to see that these are placed at the disposal of its own industry and trade under the best possible conditions for success." [2]

In the matter of banking, as in so many other departments, our rulers have drifted into a policy of mechanical reproduction of English institutions and methods, unmindful of the vital differences in the economic requirements of India and those of Great Britain. The history of the growth of German banking in the period between 1870 and 1910 has greater interest and more relevance for the needs of India than the history of English banking institutions. With the help of her bankers and financiers, " Germany has effected the surprising *tour de force* of securing her financial supremacy in foreign countries while locking up every tittle of her own capital ". Professor

[1] Compare Sir Basil Blackett: " If the hopes of those who have acclaimed the adoption of protection by India are to be realised, parallel efforts should be made to improve our technical education and technical equipment both in industrial matters and in the sphere of banking and finance " (Speech at Calcutta, July 24, 1924).

[2] H. S. Foxwell, *Papers on Current Finance* (1919), p. 112.

Foxwell recognises that "the intimate connection of German banking with German industrial life, while it has elements of danger for the banks, is undoubtedly the main cause of the success of modern German enterprise. German banks are partners, often controlling partners, 'predominant partners', in many of the largest and most successful German enterprises. Many of these have been nursed from their earliest beginnings by the banks, and largely owe their success to guidance received from them". Perhaps our requirements are parallel to those of Germany: we want methods of banking in which the interests of investors may be safeguarded, whilst private enterprise may find scope through the adequate supply of capital and expert advice from the banks.[1]

[1] "German banking does not stand aloof from industry and commerce. The men who direct the German banks are all the time in close touch with the iron and coal industries, the manufacturing and trading classes, and the ocean steam lines. With them finance, industry, and transportation go hand-in-hand and are regarded as integral parts of the same problem. He (the German banker) is represented directly or indirectly on the boards of manufacturing, trading, shipping, and mining companies. He has his eye on all the staple markets. Underwriting is one of his recognised functions" (W. R. Lawson, *Bankers' Magazine*, July 1906 (quoted by Professor Foxwell, *Papers on Current Finance*, pp. 117-18)).

"The German banks are stock, bill and exchange brokers and dealers, banker merchants, trust financial and promoting companies, etc. What may be described as their chief merit and defect is their intimate connection with German industrial life. There are few commercial or industrial German ventures, be they private ventures or joint-stock companies, which do not have at their disposal a fixed credit with one or more banks. Not only have the banks promoted most of the industrial joint-stock companies, and retained part of their share capital, but their managing directors remain members of the boards of these companies, and draw personally large incomes for their services in this capacity" (the *Economist*, October 21, 1911).

Cf. also Sir R. H. Inglis Palgrave in the *Bankers' Magazine*, June 1916: "Among them (the banks) is one which controls mines at Bochum, in the centre of the iron industries of Germany, not far from the enormous works of Krupp & Co. Another carries on a factory for working in cast steel, the business of another is to establish waterworks on the continent of Europe; another works mineral oil, another salt works; some undertake mines and smelting works, others work in aluminium, others in copper and brass and in making metal screws.

AGRICULTURAL CREDIT

What we have said of our industries applies equally to agricultural development. The primary industry of India is agriculture, and despite its great potentialities agriculture is to this day carried on by what one might call primitive methods. The problem of agricultural credit is twofold—to wipe out the enormous amount of agricultural indebtedness, and to supply the cultivators with working capital. We have seen that the co-operative credit societies are supplying working capital to a limited extent, while the problem of indebtedness is not yet touched. If this last problem is to be seriously handled, if we are to abolish the condition of permanent indebtedness, we require a Land Mortgage Bank, preferably a centralised institution, with branches reaching all convenient areas, from which the agriculturist may borrow to liquidate his present debts, on condition that the repayment to the bank may be effected definitely, say within a period of thirty years. The interest charged in that case would be calculated so as to include a portion of capital repayment. If the Government could guarantee a moderate interest of even 5 per cent through the centralised Land Bank, investors would be forthcoming in sufficient numbers to make the experiment a success. A yet easier way out may be suggested. By means of a compulsory process of registration through a bank of the type here suggested, and by subjecting the registered debt to the statutory maximum of interest, we could easily avoid a considerable proportion of the wastage involved in the present agricultural indebtedness. The natural *modus operandi* would be that the bank

We may also mention that the bank also appoints the vice-chairman of a company which makes the machinery employed in the works required for storing electricity, for works employed by companies which deal with the transmission of mechanical power. They are also connected with eight insurance companies. It is easy to see how these different industries assist each other by undertaking different parts of a considerable undertaking."

would nominally advance money, equivalent to the proved and admitted debt, to the agriculturist in the first instance; but the money so advanced would not be paid over to him, but would simply be credited to the Sowkar, who is his creditor. The Sowkar would then be paid by the bank, interest as well as capital, by regular stipulated instalments, which, when ended, would automatically end the debt. That would settle the account between the Sowkar and the bank. As for the account between the bank and the agriculturist, the latter would become a debtor of the bank, and would pay the bank regularly by fixed instalments, extended, if necessary, over a longer period than the period of payment by the bank to the Sowkar; but the agriculturist would pay a somewhat higher rate of interest and capital redemption charge than that paid by the bank. This will mainly be a matter of book-entries in the initial years. No large amount of capital will be required, and if only the Government of India would help with its reserves, the success of the experiment would be amply guaranteed.[1]

The problem of industrial finance in India may partly be solved by the development of co-operative banking. If industrial concerns are started and financed by co-operative banking with a Government guarantee, their success is assured. One way out of the difficulties involved in the conflict between capital and labour is to have these industries financed by the funds of the persons who are to work in them, or by funds obtained on the principle of co-operation. The co-operative principle with Government guarantee holds out bright prospects, and the experiment is worth a trial on a large scale.

We have already noticed that there are no firms of underwriters or financial houses to take over the issue of loans or stocks of private joint-stock companies. The Stock Exchanges are not highly developed, the facilities for the negotiation of securities are insufficient, and

[1] See the *Indian Economist*, February 1, 1925.

industrial growth is consequently retarded. Speculation of a healthy character acts as a kind of social insurance ; the Stock Exchanges spread the risk of fluctuations in the prices of securities of all kinds from the individual promoters or shareholders over the entire group of dealers or owners of stocks and shares. They facilitate the flotation of new concerns and the financing of loans by old. But in India our Stock Exchanges and share-brokers' associations are not efficient, and the mania for cornering and speculation in the shares of industrial concerns has often brought ruin in the past and has shaken public confidence in industrial concerns. The Atlay Committee's Report on the Bombay Stock Exchange, and the Government resolution on it (1925), afford sufficient evidence of the abuses to which the Bombay Stock Exchange has fallen a victim ; and one can only hope that those who are responsible for the working of the Stock Exchanges in India will realise their obligations to the country at large, and will come to feel that on the proper functioning of these undertakings depends the future of Indian industrialism. These Exchanges are the custodians of the funds of the investing public. They are not institutions for getting rich quickly ; we do not want them to be run by gamblers who are likely to reproduce the tactics of horse-racing in dealing with the stocks and shares of private companies or gilt-edged securities. Gambling on the racecourse may be confined in its effects to those who indulge in it, but heedless gambling on the Stock Exchanges may involve the entire investing public in suffering. If public opinion could be aroused, it might exercise a more effective control over their working than any legislation. For the rapid development of industrialism we need Stock Exchanges all over the country, conducted by men alive to their social responsibilities, and acting in close association with those who are connected with industries and commerce. The Bombay Committee to inquire into the rehabilitation of Government securities (1919) are

fully conscious of this need: "In order to create broad and expanding markets for securities and to rehabilitate the existing securities, the Government should endeavour to establish Stock Exchanges in each of the provincial capitals, under non-official control, and should give a grant for land and buildings at places where Stock Exchanges do not exist at present."

To conclude, from the standpoint of the adequacy of the money market we find that the facilities for banking are exceedingly imperfect, that there are vast potentialities in the extension of banking by a network of branches all over the country. In the next place, we see that so far we have only had commercial banking, in close imitation of English banking institutions; investment and industrial banking is still unknown. Even commercial banking, such as we possess, is found to suffer from lack of co-ordination, and involves considerable wastage of the monetary power of the country. Owing partly to illiteracy, partly to conservative habits, the country is not yet familiarised with banking institutions; and the monetary policy of the Government directed to maintaining stability of exchange has aggravated the tendency to waste our monetary resources; crores' worth of gold which the country absorbs from year to year disappears from circulation, instead of fertilising industry by the creation of credit. The available surplus capital per annum is small, and this surplus is absorbed by Government either for meeting deficits or for the extension of railways, industrial enterprise being thereby left to starve. In the absence of other facilities for raising money, the country has evolved a system of deposit banking, with the help of which industrial concerns find working capital. But this method of raising money by short-term deposits is precarious, and creates an atmosphere of uncertainty unfavourable to further development. Finally, with an inadequate system of banking, the country has to pay a high price for the use of money, which increases the cost of production and

puts India in an unfavourable position in the world market. The Indian producer is not in a position to compete with the foreign producer, who enjoys all the advantages of excellent banking facilities and cheap money.

The development of industrial banking is essential to the country's economic progress, and we have striven to show the necessity of reorganising the currency system and revising the currency policy. For the purposes of her economic development India requires all the gold that is at present locked up in London against a contingency which might possibly arise once in ten years. If we aim at genuine and lasting prosperity, we must face the necessity of creating the closest possible relationship between banking, trade, commerce, and industry, establishing financial houses and underwriting firms, multiplying Stock Exchanges, introducing Land Mortgage Banks, and experimenting with co-operative banking in the field of industry. Above all, it is necessary to co-ordinate the existing banking institutions of the country by making the Imperial Bank of India a bankers' bank, by placing at its disposal the gold reserves, and thus enable it to control the money market in the interests of India as a whole.

CHAPTER XXXIX

STABILITY OF THE MONEY MARKET IN INDIA

We have so far discussed the question of Indian banking from the standpoint of its adequacy. We have now to raise and answer another and equally important question. Is our banking system stable ? If a banking system is to be efficient, it should be both adequate and stable. A fully developed banking organisation possesses both characteristics. If banking is to render effective assistance to commerce, trade, and industry, to production in general, it should secure stability in the rate for money, or in other words in the charge for the use of capital. Where there are violent fluctuations in the rate for money, these are symptomatic of financial instability, and even of recurrent financial crises. Trade and industries naturally cannot grow so rapidly in an atmosphere of uncertainty and instability as they do under conditions of relative stability, where the price for the use of money is a reliable quantity. It is significant that a Government that professes to secure stability in the value of money by its currency policy should be faced, as the direct result of that policy, with the problem of an unstable money market, liable to sudden and violent fluctuations in the rate for money.

The Indian money market is the most unstable in the world. A mere glance at the rates of discount of the Imperial Bank of India will bear out the contention. The fluctuations in the discount rates are rapid and great. The difference between the lowest and highest rates in any given year is marked. The pre-war English banking

system was the most stable in the world, the discount rate remaining steady sometimes for years together.

It is important to analyse the reasons for these sudden variations in the rates for money, which are grave hindrances to industrial development, creating a condition of uncertainty disastrous to those who carry on industrial production on borrowed capital. Enterprise and business ability decline under conditions of dead stability, but they cannot flourish under conditions of extreme uncertainty, such as sharp fluctuations in the Bank rate involve in this country. This element of uncertainty favours speculation and leads to the intensification of business risks, and subjects the business community to great hardships. The inadequacy of the banking organisation and the uncertainties of the discount rate have very harmful effects on industrial growth, all the more so as these effects are subtle and unapparent.

CAUSES OF FLUCTUATIONS IN THE RATE FOR MONEY

The causes responsible for the instability in the rates for money in India may be conveniently considered under two heads.

1. *Seasonal Stringency*

There are what we may call the natural causes that lead to sudden demands for money at stated intervals —causes which are not confined to India, but may be found operating in other agricultural countries as well. It is unfortunate that India should be compared with England in this respect. We have seasonal stringency in Canada and in Australia, but the banking and monetary organisation in these countries is so devised and so consciously controlled as to make the seasonal stringency felt as little as possible. We must be prepared to recognise that the stability and expansion of the money market, as illustrated by the history of these colonies, depend upon a progressive monetary policy, adequately responding

to the monetary requirements of the people, and providing a currency sufficiently elastic to meet all seasonal demands. The problem of making the monetary system so elastic as to secure a relatively stable rate of discount throughout the year is one of the most vital of the problems facing the Government of India. It has been confronting the Government for a number of years, and it has been met by the adoption of temporary expedients, such as the provision of emergency currency, a policy which trifles with the symptoms instead of eradicating the disease. The only statesmanlike way of solving the problem lies in the reorganisation of India's monetary system on a basis of conscious control.

There is no doubt that in India seasonal stringency of money is a normal phenomenon. The demand for money during the harvest seasons is abnormal, and the temporary demand is so great and pressing that the normal volume of currency is not able to meet it. Money is required during the busy seasons as well as during the marriage seasons, and it has to lie idle during the dull months, with the result that we witness abnormal discount rates and seasonal variations, unknown to any other country in the world. The Government revenue collections in the early part of each year lead to the withdrawal of large sums from active circulation at a time when money is urgently needed by the trading community.[1] Before the Imperial Bank was brought into existence,

[1] " In times of dear money Bombay and Calcutta appear always to be in the position to pay much higher rates of interest than up-country trade can stand, and therefore money is drained to these centres, generally at the particular season of the year when it is most urgently needed in the Mofussil for produce. At these times the banks show a not unnatural disposition to do as little business as they can at their branches, so as to have the bulk of their funds available at the seaports above named. My Committee simply desire to direct attention to the disastrous effect of the present system on up-country business: that it is hurting both cultivators and dealers, and if not modified, agriculture, as well as the trade in the Mofussil, and consequently that of the seaports, will be seriously crippled " (Letter from the Secretary, Upper India Chamber of Commerce, to the Secretary, Bengal Chamber of

the Government of India maintained its separate and independent Treasury system, which locked up the large sums of money received as revenue. This peculiar arrangement, which immobilised large sums when they were most needed, was to a large extent responsible for accentuating the seasonal stringency and helping the upward trend of the discount rate. The balances of the Government of India are now kept with the Imperial Bank, and the funds are made available to the public through the Bank. It was believed that with the abolition of the separate and independent Treasury system, and with the transference of the public funds to the Imperial Bank, a good deal of the seasonal stringency would disappear ; but this hope has not been realised. Though the benefits arising from the abolition of the separate Treasury system cannot be denied, and though much may be done by legislative provision for emergency currency, the sudden fluctuations in the rates of discount are not likely to disappear. The Government of India fully realises the difficulties of solving the problem : " The Government of India agree that no automatic provision for expanding the currency exists as things are at present. They are, however, doubtful whether the stabilisation of the rupee in terms of gold would greatly relieve stringency

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Commerce, dated April 10, 1890 (Appendices to the *Chamberlain Commission Report*, pp. 393-94).

The nature and extent of the seasonal demand may be vaguely guessed from the observations made by M. M. S. Gubbay, the then Controller of Currency, in a memorandum dated January 23, 1918 : " There is at the beginning of each crop season a very regular and easily discernible flow of rupees from commercial centres into country districts, and to illustrate the extent to which this movement may attain, I may say that in 1916–17, rupees to the value of nearly £8,000,000 were issued from currency offices for the purchase of jute crops, an equal amount for the purchase of cotton crops, and a rather larger amount for the purchase of wheat crops. These figures represent issues from currency offices, but of course it will be understood they were supplemented to an extent which it is not possible to estimate by the metallic rupee funds which are constantly in the hands of shroffs " (Babington-Smith Committee, *Minutes of Evidence*, vol. ii. p. 86).

in the money market, even when both rupees and sterling have a stable exchange value. A pre-war experience proves that there is a strong probability that the condition of the money market in India will for many years to come vary during the year between considerable ease and somewhat acute stringency."[1] Elasticity in the money market may be difficult to realise with a policy of persistent adherence to the Gold-Exchange Standard; no amount of provisional expedients and palliatives will effect what the gold standard might achieve. What we require is the adoption of an effective gold standard and the reorganisation of our banking on a single reserve system, with our gold resources within the country helping the Imperial Bank to control the expansion and contraction of credit according to the requirements of the money market.

Sir Basil Blackett would explain away the stringency in the Indian money market as an entirely natural phenomenon. "Stringency in the money market has its roots in the facts of nature. In a country which is predominantly agricultural, more currency is necessarily required in those periods of the year when crops are being harvested. In India the recurrence of a period of three months during the summer when the monsoon is with us, and activity of all sorts is necessarily restricted by weather conditions, adds a further and special seasonal influence. During these three months the demand for currency is reduced to a minimum, and the monsoon thus increases the wideness of the margin between the amount of currency and credit required when activity is at its maximum, and the amount required when the activity is at its minimum during the year. It is absolutely inevitable that money should be cheap during the summer months in India. During that period money must be kept liquid in order that it may be available for use during the winter and spring."[2]

[1] Reply of the Finance Department to the Letter of the Bengal Chamber of Commerce, dated July 16, 1924.

[2] Speech while opening the Calcutta branch of the Central Bank of India, July 24, 1924.

2. *The Divorce between Paper Currency and Banking Organisation*

However far one may be prepared to go with Sir Basil Blackett in admitting the naturalness of the seasonal stringency in India, one cannot, in a dispassionate analysis of the situation, overlook another important and operative cause of fluctuations in the discount rates—and this is the divorce between the paper currency and the banking machinery. "The paper currency established by the Indian Legislature fully answers the purpose so far as business requires an easier means of exchange than gold or silver coin ; but no connection whatever exists between the issue of the fiduciary currency and the wants of the public to have their bills or other commodities converted into a current medium of exchange ; and this is the sole cause of the unexpected convulsions and sudden transitions in the money market, so utterly detrimental to business, to which the British Indian trade is constantly exposed."[1] If the banks were free to issue notes or create credit instruments on reasonably liquid assets, they could meet the seasonal demand without difficulty, and the country would be saved the harmful consequences of such fluctuations in the rate for money. The power to meet the monetary demand by means of currency and paper money is the monopoly of the Government, and Government can meet this demand only to a limited extent. Moreover, to meet the seasonal demand by an expansion of the currency may not be desirable, as the present monetary machinery makes no provision for a contraction of currency, or for the withdrawal of redundant currency. As Sir Basil Blackett acknowledges : "It is not possible, unfortunately, to devise any sure method of securing that redundant currency shall be withdrawn at the moment it ceases to be required ".[2]

[1] Van Den Berg, *The Money Market and Paper Currency of British India.* Quoted by Ambedkar in *The Problem of the Rupee,* p. 63.

[2] "The danger of emergency currency is that it may be issued in times of pressure and not withdrawn when the pressure ceases to exist.

The proper institution for securing an elastic currency is a Central Bank, which by granting loans or creating credit instruments of short duration can meet the seasonal demand for money, and when the demand slackens, can automatically cancel the instruments or loans. This mechanism does not exist in India, and its absence is largely responsible for the variations in the rate of discount.[1]

Thus it is necessary and desirable that the issue of notes should be handed over to the Imperial Bank of India, but this by itself will not afford an adequate solution of the problem. Under the present decentralised or multiple reserve system all the banks in India keep separate reserves. As the soundness and strength of the banks depend on their ability to meet the demands of their clients, every bank is obliged to keep reasonable funds in liquid form. In the absence of a centralised system with a single reserve, the funds available to the banks are not utilised to the fullest extent for the building up of credit. The Imperial Bank of India offers the possibility of securing for the country a bankers' bank with a single central reserve. In addition we need a rapid extension of branch banking, which would bring banking facilities to every part of this vast country and encourage and popularise the use of cheques. The

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The result of that is the vicious circle of inflation, and however inconvenient stringency in the money market may be, I think that every one with experience of the last ten years will agree that temporary stringency is very preferable to permanent inflation" (Sir Basil Blackett's speech before the Indian Merchants' Chamber, July 9, 1924).

[1] "The existing divorce between responsibility for the note issue and for banking generally is contrary to modern banking practice, and is, in several respects, a source of weakness. In particular it leads to the keeping of two distinct reserves—the Government's reserves and the bankers' reserves—with no clearly defined relation between them, so that the reserves of the latter may be insufficient, without the assumption by the former of the fact or the machinery of responsibility. It leads also to a want of elasticity in the system, since in modern conditions this elasticity is most commonly provided by exactly that co-operation between banking and note issue which is lacking in India" (J. M. Keynes, *Indian Currency and Finance*, p. 236).

extension of the use of cheques would itself economise cash, and enable the same volume of currency to do a larger amount of work. The problem of seasonal stringency may thus be solved to a large extent by a reorganisation of the banking system, the transference of the right of note issue to the Imperial Bank of India, the creation of a single reserve system, the extension of the use of cheques, and above all, by the adoption of a sounder monetary system. With every advance in banking facilities in the outlying districts, the rapidity of circulation or the effectiveness of money can be enormously increased. Demand for additional money can be met either by additions to the existing volume of currency, or by increasing the effectiveness or rapidity of circulation of money. The problem of seasonal stringency should be approached from both these points of view.[1]

By way of explaining the cause of monetary stringency in India, Sir Basil Blackett declared: "For a more far-reaching remedy we must look to an increase in the amount of new savings in India, *i.e.* in the amount of new capital within India herself, so that the supply may be more nearly equal to the demand, for it is shortage in the supply of capital which is at the root of the difficulty". This at the best is a half-truth. Undoubtedly monetary ease or stringency in the money market ultimately depends on the demand and supply of capital. But Sir Basil is mixing up two distinct issues—the supply of capital and the supply of the media of exchange or titles to legal tender. Capital can be increased only through savings, but a given amount of capital can be made to do more work by an efficient banking organisation, and even

[1] "The steady extension of the business of banks such as the Central Bank on sound lines, leading the way to an extension of banking facilities throughout India in a way that will link up the indigenous banking system with the bigger banks and the Imperial Bank, and provide India with a financial machinery adapted to the genius of the Indian peoples, offers to my mind one of the most promising prospects of eventual relief from the difficulties of seasonal stringency" (Speech by Sir Basil Blackett when opening the Calcutta branch of the Central Bank of India).

existing savings without any additions may relieve the monetary stringency if they are utilised in accordance with proper methods of banking. It is not so much a question of supplying more capital as of finding out ways and means for meeting the trade and business demand in busy seasons. The dearness of money in India is undoubtedly due to the paucity of available capital in comparison with her vast requirements. The real problem of industrial finance in this country is the provision of industrial capital. Although Indian capital does not shrink from sound investment, the requirements of the country in the shape of capital for the development of her agricultural and other resources are so large that they are not likely to be supplied through private agency unaided by the State.[1] It is necessary that all the savings of the people should be mobilised and made available for investment, and that at the same time all the reserves should be economised to create a credit superstructure on a sound basis. When we consider that we have £40,000,000 in the Gold Standard Reserve and another £22,000,000 in the Paper Currency Reserve, and that the fiduciary portion of the latter can be increased; that in addition we have the Government cash balances, the Post Office Savings Banks deposits, and the gold received by India from year to year in settlement of her trade balance, not to mention the accumulated stocks of gold; the problem of supplying India with all her capital requirements does not present insuperable difficulties. Scarcity

[1] "The greatest need of India to-day was new capital expenditure both for private and Government enterprise. . . . There was an immense scope for expenditure on the development of India's resources" (Finance Member, Proceedings of the Legislative Assembly, January 1925).

"While during the last half-century there has been considerable progress in respect of the investment of capital, it has been upon comparatively restricted lines, and there has been little enterprise in new directions. . . . Money for investment, whether on loan or by way of subscription to capital, is not readily forthcoming, and the wealth actually possessed does a very small amount of work owing to its inactivity" (*Report of the Indian Industrial Commission*, 1916–18, paras. 280-281).

of capital and stringency of money alike can be removed by a rational, well-directed monetary policy, helped by a developed banking organisation and by the resources that Government can place at the disposal of this organisation.

So much with regard to stability in the rate for money. There is then the question of the stability of Indian banking from a structural point of view. Indian banking does not rest on a solid basis ; it is vulnerable, liable to be upset by financial crises, or by unwonted strain in the form of a run or a sudden demand for the withdrawal of money. This is because it possesses a multiple reserve system, without adequate cash reserves to maintain it on that basis. If we examine the proportion of cash reserves to the total liabilities of the Exchange Banks, it is not too much to assert that these banks undertake immense liabilities without making any adequate provision for contingencies. They have been fortunate till now, because they have a safe and secure business and have two sources to tap—they receive money from home as well as in India. So also the Indian joint-stock banks do business on a scale which their liquid resources do not warrant. Some of them even go to the length of indulging in speculative business. Ever since the failure of the Specie Bank (1913) and the epidemic of bank failures that followed, depositors have been reluctant to place their money with the joint-stock banks. They prefer dealings with the Imperial Bank of India, or with the Post Office Savings Banks. Rumours as to the unsoundness of Indian joint-stock banks are frequently current. Wild tales concerning the one great Indian bank—the Central Bank of India—often circulate in the market, with the result that depositors begin a run on the Bank, and incur the risks of a crisis.[1]

[1] Thus in 1924 a rumour reflecting on the soundness of the Central Bank of India spread in Calcutta, and there was a rush on the Calcutta branch, but prompt action on the part of the Bank in meeting the demands of the depositors saved the situation. A similar rush on the Bombay branch of the Bank in August 1925 was met by payment to the extent of a crore and a quarter in a single day.

Nobody can stop the circulation of bazaar rumours, but it is the duty of those who carry on banking business to realise that they are the custodians of public money, that their work is not to be judged by the dividends they pay to shareholders, but in the light of the larger services they are able to render to the country by a wise and prudent use of the resources that they can place at the disposal of trade and industry.

It is necessary that all the banks in India should be co-ordinated, so that they can rely upon the Central Bank for assistance in case of need, with greater chances of averting a crisis. If the position, cash reserves, and growth of liabilities of the Imperial Bank of India are carefully watched by the Government and the educated public, the stability of the banking system of India is assured. During a period of financial nervousness, when the mass mind becomes suspicious, Bagehot's advice of "lending freely" seems to be the only statesmanlike method of averting a crisis. Financial panic can only be allayed by readiness on the part of banks to meet all demands freely and promptly. But in order that a bank may lend freely, it should be helped by other banks. The liquid resources of any one bank are limited, and if it has no others to rely upon, they can soon be exhausted. In a multiple reserve system, when one bank is affected, other banks are afraid, and instead of lending a helping hand they adopt a policy of aloofness, and strengthen their own position lest they too should have to face the storm. It was this spirit of indifference, this anxiety to safeguard their own position, combined with the hostility of some of the banks towards the People's Bank of India, that accentuated the banking crisis of 1913.[1]

[1] "During the crisis there was no co-operation between the Indian banks themselves, or between them and the English banks, or between them and the old-fashioned Indian banks. . . . The Lahore branch (of the Bank of Bengal) was willing to help and make recommendations to Calcutta, but these were rejected with curtness, and not even on the deposit of Government paper would the Bank of Bengal consent to advance money to the Punjab National Bank" (Report of the Com-

Had there been help from the proper quarters, on sound securities, India would have been saved this crisis and the set-back in the growth of banking that it involved. The best method of preventing such crises would be the introduction of the single reserve system, so that the Central Bank could come to the help of any institution in difficulties. The proposal for centralisation of banking in India was mooted long since, and it ultimately materialised to some extent in the formation of the Imperial Bank of India in 1921. But this institution, though it serves as a co-ordinating agency, is not a bankers' bank in the strict sense of the term. The other banks keep their reserves with the Imperial Bank only to a limited extent. The present position of the Imperial Bank in the banking organisation of India is a transitional position ; what is needed is to make it the central institution and to link all other banks to it. If this were achieved, many of the weaknesses of the Indian money market would disappear. The fluctuations in the rates of discount, which involve instability to commerce and trade, would be minimised ; and trade and commerce could be fostered by the introduction of rediscounting facilities. Since the failure of the Alliance Bank of Simla, in which the Government became compromised through helping that institution, a new principle has been accepted, and the Imperial Bank Act has now been modified, empowering the Bank to support deserving banking institutions in times of panic. This measure is meant to impart stability to the banking organisation, and it is a step in the right direction. We want a network of banks to grow up round the Imperial Bank of India, so as to enable the latter to develop its functions as the bankers' bank—one of the main purposes for which the Presidency Banks were amalgamated in 1921.

The money and money market of India should be consciously organised with a definite purpose in view.

mittee appointed to examine the failures in financial and industria enterprises in the Punjab).

There is a demand for a definite amount of purchasing power in the country, and the monetary and banking policy should be so directed as to meet this demand effectively without violently affecting the value of money. By the adoption of an effective gold standard, the establishment of a single reserve banking system, and the organisation of industrial and agricultural banks with numerous branches, India's monetary and banking requirements can be properly satisfied. What we need above all is the power of vision, the instinct of statesmanship, and the foresight that alone can overcome the bureaucratic opportunism that accepts things as they are, and seeks to construct a policy out of the unpremeditated consequences of a blundering expediency.

CHAPTER XL

CONCLUDING REMARKS

In every country at a given time there is a demand for a definite amount of purchasing power necessary for the maintenance and growth of its economic life, for the upkeep of its trade, commerce, and industries. The amount of purchasing power required depends upon the nature of its economic life, the habits of the people, the stage of economic development that the country has reached, the national wealth and the national temperament. So long as the supply of purchasing power is below this amount, the country leads a restricted economic life, with its industries undeveloped or suffering from the lack of the necessary life-blood in the shape of capital, and its trade and commerce hampered in the increasingly acute competition of modern life. It is extremely difficult to ascertain in precise terms the amount of purchasing power that a country requires at a given time; but a study of the movements of the Bank rate and the prices of securities, as well as of the trend of general prices, affords a pretty accurate measure of the adequacy or inadequacy of the supply.

Judging by these criteria, there can be no reasonable doubt about the fact that the supply of purchasing power in India is far from sufficient to the demand. The violent fluctuations of the Bank rate are an indication, and a reliable indication, of the want of adjustment between the country's demand for money in the larger sense and the supply. The primary industry of the country is

agriculture—an industry on which more than 250,000,000 people are directly dependent. To finance their produce, these millions have to pay anything between 12 and 25 per cent as interest. The fundamental object of the monetary policy of the rulers of our country should be, in the first place, to provide an adequate supply of currency in order to satisfy the requirements of her trading classes, and in the next to secure an adequate supply of capital for the development of her industries and the promotion of her agriculture, by mobilising available capital within the country through the agency of banking institutions, and to employ her credit in borrowing capital from abroad on reasonable terms. An adequate supply of currency that can expand and contract with the requirements of trade and commerce is one of the basic needs of economic life ; and in India this object could best be achieved by a free, open, and automatic system resting upon a gold basis. Finance and currency cannot be divorced from politics ; a " managed " currency, as a long and varied experience has taught the world, can answer the economic requirements of a country far better than a currency which is not so completely managed. A currency managed on a gold basis gives rise to fewer opportunities for manipulation, and presents fewer temptations for abuse of powers, than a currency managed under the Gold-Exchange Standard or a standard based on index numbers. The economic development of India can best be fostered by the introduction of an effective gold standard, and it can only be regarded as a serious misfortune that her rulers should persist in the view that her best interests can be promoted by adherence to the Gold-Exchange Standard. To-day we have neither a gold standard nor a Gold-Exchange Standard ; we are passing through a transition period ; neither the Government nor the leaders of public opinion seem to be clear about the goal of the currency system and the objective of monetary policy. The Government of India believes, however, that the economic salvation of the country lies in a return

to the Gold-Exchange Standard with fixity of exchange, while the leaders of public opinion endorse this view by clamouring for a return to the pre-war ratio of exchange. It is not a matter for surprise if those who are aware of the realities of India's economic situation, and its contributory causes, find it hard to repress their impatience and disappointment.

It is not merely a sound currency system that India needs. She needs a whole monetary policy of a more comprehensive character, designed directly to foster the economic life of her people, to promote and increase her productive powers, operating through the development of banking, the employment of the existing gold resources of the country for the country's benefit, the readiness to pledge her credit for the acquirement of industrial technique and equipment, and above all, through the widest publicity with reference to all currency and exchange operations, which will leave no room for ignorance and misconception, and will assure the country that its monetary system is managed and controlled for truly national purposes.

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