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A TRACT
ON
MONETARY REFORM

BY

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(1884 - 1946)

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PREFACE

WE leave Saving to the private investor, and we encourage him to place his savings mainly in titles to money. We leave the responsibility for setting Production in motion to the business man, who is mainly influenced by the profits which he expects to accrue to himself in terms of money. Those who are not in favour of drastic changes in the existing organisation of society believe that these arrangements, being in accord with human nature, have great advantages. But they cannot work properly if the money, which they assume as a stable measuring-rod, is undependable. 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.

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. Currency Reforms, which led to the adoption by this country and the world at large of sound monetary principles, would diminish the wastes of *Risk*, which consume at present too much of our estate.

Nowhere do conservative notions consider themselves more in place than in currency; yet nowhere is the need of innovation more urgent. One is often warned that a scientific treatment of currency questions is impossible because the banking world is intellectually incapable of understanding its own problems. If this is true, the order of Society, which they stand for, will decay. But I do not believe it. What we have lacked is a clear analysis of the real facts, rather than ability to understand an analysis already given. If the new ideas, now developing in many quarters, are sound and right, I do not doubt that sooner or later they will prevail. I dedicate this book, humbly and without permission, to the Governors and Court of the Bank of England, who now and for the future have a much more difficult and anxious task entrusted to them than in former days.

J. M. KEYNES. E. C.
England Civil Service

October 1923.

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[I have utilised, mainly in the first chapter and in parts of the second and third, the material, much revised and re-written, of some articles which were published during 1922 in the Reconstruction Supplements of the *Manchester Guardian Commercial*.—
J. M. K.]

CHAPTER II

PUBLIC FINANCE AND CHANGES IN THE VALUE OF MONEY

I. *Inflation as a Method of Taxation*

A GOVERNMENT can live for a long time, even the German Government or the Russian Government, by printing paper money. That is to say, it can by this means secure the command over real resources,—resources just as real as those obtained by taxation. The method is condemned, but its efficacy, up to a point, must be admitted. A Government can live by this means when it can live by no other. It is the form of taxation which the public find hardest to evade and even the weakest Government can enforce, when it can enforce nothing else. Of this character have been the progressive and catastrophic inflations practised in Central and Eastern Europe, as distinguished from the limited and oscillatory inflations, experienced for example in Great Britain and the United States, which have been examined in the preceding chapter.

The Quantity Theory of Money states that the

amount of cash which the community requires, *assuming certain habits of business and of banking to be established*, and assuming also a given level and distribution of wealth, depends on the level of prices. If the consumption and production of actual goods are unaltered but prices and wages are doubled, then twice as much cash as before is required to do the business. The truth of this, properly explained and qualified, it is foolish to deny. The Theory infers from this that the *aggregate real value* of all the paper money in circulation remains more or less the same, irrespective of the *number of units* of it in circulation, provided the habits and prosperity of the people are not changed,—*i.e.* the community retains in the shape of cash the command over a more or less constant amount of real wealth, which is the same thing as to say that the total quantity of money in circulation has a more or less fixed purchasing power.¹

Let us suppose that there are in circulation 9,000,000 currency notes, and that they have altogether a value equivalent to 36,000,000 gold dollars.² Suppose that the Government prints a further 3,000,000 notes, so that the amount of currency is now 12,000,000 ; then, in accordance with the above theory, the 12,000,000 notes are still

¹ See also Chapter III., Section I.

² It will simplify the argument to ignore the fact that the value of gold in terms of commodities is itself a fluctuating one, and to treat the value of a currency in terms of gold as a rough measure of its value in terms of "real resources" generally.

its influence on sentiment. The only important exception to this statement is where there exists on a large scale a long-period speculative investment in a country's currency on the part of foreigners, as in the case of German marks. But such investments are comparable to borrowing abroad and exercise a different kind of influence altogether from a speculative transaction proper, which is opened with the intention of its being closed again within a short period. And even speculative investment in a currency, since it is bound to diminish sooner or later, cannot permanently prevent the exchanges from reaching the equilibrium justified by conditions of trading and relative price levels.

It follows that, whilst purely seasonal fluctuations do not interfere with the forces which determine the ultimate equilibrium of the exchanges, nevertheless stability of the exchange from day to day cannot be maintained merely by the *fact* of stability in these underlying conditions. It is necessary also that bankers should have a sufficiently certain *expectation* of such stability to induce them to look after the daily and seasonal fluctuations of the market in return for a moderate commission.

After recent experience it is unlikely that they will actually entertain any such expectation, even if the underlying facts were of a kind to justify it, with sufficient conviction to act, unless it is backed up by a guarantee on the part of the Central Authority

(Bank or Government) to employ all their resources for the maintenance of the level of exchange at a stated figure. At present the declared official policy is to bring the franc and the lira (for example) back to par, so that operations favouring a fall of these currencies are not free from danger. On the other hand no steps are taken to make this policy effective, and the conditions of internal finance in France and Italy indicate that their exchanges may go much worse. Thus, since no one can have complete confidence whether they are to be a great deal better or very much worse, there must be a wide fluctuation before financiers will come in, purely from motives of self-interest, to balance the day-to-day fluctuations and the month-to-month fluctuations round about the unpredictable point of equilibrium.

If, therefore, the exchanges are not stabilised by policy, they will never come to an equilibrium of themselves. As time goes on and experience accumulates, the oscillations may be smaller than at present. Speculators may come in a little sooner, and importers may make greater efforts to spread their requirements more evenly over the year. But even so, there must be a substantial difference of rates between the busy season and the slack season, until the business world knows for certain at what level the exchanges in question are going to settle down. Thus a seasonal fluctuation of the exchanges (including the sterling-dollar exchange) is inevitable,

even in the absence of any decided long-period tendency of an exchange to rise or to fall, unless the Central Authority, by a guarantee of convertibility or otherwise, takes special steps to provide against it.

IV. *The Forward Market in Exchanges.*

When a merchant buys or sells goods in a foreign currency the transaction is not always for immediate settlement by cash or negotiable bill. During the interval before he can cover himself by buying or selling (as the case may be) the foreign currency involved, he runs an exchange risk, losses or gains on which may often, in these days, swamp his trading profit. He is thus involuntarily engaged in a heavy risk of a kind which it is hardly in his province to undertake. The subject of what follows is a piece of financial machinery—namely, the market in “forward” exchanges as distinguished from “spot” exchanges—for enabling the merchant to avoid this risk, not, indeed, during the interval when he is negotiating the contract, but as soon as the negotiation is completed.

Transactions in “spot” exchange are for cash—that is to say, cash in one currency is exchanged for cash in another currency. But merchants who have bought goods in terms of foreign currency for future delivery may not have the cash available pending delivery of the goods; whilst merchants

who have sold goods in terms of foreign currency, but are not yet in a position to sell a draft on the buyer, cannot, even if they have plenty of cash in their own currency, protect themselves by a "spot" sale of the exchange involved, save in the exceptional case when they have cash available in the foreign currency also.

A "forward" contract is for the conclusion of a "spot" transaction in exchanges at a later date, fixed on the basis of the spot rate prevailing at the original date. Pending the date of the maturity of the forward contract no cash need pass (although, of course, the contracting party may be required to give some security or other evidence for his ability to complete the contract in due course), so that the merchant entering into a forward contract is not required to find cash any sooner than if he ran the risk on the exchange until the goods were delivered; yet he is protected from the consequences, of any fluctuation in the exchanges in the meantime.

The tables given below show that in London, in the case of the exchanges which have a big market (the dollar, the franc, and the lira), competition between dealers has brought down the charges for these facilities to a fairly moderate rate. During 1920 and 1921 the cost to an English buyer of foreign currency for forward delivery was a little more expensive than for spot delivery in the case of francs, lire, and marks, and a little cheaper in the case of

dollars. Correspondingly, French, Italian, and German merchants were generally in a position to buy both sterling and dollars for forward delivery at a slightly cheaper rate than for spot delivery—that is to say, if they dealt in London. As regards the rates charged in foreign centres my information is not extensive, but it indicates that in Milan, for example, very much less favourable terms for these transactions are frequently charged to the seller of forward sterling than those ruling in London. During 1922, however, the effect of the progressive cheapening of money in London was, for reasons to be explained in a moment, to cheapen the cost to English buyers of foreign currency for forward delivery, forward francs falling to an appreciable discount on spot francs, and forward dollars becoming at the end of the year decidedly cheaper than spot dollars. Later on, the raising of the bank-rate in June 1923 acted again, as could have been predicted, in the opposite direction.

Proceeding to details, we see below (pp. 118, 119) the quotations for forward exchange ruling in the London market since the beginning of 1920. During 1920–21 forward dollars were generally cheaper than spot dollars to a London buyer to the extent of from 1 to $1\frac{1}{2}$ per cent per annum. Occasionally, however, when big movements of the exchange were taking place, the discount on forward dollars was temporarily much higher, having risen, for example,

TABLE OF EXCHANGE QUOTATIONS IN LONDON ONE MONTH FORWARD ¹

| NEW YORK. | | | | PARIS. | | |
|-----------|---------------------------------|---|--------------------------------|---------------------|--------------------|--------------------------------|
| Date. | Spot. | One Month Forward. | Difference per cent per annum. | Spot. | One Month Forward. | Difference per cent per annum. |
| 1920 | | | | | | |
| January . | 3.79 | + $\frac{3}{8}$ cent | + 1.2 | 40.90 | + 6 centime | + 1.7 |
| February | 3.48 $\frac{7}{8}$ | + $\frac{1}{4}$ " | + .9 | 46.90 | + 4 " | + 1.0 |
| March . | 3.41 $\frac{3}{8}$ | + $\frac{1}{4}$ " | + .9 | 48.55 | + 3 " | + .7 |
| April . | 3.90 $\frac{1}{2}$ | + $\frac{3}{8}$ " | + 1.2 | 57.80 | + 3 " | + .6 |
| May . | 3.82 $\frac{1}{2}$ | + $\frac{1}{2}$ " | + 1.6 | 64.04 | + 1 " | + 1.8 |
| June . | 3.89 $\frac{1}{2}$ ⁵ | + $\frac{3}{8}$ " | + 1.2 | 50.45 | - 5 " | - 1.2 |
| July . | 3.96 $\frac{1}{2}$ | + $\frac{3}{8}$ " | + 1.9 | 47.05 | - 10 " | - 2.8 |
| August . | 3.67 | + $\frac{1}{2}$ " | + 1.6 | 49.00 | - 10 " | - 2.4 |
| September | 3.56 $\frac{7}{8}$ | + $\frac{1}{2}$ " | + 1.7 | 51.22 $\frac{1}{2}$ | - 5 " | - 1.2 |
| October . | 3.48 $\frac{5}{8}$ | + $\frac{1}{2}$ " | + 1.7 | 52.10 | - 10 " | - 2.3 |
| November | 3.44 $\frac{3}{8}$ | + 1 $\frac{3}{8}$ " | + 5.7 | 54.45 | - 15 " | - 3.3 |
| December | 3.49 | + $\frac{1}{2}$ " | + 1.7 | 57.45 | - 15 " | - 3.2 |
| 1921 | | | | | | |
| January . | 3.58 $\frac{3}{8}$ | + $\frac{3}{8}$ " | + 1.3 | 61.07 $\frac{1}{2}$ | - 30 " | - 5.9 |
| February | 3.84 $\frac{1}{2}$ | + 1 " | + 3.1 | 54.50 | - 20 " | - 4.4 |
| March . | 3.88 $\frac{3}{8}$ | + $\frac{7}{8}$ " | + 2.7 | 54.40 | - 27 " | - 5.9 |
| April . | 3.92 | + $\frac{3}{8}$ " | + 1.1 | 55.37 $\frac{1}{2}$ | - 15 " | - 3.3 |
| May . | 3.98 | + $\frac{1}{2}$ " | + 1.5 | 50.22 $\frac{1}{2}$ | - 12 " | - 2.9 |
| June . | 3.90 $\frac{3}{8}$ | + $\frac{3}{4}$ " | + 2.3 | 46.35 | - 10 " | - 2.6 |
| July . | 3.71 $\frac{1}{8}$ | + $\frac{5}{8}$ " | + 2.0 | 46.72 $\frac{1}{2}$ | - 10 " | - 2.6 |
| August . | 3.56 $\frac{3}{8}$ | + $\frac{1}{2}$ " | + 1.7 | 46.77 $\frac{1}{2}$ | + 2 " | + .5 |
| September | 3.71 $\frac{3}{8}$ | + $\frac{3}{8}$ " | + 1.2 | 48.68 $\frac{1}{2}$ | + 3 " | + .7 |
| October . | 3.76 $\frac{1}{8}$ | + $\frac{1}{2}$ " | + 1.6 | 52.27 $\frac{1}{2}$ | + 1 " | + .2 |
| November | 3.92 $\frac{1}{8}$ | + $\frac{7}{8}$ " | + 2.7 | 53.44 | + 4 " | + .9 |
| December | 4.08 $\frac{1}{8}$ | + $\frac{3}{8}$ " | + 1.1 | 54.24 | + 2 " | + .4 |
| 1922 | | | | | | |
| January . | 4.20 $\frac{1}{8}$ | + $\frac{1}{8}$ " | + .4 | 52.32 $\frac{1}{2}$ | par | ... |
| February | 4.30 $\frac{1}{2}$ | par | ... | 51.62 $\frac{1}{2}$ | " | ... |
| March . | 4.42 | " | ... | 48.45 | " | ... |
| April . | 4.39 | " | ... | 48.15 | - 1 centime | - .25 |
| May . | 4.44 $\frac{1}{2}$ | " | ... | 48.47 | + 1 " | + .25 |
| June . | 4.46 $\frac{1}{2}$ | + $\frac{1}{8}$ cent | + .5 | 49.00 | + 2 " | + .49 |
| July . | 4.44 $\frac{3}{4}$ | + $\frac{1}{16}$ " | + .17 | 56.20 | + 8 " | + 1.8 |
| August . | 4.45 $\frac{1}{2}$ | + $\frac{1}{16}$ " | + .5 | 54.10 | + 10 " | + 2.21 |
| September | 4.46 | + $\frac{3}{8}$ " | + 1 | 57.40 | + 3 " | + .63 |
| October . | 4.42 | + $\frac{1}{4}$ " | + .68 | 58.25 | + 3 " | + .62 |
| November | 4.46 $\frac{1}{2}$ | + $\frac{5}{8}$ " | + 1.68 | 64.65 | + 14 " | + 2.59 |
| December | 4.51 $\frac{1}{2}$ | + 1 " | + 2.65 | 64.30 | + 8 " | + 1.49 |
| 1923 | | | | | | |
| January . | 4.64 $\frac{1}{2}$ | + 1 $\frac{1}{4}$ " | + 3.23 | 66.40 | + 5 " | + .9 |
| February | 4.67 | + $\frac{7}{8}$ " | + 2.25 | 75.50 | + 16 " | + 2.54 |
| March . | 4.70 $\frac{5}{8}$ | + 1 " | + 2.55 | 77.50 | + 11 " | + 1.70 |
| April . | 4.66 $\frac{3}{8}$ | + $\frac{3}{4}$ " | + 1.93 | 70.40 | + 5 " | + .85 |
| May . | 4.62 $\frac{1}{2}$ | + $\frac{1}{4}$ ⁵ / ₈ " | + 2.43 | 69.35 | + 5 " | + .86 |
| June . | 4.62 $\frac{3}{4}$ | + $\frac{7}{8}$ " | + 2.27 | 71.60 | + 5 " | + .84 |
| July . | 4.56 $\frac{1}{2}$ | + $\frac{1}{2}$ " | + 1.31 | 78.35 | + 4 " | + .61 |
| August . | 4.57 | + $\frac{1}{4}$ " | + 0.66 | 79.20 | + 9 " | + .60 |

First day of month in 1920, first Wednesday in 1921, and first Friday thereafter

TABLE OF EXCHANGE QUOTATIONS IN LONDON ONE MONTH FORWARD

| ITALY. | | | | GERMANY. | | |
|-------------------|-------------------|----------------------|--------------------------------|-------------------|----------------------------|--------------------------------|
| Date. | Spot. | One Month Forward. | Difference per cent per annum. | Spot. | One Month Forward. | Difference per cent per annum. |
| 1920 ¹ | | | | | | |
| January . | 50 | - $\frac{1}{8}$ lire | -3.0 | 187 | marks | |
| February | 55 | - $\frac{1}{8}$ " | -2.7 | 305 | | |
| March . | 62 $\frac{1}{2}$ | - $\frac{1}{4}$ " | -4.7 | 337 | | |
| April . | 80 $\frac{1}{2}$ | - $\frac{1}{4}$ " | -3.7 | 275 | | |
| May . | 83 | - $\frac{1}{8}$ " | -7.1 | 218 $\frac{1}{2}$ | - 1 " | - 5.5 |
| June . | 66 $\frac{3}{8}$ | - $\frac{1}{2}$ " | -9.1 | 150 $\frac{1}{2}$ | - 1 " | - 8.0 |
| July . | 65 $\frac{3}{8}$ | - $\frac{1}{2}$ " | -9.2 | 150 | - $\frac{1}{2}$ " | - 4.0 |
| August . | 70 | - $\frac{1}{2}$ " | -8.5 | 160 $\frac{1}{2}$ | - 1 " | - 7.5 |
| September | 76 $\frac{1}{2}$ | - $\frac{1}{2}$ " | -7.9 | 176 | - $\frac{1}{2}$ " | - 3.4 |
| October . | 83 $\frac{1}{2}$ | - $\frac{1}{2}$ " | -7.2 | 215 | - 1 " | - 5.6 |
| November | 93 $\frac{1}{2}$ | - $\frac{1}{2}$ " | -6.4 | 266 $\frac{1}{2}$ | - $\frac{1}{2}$ " | - 2.2 |
| December | 94 $\frac{1}{2}$ | - $\frac{1}{2}$ " | -6.3 | 241 $\frac{1}{2}$ | - 1 " | - 4.9 |
| 1921 | | | | | | |
| January . | 104 $\frac{3}{8}$ | par | ... | 269 $\frac{1}{2}$ | - 2 " | - 8.9 |
| February | 105 $\frac{1}{2}$ | - $\frac{3}{8}$ lire | -8.5 | 243 $\frac{1}{2}$ | - 1 " | - 4.9 |
| March . | 106 $\frac{1}{2}$ | - $\frac{5}{8}$ " | -7.0 | 243 $\frac{1}{2}$ | - 1 " | - 4.9 |
| April . | 92 $\frac{1}{2}$ | - $\frac{1}{2}$ " | -6.5 | 239 $\frac{1}{2}$ | - 2 " | - 10.0 |
| May . | 81 $\frac{3}{8}$ | - $\frac{5}{8}$ " | -9.1 | 262 $\frac{1}{2}$ | - 1 $\frac{3}{4}$ " | - 8.0 |
| June . | 73 $\frac{1}{2}$ | - $\frac{1}{2}$ " | -8.1 | 245 $\frac{1}{2}$ | - 1 $\frac{1}{2}$ " | - 7.3 |
| July . | 77 | - $\frac{1}{2}$ " | -7.8 | 279 $\frac{1}{2}$ | - 1 $\frac{1}{2}$ " | - 6.45 |
| August . | 85 $\frac{1}{8}$ | - $\frac{1}{2}$ " | -3.5 | 286 | - 1 " | - 4.2 |
| September | 85 $\frac{1}{8}$ | - $\frac{3}{8}$ " | -5.2 | 347 $\frac{1}{2}$ | - 1 $\frac{1}{2}$ " | - 5.1 |
| October . | 94 $\frac{1}{2}$ | - $\frac{3}{8}$ " | -4.8 | 471 | - 5 " | - 12.7 |
| November | 96 $\frac{3}{8}$ | - $\frac{1}{4}$ " | -3.1 | 764 $\frac{1}{2}$ | - 2 $\frac{1}{2}$ " | - 3.5 |
| December | 93 $\frac{1}{8}$ | - $\frac{1}{2}$ " | -6.4 | 855 | - 1 $\frac{1}{2}$ " | - 2.1 |
| 1922 | | | | | | |
| January . | 97 $\frac{1}{2}$ | - $\frac{1}{4}$ " | -3.0 | 777 $\frac{1}{2}$ | - 3 $\frac{1}{2}$ " | - 5.4 |
| February | 92 $\frac{1}{2}$ | - $\frac{1}{7}$ " | -5.7 | 872 | - 2 $\frac{1}{2}$ " | - 3.4 |
| March . | 83 $\frac{1}{8}$ | - $\frac{1}{4}$ " | -3.6 | 1117 | - 1 $\frac{1}{2}$ " | - 1.6 |
| April . | 83 $\frac{1}{8}$ | -15 pts. | -2.16 | 1440 | - 8 " | - 6.6 |
| May . | 83 | -10 " | -1.45 | 1270 | - $\frac{1}{2}$ " | - .47 |
| June . | 85 $\frac{3}{8}$ | -3 " | - .41 | 1222 | par | ... |
| July . | 100 | par | ... | 2320 | + 5 marks | + 2.59 |
| August . | 96 | par | ... | 3175 | +20 " | + 7.56 |
| September | 101 | -11 " | -1.31 | 5700 | nominal | ... |
| October . | 103 | -10 " | -1.16 | 9900 | + 450 mks | + 54.54 |
| November | 106 | - 8 " | - .91 | 26,250 | + 6,000 " | + 274.3 |
| December | 93 $\frac{1}{2}$ | -20 " | -2.56 | 35,000 | + 5,500 " | + 188.58 |
| 1923 | | | | | | |
| January . | 92 | -11 " | -1.43 | 39,500 | + 1,750 " | + 53.16 |
| February | 97 $\frac{1}{2}$ | -23 " | -2.83 | 190,000 | + 27,000 " | + 170.53 |
| March . | 97 $\frac{3}{4}$ | -23 " | -2.82 | 105,000 | + 10,000 " | + 114.28 |
| April . | 93 $\frac{3}{4}$ | -18 " | -2.30 | 97,500 | + 6,000 " | + 73.85 |
| May . | 94 $\frac{1}{2}$ | -19 " | -2.28 | 170,000 | + 20,000 " | + 141.18 |
| June . | 99 | -15 " | -1.82 | 350,000 | + 40,000 " | + 137.14 |
| July . | 106 $\frac{1}{2}$ | -22 " | -2.47 | 900,000 | + 30,000 ¹ " | + 40.00 |
| August . | 105 $\frac{1}{2}$ | -28 " | -3.18 | 5,500,000 | + 1,500,000 ¹ " | + 327.27 |

¹ Nominal.

in November 1920, when sterling was at its lowest point, to nearly 6 per cent—for reasons which I will endeavour to elucidate later. During the first half of 1922 the discount on forward dollars dwindled, but rose again during the latter half of the year, reacting again in the middle of 1923 after money rates in London had been slightly raised. Thus a London merchant, who has had dollar commitments for the purchase of goods, has not only been able to cover his exchange risk by means of a forward transaction, but on the average he has got his exchange a little cheaper by providing for it in advance.

Forward purchases of francs, after being dearer than spot transactions by $2\frac{1}{2}$ per cent per annum or more from the middle of 1920 to the middle of 1921, were nearly level in price from the middle of 1921 to the middle of 1922, whilst since that time they have been $\frac{1}{2}$ to $2\frac{1}{2}$ per cent per annum cheaper. In the case of lire there have been much wider gaps, forward purchases being frequently 3 per cent or more dearer than spot. In the case of German marks, the forward rate, after ranging round about 5 per cent per annum dearer than spot, has reached, since the autumn of 1922 and the complete collapse of the mark, a figure fantastically cheaper, thus reflecting the sensational rate of interest for short loans current inside Germany.

But in all these cases (except in Germany since the complete collapse of the mark), whether for-

ward exchange is at a discount or at a premium on spot, the expense, if any, of dealing forward has been small in relation to the risks that are avoided.

Nevertheless, in practice merchants do not avail themselves of these facilities to the extent that might have been expected. The nature of forward dealings in exchange is not generally understood. The rates are seldom quoted in the newspapers. There are few financial topics of equal importance which have received so little discussion or publicity. The present situation did not exist before the war (although even at that time forward rates for the dollar were regularly quoted), and did not begin until after the "unpegging" of the leading exchanges in 1919, so that the business world has only begun to adapt itself. Moreover, for the ordinary man, dealing in forward exchange has, it seems, a smack of speculation about it. Unlike Manchester cotton spinners, who have learnt by long experience that it is not the hedging of open cotton commitments on the Liverpool futures market, but the failure to do so, which is speculative, merchants, who buy or sell goods of which the price is expressed in a foreign currency, do not yet regard it as part of the normal routine of prudent business to hedge these indirect exchange commitments by a transaction in forward exchange.

It is important, on the other hand, not to exaggerate the extent to which, at the present time, merchants

can by this means protect themselves from risk. In the first place, for reasons, some of which will be considered below, it is only in certain of the leading exchanges that these transactions can be carried out at a reasonable charge. It is not clear that even the banks themselves have yet learnt to look on the provision for their clients of such facilities at fair and reasonable rates as one of the most useful services they can offer. They have been too much influenced, perhaps, by the fear that these facilities might tend at the same time to increase speculation.

But there is a further qualification, not to be overlooked, to the value of forward transactions as a protection against risk. The price of a particular commodity, in terms of a particular currency, does not exactly respond to changes in the value of that currency on the exchange markets of the world, with the result that a movement in a country's exchanges may, in the case of a commodity of which that country is a large seller or a large purchaser, change the commodity's world-value expressed in terms of gold. In that case a merchant, even though he is hedged in respect of the exchange itself, may lose, in respect of his unsold trading stocks, through a movement in the world-value of the commodity he is dealing in, directly occasioned by the exchange fluctuation.

If we turn to the theoretical analysis of the

forward market, what is it that determines the amount and the sign (whether plus or minus) of the divergence between the spot and forward rates as recorded above ?

If dollars one month forward are quoted cheaper than spot dollars to a London buyer in terms of sterling, this indicates a preference by the market, on balance, in favour of holding funds in New York during the month in question rather than in London,—a preference the degree of which is measured by the discount on forward dollars. For if spot dollars are worth \$4.40 to the pound and dollars one month forward $\$4.40\frac{1}{2}$ to the pound, then the owner of \$4.40 can, by selling the dollars spot and buying them back one month forward, find himself at the end of the month with $\$4.40\frac{1}{2}$, merely by being during the month the owner of £1 in London instead of \$4.40 in New York. That he should require and can obtain half a cent, which, earned in one month, is equal to about $.1\frac{1}{2}$ per cent per annum, to induce him to do the transaction, shows, and is, under conditions of competition, a measure of, the market's preference for holding funds during the month in question in New York rather than in London.

Conversely, if francs, lire, and marks one month forward are quoted dearer than the spot rates to a London buyer, this indicates a preference for holding funds in London rather than in Paris, Rome, or Berlin.

The difference between the spot and forward rates is, therefore, precisely and exactly the measure of the preference of the money and exchange market for holding funds in one international centre rather than in another, *the exchange risk apart*, that is to say under conditions in which the exchange risk is covered. What is it that determines these preferences ?

1. The most fundamental cause is to be found in the interest rates obtainable on "short" money—that is to say, on money lent or deposited for short periods of time in the money markets of the two centres under comparison. If by lending dollars in New York for one month the lender could earn interest at the rate of $5\frac{1}{2}$ per cent per annum, whereas by lending sterling in London for one month he could only earn interest at the rate of 4 per cent, then the preference observed above for holding funds in New York rather than in London is wholly explained. That is to say, forward quotations for the purchase of the currency of the dearer money market tend to be cheaper than spot quotations by a percentage per month equal to the excess of the interest which can be earned in a month in the dearer market over what can be earned in the cheaper. It must be noticed that the governing factor is the rate of interest obtainable for short periods, so that a country where, owing to the absence or ill-development of an organised money market, it is difficult to lend

money satisfactorily at call or for very short periods, may, for the purposes of this calculation, reckon as a low interest-earning market, even though the prevailing rate of interest for longer periods is not low at all. This consideration generally tends to make London and New York more attractive markets for short money than any Continental centres.

The effect of the cheap money rates ruling in London from the middle of 1922 to the middle of 1923 in diminishing the attractiveness of London as a depository of funds is strikingly shown, in the above tables, by the cheapening of the forward quotations of foreign currencies relatively to the spot quotations. In the case of the dollar the forward quotation had risen by the beginning of 1923 to a rate 3 per cent per annum above the spot quotation (*i.e.* forward dollars were 3 per cent per annum *cheaper* than spot dollars in terms of sterling), which meant (subject to modification by the other influences to be mentioned below) that the effective rate for short loans approached 3 per cent higher in New York than in London.

In the case of francs forward quotations which had been below spot, so long as money was dear in London, rose above the spot quotations, thus indicating that the relative dearness of money in London as compared with Paris had disappeared; whilst in the case of lire forward quotations, although still below spot quotations, rose, under the same influence, nearer to the spot level. Nevertheless, in the case of

both these currencies, a preponderance of bearish anticipations about their future prospects probably also played a part, for the reasons given in detail below, in producing the observed result.

The most interesting figures, however, are those relating to marks, which illustrate vividly what I have mentioned on page 23 above concerning the enormous money rates of interest current in Germany subsequent to the collapse of October 1922, as a result of the effort of the real rate of interest to remain positive in face of a general anticipation of a catastrophic collapse of the monetary unit. It will be noticed that the effective short money rate of interest in terms of marks ranged from 50 per cent per annum upwards, until finally the quotations were merely nominal.

2. If questions of credit did not enter in, the factor of the rate of interest on short loans would be the dominating one. Indeed, as between London and New York, it probably is so under existing conditions. Between London and Paris it is still important. But elsewhere the various uncertainties of financial and political risk, which the war has left behind, introduce a further element which sometimes quite transcends the factor of relative interest. The possibility of financial trouble or political disturbance, and the quite appreciable probability of a moratorium in the event of any difficulties arising, or of the sudden introduction of

exchange regulations which would interfere with the movement of balances out of the country, and even sometimes the contingency of a drastic demonetisation, —all these factors deter bankers, even when the exchange risk proper is eliminated, from maintaining large floating balances at certain foreign centres. Such risks prevent the business from being based, as it should be, on a mathematical calculation of interest rates; they obliterate by their possible magnitude the small “turns” which can be earned out of differences between interest rates plus a normal banker’s commission; and, being incalculable, they may even deter conservative bankers from doing the business on a substantial scale at any reasonable rate at all. In the case of Roumania or Poland, for example, this factor is, at times, the dominating one.

3. There is a third factor of some significance. We have assumed so far that the forward rate is fixed at such a level that the dealer or banker can cover himself by a simultaneous spot transaction and be left with a reasonable profit for his trouble. But it is not necessary to cover every forward transaction by a corresponding spot transaction; it may be possible to “marry” a forward sale with a forward purchase of the same currency. For example, whilst some of the market’s clients may wish to sell forward dollars, other clients will wish to buy forward dollars. In this case the market can set off these, one against

the other, in its books, and there will be no need of any movement of cash funds in either direction. The third factor depends, therefore, on whether it is the sellers or the buyers of forward dollars who predominate. To fix our minds, let us suppose that money-market conditions exist in which a sale of forward dollars against the purchase of spot dollars, at a discount of $1\frac{1}{2}$ per cent per annum for the former, yields neither profit nor loss. Now if in these conditions the purchasers of forward dollars, other than arbitragers, exceed sellers of forward dollars, then this excess of demand for forward dollars can be met by arbitragers, who have cash resources in London, at a discount which falls short of $1\frac{1}{2}$ per cent per annum by such amount (say $\frac{1}{2}$ per cent) as will yield the arbitragers sufficient profit for their trouble. If, however, sellers of forward dollars exceed the purchasers, then a sufficient discount has to be accepted by the former to induce arbitrage the other way round—that is to say, by arbitragers who have cash resources in New York—namely, a discount which exceeds $1\frac{1}{2}$ per cent per annum by, say, $\frac{1}{2}$ per cent. Thus the discount on forward dollars will fluctuate between 1 and 2 per cent per annum according as buyers or sellers predominate.

4. Lastly, we have to provide for the case, quite frequent in practice, where our assumption of a large and free market breaks down. A business in forward exchange can only be transacted by banks or similar

institutions. If the bulk of the business in a particular exchange is in a few hands, or if there is a tacit agreement between the principal institutions concerned to maintain differences which will allow more than a competitive profit, then the surcharge representing the profit of a bank for arbitraging between spot and forward transactions may much exceed the moderate figure indicated above. The quotations of the rates charged in Milan for forward dealings in lire, when compared with the rates current in London at the same date, indicate that a bank which is free to operate in both markets can frequently make an abnormal profit.

But there is a further contingency of considerable importance which occurs when speculation is exceptionally active and is all one way. It must be remembered that the floating capital normally available, and ready to move from centre to centre for the purpose of taking advantage of moderate arbitrage profits between spot and forward exchange, is by no means unlimited in amount, and is not always adequate to the market's requirements. When, for example, the market is feeling unusually bullish of the European exchanges as against sterling, or of sterling as against dollars, the pressure to sell forward sterling or dollars, as the case may be, may drive the forward price of these currencies to a discount on their spot price which represents an altogether abnormal profit to any one who is in a position to

buy these currencies forward and sell them spot. This abnormal discount can only disappear when the high profit of arbitrage between spot and forward has drawn fresh capital into the arbitrage business. So few persons understand even the elements of the theory of the forward exchanges that there was an occasion in 1920, even between London and New York, when a seller of spot dollars could earn at the rate of 6 per cent per annum above the London rate for short money by converting his dollars into sterling and providing at the same time by a forward sale of the sterling for reconversion into dollars in a month's time ; whilst, according to figures supplied me, it was possible, at the end of February 1921, by selling spot sterling in Milan and buying it back a month forward, to earn at the rate of more than 25 per cent per annum over and above any interest obtainable on a month's deposit of cash lire in Milan.

It is interesting to notice that when the differences between forward and spot rates have become temporarily abnormal, thus indicating an exceptional pressure of speculative activity, the speculators have often turned out to be right. For example, the abnormal discount on forward dollars, which persisted more or less from November 1920 to February 1921, thus indicating that the market was a bull of sterling, coincided with the sensational rise of sterling from 3.45 to 3.90. This discount was at its maximum when sterling touched its lowest

point and at its minimum (in the middle of May 1921) when sterling reached its highest point on that swing, which showed a remarkably accurate anticipation of events by the balance of professional opinion. The comparatively high discount on forward dollars current at the end of 1922 may, in the same way, have been partly due to an excess of bull speculation in favour of sterling based on an expectation of its recovery towards par, and not merely to the cheapness of money in London as compared with New York.

The same thing seems to have been true for the franc. In January and February 1921, the abnormal premium on the forward franc indicated that, in the view of the market, the franc had fallen too low, which turned out to be the case. They turned round at the precise moment when the franc reached its highest value (end of July 1921), and were right again. During the first five months of 1922, when the franc was almost stable, spot and forward quotations were practically at par with one another, whilst the progressive fall of the franc since June 1922 has been accompanied by a steady and sometimes substantial discount on forward francs; indicating, on this test, that the professional market was bearish of francs and therefore right once more. The lira tells somewhat the same tale. Thus, whilst the reader can see for himself by a study of the tables that no precise generalisation would be accurate, nevertheless the market has been broadly right when it

has taken a very decided view, as measured by forward rates.

This result may seem surprising in view of the huge amounts which exchange speculators in European currencies, more particularly on the bull side, are reputed to have lost. But the mass of amateur speculators throughout the world operate by cash purchases of the currency of which they are bulls, forward transactions being neither known nor available to them. Such speculation may afford temporary support to the spot exchange, but it has no influence on the difference between spot and forward, the subject now under discussion. The above conclusion is limited to the fact that when the type of professional speculation which makes use of the forward market is exceptionally active and united in its opinion, it has proved roughly correct, and has, therefore, been a useful factor in moderating the extreme fluctuations which would have occurred otherwise.

Out of the various practical conclusions which might be drawn from this discussion and the figures which accompany it, I will pick out three.

1. Those exchanges in which the fluctuations are wildest and the merchant is most in need of facilities for hedging his risk are precisely those in which facilities for forward dealing at moderate rates are

least developed. But this is to be explained, not necessarily by the instability of the exchange in itself, but by certain accompanying circumstances, such as distrust of the country's internal arrangements or its banking credit, a fear of the sudden imposition of exchange regulations or of a moratorium, and the other analogous influences mentioned above (pp. 126-7). There is no theoretical reason why there should not be an excellent forward market in a highly unstable exchange. In those countries, therefore, where regulation is still premature, it may nevertheless be possible to mitigate the evil consequences of fluctuation by organising facilities for forward dealings.

This is a function which the State banks of such countries could usefully perform. For this they must either themselves command a certain amount of foreign currency or they must provide facilities for accepting short-period deposits in their own currency from foreign bankers, on conditions which inspire these bankers with complete confidence in the freedom and liquidity of such deposits. Various technical devices could be suggested. But the simplest method might be for the State banks themselves to enter the forward market and offer to buy or sell forward exchange at a reasonable discount or premium on the spot quotation. I suggest that they should deal not direct with the public but only with approved banks and financial houses, from whom

they should require adequate security ; that they should quote every day their rates for buying and selling exchange either one or three months forward ; but that such quotation should take the form, not of a price for the exchange itself, but of a percentage difference between spot and forward, and should be a quotation for the double transaction of a spot deal one way and a simultaneous forward deal the other—*e.g.* the Bank of Italy might offer to sell spot sterling and buy forward sterling at a premium of $\frac{1}{8}$ per cent per month for the former over the latter, and to buy spot sterling and sell forward sterling at par. For the transaction of such business the State banks would require to command a certain amount of resources abroad, either in cash or in borrowing facilities. But this fund would be a revolving one, automatically replenished at the maturity of the forward contracts, so that it need not be on anything like the scale necessary for a fund for the purpose of supporting the exchange. Nor is it a business which involves any more risk than is inherent in all banking business as such ; from exchange risk proper is free.

With free forward markets thus established no merchant need run an exchange risk unless he wishes to, and business might find a stable foothold even in a fluctuating world. A recommendation in favour of action along these lines was included amongst the Financial Resolutions of the Genoa Conference of 1922.

I shall develop below (Chap. V.) a proposal that the Bank of England should strengthen its control by fixing spot and forward prices for gold every Thursday just as it now fixes its discount rate. But other Central Banks also would increase their control over fluctuations in exchange if they were to adopt the above plan of quoting rates for forward exchange in terms of spot exchange. By varying these rates they would be able, in effect, to vary the interest offered for *foreign* balances, as a policy distinct from whatever might be their bank-rate policy for the purpose of governing the interest obtainable on *home* balances.

2. It is not unusual at present for banks to endeavour to distinguish between speculative dealings in forward exchange and dealings which are intended to hedge a commercial transaction, with a view to discouraging the former; whilst official exchange regulations in many countries have been aimed at such discrimination. I think that this is a mistake. Banks should take stringent precautions to make sure that their clients are in a position to meet any losses which may accrue without serious embarrassment. But, having fully assured themselves on this point, it is not useful that they should inquire further—for the following reasons.

In the first place, it is almost impossible to prevent the evasion of such regulations; whilst, if the business is driven to methods of evasion, it tends to be pressed

underground, to yield excessive profits to middlemen, and to fall into undesirable hands.

But, what is more important and is less appreciated, the speculator with resources can provide a useful, indeed almost an essential, service. Since the volume of actual trade is spread unevenly through the year, the seasonal fluctuation, as explained above, is bound to occur with undue force unless some financial, non-commercial factor steps in to balance matters. A free forward market, from which speculative transactions are not excluded, will give by far the best facilities for the trader, who does not wish to speculate, to avoid doing so. The same sort of advantages will be secured for merchants generally as are afforded, for example, to the cotton trade by the dealings in "futures" in the New York and Liverpool markets. Where risk is unavoidably present, it is much better that it should be carried by those who are qualified or are desirous to bear it, than by traders, who have neither the qualification nor the desire to do so, and whose minds it distracts from their own business. The wide fluctuations in the leading exchanges over the past three years, as distinct from their persisting depreciation, have been due, not to the presence of speculation, but to the absence of a sufficient volume of it relatively to the volume of trade.

3. A failure to analyse the relation between spot and forward exchange may be, sometimes, partly responsible for a mistaken bank-rate policy. Dear

money—that is to say, high interest rates for short-period loans—has two effects. The one is indirect and gradual—namely, in diminishing the volume of credit quoted by the banks. This effect is much the same now as it always was. It is desirable to produce it when prices are rising and business is trying to expand faster than the supply of real capital and effective demand can permit in the long run. It is undesirable when prices are falling and trade is depressed.

The other effect of dear money, or rather of dearer money in one centre than in another, used to be to draw gold from the cheaper centre for temporary employment in the dearer. But nowadays the only immediate effect is to cause a new adjustment of the difference between the spot and forward rates of exchange between the two centres. If money becomes dearer in London, the discount on forward dollars diminishes or gives way to a premium. The effect has been pointed out above of the relative cheapening of money in London in the latter half of 1922 in increasing the discount on forward dollars, and of the relative raising of money-rates in the middle of 1923 in diminishing the discount. Such are, in present circumstances, the principal direct consequences of a moderate difference between interest rates in the two centres, apart, of course, from the indirect, long-period influence. Since no one is likely to remit money temporarily from one money market

to another on any important scale, with an uncovered exchange risk, merely to take advantage of $\frac{1}{2}$ or 1 per cent per annum difference in the interest rate, the direct effect of dearer money on the *absolute* level of the exchanges, as distinguished from the difference between spot and forward, is very small, being limited to the comparatively slight influence which the relation between spot and forward rates exerts on exchange speculators.¹ The pressure of arbitragers between spot and forward exchange, seeking to take advantage of the new situation, leads to a rapid adjustment of the difference between these rates, until the business of temporary remittance, as distinct from exchange speculation, is no more profitable than it was before, and consequently does not occur on any increased scale ; with the result that there is no marked effect on the absolute level of the spot rate.

The reasons given for the maintenance of a close relationship between the Bank of England's rate and that of the American Federal Reserve Board sometimes show confusion. The eventual influence of an effective high bank-rate on the general situation is undisputed ; but the belief that a moderate differ-

¹ If interest rates are raised in London, the discount on forward dollars will decrease or a premium will appear. This is likely to have some influence in encouraging speculative sales of forward dollars (how much influence depends on the proportion borne by the difference between the spot and forward rates to the probable range of fluctuation of the spot rate which the speculator anticipates) ; and in so far as this is the case, the covering sales of spot dollars by banks will move the rate of exchange in favour of London.

ence between bank-rates in London and New York reacts directly on the sterling-dollar exchange, as it used to do under a régime of convertibility, is a misapprehension. The direct reaction of this difference is on the discount for forward dollars as against spot dollars ; and it cannot much affect the absolute level of the spot rate unless the change in relative money-rates is comparable in magnitude (as it used to be but no longer is) with the possible range of exchange fluctuations.

CHAPTER IV

ALTERNATIVE AIMS IN MONETARY POLICY

OUR first two chapters, on the evils proceeding from instability in the purchasing power of money and on the part played by the exigencies of Public Finance, have indicated the practical importance of our subject to the welfare of society. In the third chapter an attempt has been made to lay a foundation of theory upon which to raise constructions. We can now turn, in this and the following chapter, to *Remedies*.

The instability of money has been compounded, in most countries except the United States, of two elements: the failure of the national currencies to remain stable in terms of what was supposed to be the standard of value, namely gold; and the failure of gold itself to remain stable in terms of purchasing power. Attention has been mainly concentrated (*e.g.* by the Cunliffe Committee) on the first of these two factors. It is often assumed that the restoration of the gold standard, that is to say, of the convertibility of each national currency at a fixed rate in terms of gold, must be, in any case, our objective;

and that the main question of controversy is whether national currencies should be restored to their pre-war gold value or to some lower value nearer to the present facts ; in other words, the choice between *Deflation* and *Devaluation*.

This assumption is hasty. If we glance at the course of prices during the last five years, it is obvious that the United States, which has enjoyed a gold standard throughout, has suffered as severely as many other countries, that in the United Kingdom the instability of gold has been a larger factor than the instability of the exchange, that the same is true even of France, and that in Italy it has been nearly as large. On the other hand, in India, which has suffered violent exchange fluctuations, the standard of value, as we shall see below, has been more stable than in any other country.

We should not, therefore, by fixing the exchanges get rid of our currency troubles. It is even possible that this step might weaken our control. The problem of stabilisation has several sides, which we must consider one by one :

1. *Devaluation versus Deflation*. Do we wish to fix the standard of value, whether or not it be gold, near the existing value ? Or do we wish to restore it to the pre-war value ?

2. *Stability of Prices versus Stability of Exchange*. Is it more important that the value of a national currency should be stable in terms of purchasing

power, or stable in terms of the currency of certain foreign countries ?

3. The Restoration of a Gold Standard. In the light of our answers to the first two questions, is a gold standard, however imperfect in theory, the best available method for attaining our ends in practice ?

Having decided between these alternative aims, we can proceed, in the next chapter, to some constructive suggestions.

I. *Devaluation* versus *Deflation*.

The policy of reducing the ratio between the volume of a country's currency and its requirements of purchasing power in the form of money, so as to increase the exchange value of the currency in terms of gold or of commodities, is conveniently called *Deflation*.

The alternative policy of stabilising the value of the currency somewhere near its present value, without regard to its pre-war value, is called *Devaluation*.

Up to the date of the Genoa Conference of April 1922, these two policies were not clearly distinguished by the public, and the sharp opposition between them has been only gradually appreciated. Even now (October 1923) there is scarcely any European country in which the authorities have made it clear whether their policy is to stabilise the value of their currency or to raise it. Stabilisation at the existing level has been recommended by International Con-

ferences;¹ and the actual value of many currencies tends to fall rather than to rise. But, to judge from other indications, the heart's desire of the State Banks of Europe, whether they pursue it successfully, as in Czecho-Slovakia, or unsuccessfully, as in France, is to *raise* the value of their currencies. In only one country so far have practical steps been taken to *fix* the exchange, namely in Austria.

The simple arguments against Deflation fall under two heads.

In the first place, Deflation is not *desirable*, because it effects, what is always harmful, a change in the existing Standard of Value, and redistributes wealth in a manner injurious, at the same time, to business and to social stability. Deflation, as we have already seen, involves a transference of wealth from the rest of the community to the *rentier* class and to all holders of titles to money; just as inflation involves the opposite. In particular it involves a transference from all borrowers, that is to say from traders, manufacturers, and farmers, to lenders, from the active to the inactive.

¹ Whilst the Conference of Genoa (April 1922) affirmed the doctrine in general, representatives of the countries chiefly affected were united in declaring that it must not be applied to them in particular. Signor Peano, M. Picard, and M. Theunis, speaking on behalf of Italy, France, and Belgium, announced, each for his own country, that they would have nothing to do with devaluating, and were determined to restore their respective currencies to their pre-war values. Reform is not likely to come by joint, simultaneous action. The experts of Genoa recognised this when they "ventured to suggest" that "a considerable service will be rendered by that country which first decides boldly to set the example of securing immediate stability in terms of gold" by devaluation.

But whilst the oppression of the taxpayer for the enrichment of the *rentier* is the chief lasting result, there is another, more violent, disturbance during the period of transition. The policy of gradually raising the value of a country's money to (say) 100 per cent above its present value in terms of goods—I repeat here the arguments of Chapter I.—amounts to giving notice to every merchant and every manufacturer, that for some time to come his stock and his raw materials will steadily depreciate on his hands, and to every one who finances his business with borrowed money that he will, sooner or later, lose 100 per cent on his liabilities (since he will have to pay back in terms of commodities twice as much as he has borrowed). Modern business, being carried on largely with borrowed money, must necessarily be brought to a standstill by such a process. It will be to the interest of every one in business to go out of business for the time being; and of every one who is contemplating expenditure to postpone his orders so long as he can. The wise man will be he who turns his assets into cash, withdraws from the risks and the exertions of activity, and awaits in country retirement the steady appreciation promised him in the value of his cash. A probable expectation of Deflation is bad enough; a certain expectation is disastrous. For the mechanism of the modern business world is even less adapted to fluctuations in the value of money upwards than it is to fluctuations downwards.

In the second place, in many countries, Deflation, even were it desirable, is not *possible*; that is to say, Deflation in sufficient degree to restore the currency to its pre-war parity. For the burden which it would shrow on the taxpayer would be insupportable. I need add nothing on this to what I have already written in the second chapter above. This practical impossibility might have rendered the policy innocuous, if it were not that, by standing in the way of the alternative policy, it prolongs the period of uncertainty and severe seasonal fluctuation, and even, in some cases, can be carried into effect sufficiently to cause much interference with business. The fact, that the restoration of their currencies to the pre-war parity is still the declared official policy of the French and Italian Governments, is preventing, in those countries, any rational discussion of currency reform. All those — and in the financial world they are many—who have reasons for wishing to appear “correct,” are compelled to talk foolishly. In Italy, where sound economic views have much influence and which may be nearly ripe for currency reform, Signor Mussolini has threatened to raise the lira to its former value. Fortunately for the Italian taxpayer and Italian business, the lira does not listen even to a dictator and cannot be given castor oil. But such talk can postpone positive reform; though it may be doubted if so good a politician would have propounded such a policy, even in bravado and exuberance, if he had

understood that, expressed in other but equivalent words, it was as follows: "My policy is to halve wages, double the burden of the National Debt, and to reduce by 50 per cent the prices which Sicily can get for her exports of oranges and lemons."

One single country—Czechoslovakia—has made the experiment on a modest but sufficient scale. Comparatively free from the burden of internal debt, and free also from serious budgetary deficits, Czechoslovakia was able in the course of 1922, in pursuance of the policy of her Finance Minister, Dr. Alois Rasin, to employ the proceeds of certain foreign loans to improve the exchange value of the Czech crown to nearly three times the rate which had been touched in the previous year. The policy has cost her an industrial crisis and serious unemployment. To what purpose? I do not know. Even now the Czech crown is not worth a sixth of its pre-war parity; and it remains unstabilised, fluttering before the breath of the seasons and the wind of politics. Is, therefore, the process of appreciation to continue indefinitely? If not, when and at what point is stabilisation to be effected? Czechoslovakia was better placed than any country in Europe to establish her economic life on the basis of a sound and fixed currency. Her finances were in equilibrium, her credit good, her foreign resources adequate, and no one could have blamed her for devaluating the crown, ruined by no fault of hers

and inherited from the Habsburg Empire. Pursuing a misguided policy in a spirit of stern virtue, she preferred the stagnation of her industries and a still fluctuating standard.¹

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If the restoration of many European currencies to their pre-war parity with gold is neither desirable nor possible, what are the forces or the arguments which have established this undesirable impossibility as the avowed policy of most of them? The following are the most important:

1. *To leave the gold value of a country's currency at the low level to which war has driven it is an injustice to the rentier class and to others whose income is fixed in terms of currency, and practically a breach of contract; whilst to restore its value would meet a debt of honour.*

The injury done to pre-war holders of fixed interest-bearing stocks is beyond dispute. Real justice, indeed, might require the restoration of the purchasing power,

¹ I cannot criticise the work, in his second term of office (1922), of Dr. Rasin, now fallen by the hand of an assassin, without reference to his great achievement during his first term (1919) in rescuing his country's currency from the surrounding chaos. The stamping of the Austrian notes and the levy on holders of titles to money which accompanied it was the only drastic, courageous, and successful measure of finance carried through anywhere in Europe at that epoch; the story of it from Dr. Rasin's own pen can be read in his *The Financial Policy of Czecho-Slovakia*. Before he had finished other influences became dominant. But, when in 1922 this austere and disinterested Minister returned to office, he missed, in my judgment, his opportunity. He could have completed his task by establishing the currency on a fixed and stable basis, instead of which he used his great authority to disorder trade by a futile process of Deflation.

and not merely the gold value, of their money incomes, a measure which no one in fact proposes; whilst nominal justice has not been infringed, since these investments were not in gold bullion but in the legal tender of the realm. Nevertheless, if this class of investors could be dealt with separately, considerations of equity and the expedience of satisfying reasonable expectation would furnish a strong case.

But this is not the actual situation. The vast issues of War Loans have swamped the pre-war holdings of fixed interest-bearing stocks, and society has largely adjusted itself to the new situation. To restore the value of pre-war holdings by Deflation means enhancing at the same time the value of war and post-war holdings, and thereby raising the total claims of the *rentier* class not only beyond what they are entitled to, but to an intolerable proportion of the total income of the community. Indeed justice, rightly weighed, comes down on the other side. Much the greater proportion of the money contracts still outstanding were entered into when money was worth more nearly what it is worth now than what it was worth in 1913. Thus, in order to do justice to a minority of creditors, a great injustice would be done to a great majority of debtors.

This aspect of the matter has been admirably argued by Professor Irving Fisher.¹ We forget, he

¹ In his article "Devaluation *versus* Deflation," published in the eleventh *Manchester Guardian* Reconstruction Supplement (Dec. 7, 1922).

says, that not all contracts require the same adjustment in order to secure justice, and that while we are debating whether we ought to deflate to secure ideal justice for those who made contracts on old price levels, new contracts are constantly being made at the new price levels. An estimate of the volume of contracts now outstanding, classified according to their age, would show that some contracts are a day old, some are a month old, some are a year old, some are a decade old, and some are a century old, the great mass, however, being of very recent origin. Consequently the average, or centre of gravity, of the total existing indebtedness is probably always somewhat near the present. Before the war, Professor Fisher estimated, very roughly, that contracts in the United States were on the average about one year old.

When, therefore, the depreciation of the currency has lasted long enough for society to adjust itself to the new values, Deflation is even worse than Inflation. Both are "unjust" and disappoint reasonable expectation. But whereas Inflation, by easing the burden of national debt and stimulating enterprise, has a little to throw into the other side of the balance, Deflation has nothing.

2. *The restoration of a currency to its pre-war gold value enhances a country's financial prestige and promotes future confidence.*

Where a country can hope to restore its pre-war parity at an early date, this argument cannot be

neglected. This might be said of Great Britain, Holland, Sweden, Switzerland, and (perhaps) Spain, but of no other European country. The argument cannot be extended to those countries which, even if they could raise somewhat the value of their legal-tender money, could not possibly restore it to its old value. It is of the essence of the argument that the *exact* pre-war parity should be recovered. It would not make much difference to the financial prestige of Italy whether she stabilised the lira at 100 to the £ sterling or at 60; and it would be much better for her prestige to stabilise it definitely at 100 than to let it fluctuate between 60 and 100.

This argument is limited, therefore, to those countries the gold value of whose currencies is within (say) 5 or 10 per cent of their former value. Its force in these cases depends, I think, upon what answer we give to the problem discussed below, namely, whether we intend to pin ourselves in the future, as in the past, to an unqualified gold standard. If we still prefer such a standard to any available alternative, and if future "confidence" in our currency is to depend not on the stability of its purchasing power but on the fixity of its gold-value, then it may be worth our while to stand the racket of Deflation to the extent of 5 or 10 per cent. This view is in accordance with that expressed by Ricardo in analogous circumstances a hundred years ago.¹ If,

¹ See below, p. 153.

on the other hand, we decide to aim for the future at stability of the price level rather than at a fixed parity with gold, in that case *cadit quaestio*.

In any case this argument does not affect our main conclusion, that the right policy for countries of which the currency has suffered a prolonged and severe depreciation is to *devalue*, and to fix the value of the currency at that figure in the neighbourhood of the existing value to which commerce and wages are adjusted.

3. *If the gold value of a country's currency can be increased, labour will profit by a reduced cost of living, foreign goods will be obtainable cheaper, and foreign debts fixed in terms of gold (e.g. to the United States) will be discharged with less effort.*

This argument, which is pure delusion, exercises quite as much influence as the other two. If the franc is worth more, wages, it is argued, which are paid in francs, will surely buy more, and French imports, which are paid for in francs, will be so much cheaper. No! If francs are worth more they will buy more labour as well as more goods,—that is to say, wages will fall; and the French exports, which pay for the imports, will, measured in francs, fall in value just as much as the imports. Nor will it make in the long run any difference whatever in the amount of goods the value of which England will have to transfer to America to pay her dollar debts, whether in the end sterling settles down at four dollars to

the pound, or at its pre-war parity. The burden of this debt depends on the value of gold, in terms of which it is fixed, not on the value of sterling. It is not easy, it seems, for men to apprehend that their money is a mere intermediary, without significance in itself, which flows from one hand to another, is received and is dispensed, and disappears when its work is done from the sum of a nation's wealth.

In concluding this section, let me quote on the issue between Deflation and Devaluation two classic authorities, Gibbon and Ricardo, the one to represent the imposing but false wisdom of the would-be upright statesman, the other to speak in clear tones the voice of instructed reason.

In the eleventh chapter of *The Decline and Fall*, Gibbon deems incredible a story of how in A.D. 274 Aurelian's deflationary zeal to restore the integrity of the coin excited an insurrection which caused the death of 7000 soldiers. "We might naturally expect," he says, "that the reformation of the coin should have been an action equally popular with the destruction of those obsolete accounts, which by the emperor's order were burnt in the forum of Trajan. In an age when the principles of commerce were so imperfectly understood, the most desirable end might perhaps be effected by harsh and injudicious means; but a temporary grievance of such a nature can scarcely excite and support a serious civil war. The

repetition of intolerable taxes, imposed either on the land or on the necessities of life, may at last provoke those who will not or who cannot relinquish their country. But the case is far otherwise in every operation which, by whatsoever expedients, restores the just value of money.”

Rome may have understood the principles of commerce imperfectly in the third century and not perfectly in the twentieth; but that does not save her citizens from experiencing their applications. Signor Mussolini might peruse with interest the annals of Aurelian, who, “ignorant or impatient of the restraints of civil institutions,” fell by the hand of an assassin within a year of his deflation of the currency, “regretted by the army, detested by the Senate, but universally acknowledged as a warlike and fortunate prince, the useful though severe reformer of a degenerate State.”

Ricardo, speaking in the House of Commons on the 12th of June 1822,¹ gave his opinion that: “If in the year 1819 the value of the currency had stood at 14s. for the pound note, which was the case in the year 1813, he should have thought that, on a balance of all the advantages and disadvantages of the case,

¹ The great debate of June 11 and 12, 1822, on Mr. Western’s Motion concerning the Resumption of Cash Payments, well illustrates, more particularly in the speeches of the opener, Mr. Western, and of the opposer, Mr. Huskisson, the regularity of the evils which follow a deflationary raising of the standard, and the unchanging antithesis between the temperaments of deflationists and devaluers, though I doubt if any present-day deflationists could make a speech at the same time so able and so unfair as Mr. Huskisson’s.

it would have been as well to fix the currency at the then value, according to which most of the existing contracts had been made; but when the currency was within 5 per cent of its par value, he thought they had made the best selection in recurring to the old standard."

The same is repeated in his *Protection to Agriculture*,¹ where he approves the restoration of the old standard when gold was £4 : 2s. per standard ounce, but adds that, if it had been £5 : 10s., "no measure could have been more inexpedient than to make so violent a change in all subsisting engagements."

II. *Stability of Prices versus Stability of Exchange.*

Since, subject to the qualification of Chapter III., the rate of exchange of a country's currency with the currency of the rest of the world (assuming for the sake of simplicity that there is only one external currency) depends on the relation between the internal price level and the external price level, it follows that the exchange cannot be stable unless *both* internal *and* external price levels remain stable. If, therefore, the external price level lies outside our control, we must submit either to our own internal price level or to our exchange being pulled about by external influences. If the external price level is unstable, we cannot keep *both* our own price level

¹ *Works*, p. 468.

and our exchanges stable. And we are compelled to choose.

In pre-war days, when almost the whole world was on a gold standard, we had all plumped for stability of exchange as against stability of prices, and we were ready to submit to the social consequences of a change of price level for causes quite outside our control, connected, for example, with the discovery of new gold mines in foreign countries or a change of banking policy abroad. But we submitted, partly because we did not dare trust ourselves to a less automatic (though more reasoned) policy, and partly because the price fluctuations experienced were in fact moderate. Nevertheless, there were powerful advocates of the other choice. In particular, the proposals of Professor Irving Fisher for a Compensated Dollar, amounted, unless all countries adopted the same plan, to putting into practice a preference for stability of internal price level over stability of external exchange.

The right choice 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. Nevertheless, there does seem to be in almost every case a presumption in favour of the stability of prices, if only it can be achieved. 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 described in Chapter I. 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. The main argument to the contrary seems to be that exchange stability is an easier aim to attain, since it only requires that the same standard of value should be adopted at home and abroad; whereas an internal standard, so regulated as to maintain stability in an index number of prices, is a difficult scientific innovation, never yet put into practice.

There has been an interesting example recently of a country which, more perhaps by chance than by design, has secured the advantages of a relatively stable level of internal prices at the expense of a fluctuating exchange, namely India. Public attention is so much fixed on the exchange as the test of the success of a financial policy, that the Government of India, under severe reproaches for what has happened, have not defended themselves as effectively as they might. During the boom of 1919-20, when world prices were soaring, the exchange value of the rupee was allowed to rise by successive stages, with the result that the highest level reached by the Indian index number in 1920 exceeded by only 12 per cent the average figure for 1919, whereas for England the figure was 29 per cent. The Report of the Indian Currency

Committee, on which the Government of India acted somewhat clumsily without enough allowance for rapidly changing conditions, was avowedly influenced by the importance in such a country as India, especially in the political circumstances of that time, of avoiding a violent upward movement of internal prices. The most just criticism of the Government of India's action, in the light of after-events, is that they went too far in attempting to raise the rupee so high as 2s. 8d.,—a rate not contemplated by the Currency Committee. Prices outside India never rose so high as to justify an exchange exceeding 2s. 3d. on the criterion of keeping Indian prices stable at the 1919 level. On the other hand, when world prices collapsed, the rupee exchange was allowed to fall with them, again with the result that the lowest point touched by the Indian index number in 1921 was only 16 per cent below the highest in 1920, whereas for England the figure was 50 per cent. The following table gives the details :

| | Indian Prices. | English Prices. ¹ | Value of Rupee in Sterling. | |
|--------------|----------------|------------------------------|-----------------------------|------------------|
| | | | Purchasing Power Parity. | Actual Exchange. |
| Average 1919 | 100 | 100 | 100 | 100 |
| Highest 1920 | 112 | 129 | 115 | 152 |
| Lowest 1921 | 95 | 65 | 69 | 72 |
| Average 1922 | 90 | 64 | 71 | 74 |

¹ *Statist.*

If the Government of India had been successful in stabilising the rupee-sterling exchange, they would necessarily have subjected India to a disastrous price fluctuation comparable to that in England. Thus the unthinking assumption, in favour of the restoration of a fixed exchange as the one thing to aim at, requires more examination than it sometimes receives.

Especially is this the case if the prospect that a majority of countries will adopt the same standard is still remote. When by adopting the gold standard we could achieve stability of exchange with almost the whole world, whilst any other standard would have appeared as a solitary eccentricity, the solid advantages of certainty and convenience supported the conservative preference for gold. Nevertheless, even so, the convenience of traders and the primitive passion for solid metal might not, I think, have been adequate to preserve the dynasty of gold, if it had not been for another, half-accidental circumstance; namely, that for many years past gold had afforded not only a stable exchange but, on the whole, a stable price level also. In fact, the choice between stable exchanges and stable prices had not presented itself as an acute dilemma. And when, prior to the development of the South African mines, we seemed to be faced with a continuously falling price level, the fierceness of the bimetallic controversy testified to the discontent provoked as soon as the existing standard appeared seriously incompatible with the stability of prices.

Indeed, it is doubtful whether the pre-war system for regulating the international flow of gold would have been capable of dealing with such large or sudden divergencies between the price levels of different countries as have occurred lately. The fault of the pre-war régime, under which the rates of exchange between a country and the outside world were fixed, and the internal price level had to adjust itself thereto (*i.e.* was chiefly governed by external influences), was that it was too slow and insensitive in its mode of operation. The fault of the post-war régime, under which the price level mainly depends on internal influences (*i.e.* internal currency and credit policy) and the rates of exchange with the outside world have to adjust themselves thereto, is that it is too rapid in its effect and over-sensitive, with the result that it may act violently for merely transitory causes. Nevertheless, when the fluctuations are large and sudden, a quick reaction is necessary for the maintenance of equilibrium ; and the necessity for quick reaction has been one of the factors which have rendered the pre-war method inapplicable to post-war conditions, and have made every one nervous of proclaiming a final fixation of the exchange.

We are familiar with the causal chain along which the pre-war method reached its result. If gold flowed out of the country's central reserves, this modified discount policy and the creation of credit, thus affecting the demand for, and hence the price of,

the class of goods most sensitive to the ease of credit, and gradually, through the price of these goods, spreading its influence to the prices of goods generally, including those which enter into international trade, until at the new level of price foreign goods began to look dear at home and domestic goods cheap abroad, and the adverse balance was redressed. But this process might take months to work itself out. Nowadays, the gold reserves might be dangerously depleted before the compensating forces had time to operate. Moreover, the movement of the rate of interest up or down sometimes had more effect in attracting foreign capital or encouraging investment abroad than in influencing home prices. Where the disequilibrium was purely seasonal, this was an unqualified advantage; for it was much better that foreign funds should ebb and flow between the slack and the busy seasons than that prices should go up and down. But where it was due to more permanent causes, the adjustment even before the war might be imperfect; for the stimulus to foreign loans, whilst restoring the balance for the time being, might obscure the real seriousness of the situation, and enable a country to live beyond its resources for a considerable time at the risk of ultimate default.

Compare with this the instantaneous effects of the post-war method. If at the existing rate of exchange the amount of sterling offered in the ex-

change market during the course of the morning exceeds the amount of dollars offered, there is no gold available for export at a fixed price to bridge the gulf. Consequently the dollar rate of exchange must move until at the new rate the offerings of each of the two currencies in exchange for one another exactly balance in amount. But it is the inevitable result of this that within half an hour the relative prices of commodities entering into English-American trade, such as cotton and electrolytic copper, have adjusted themselves accordingly. Unless the American prices move to meet them half-way, the English prices immediately rise correspondent to the movement of the exchange.

This means that relative prices can be knocked about by the most fleeting influences of politics and of sentiment, and by the periodic pressure of seasonal trades. But it also means that the post-war method is a most rapid and powerful corrective of real disequilibria in the balance of international payments arising from whatever causes, and a wonderful preventive in the way of countries which are inclined to spend abroad beyond their resources.

Thus when there are violent shocks to the pre-existing equilibrium between the internal and external price-levels, the pre-war method is likely to break down in practice, simply because it cannot bring about the re-adjustment of internal prices *quick enough*. Theoretically, of course, the pre-war method must

be able to make itself effective sooner or later, provided the movement of gold is allowed to continue without restriction, until the inflation or deflation of prices has taken place to the necessary extent. But in practice there is usually a limit to the rate and to the amount by which the actual currency or the metallic backing for it can be allowed to flow abroad. If the supply of money or credit is reduced faster than social and business arrangements allow prices to fall, intolerable inconveniences result. Perhaps some of the incidents of debasement of the coinage which are sprinkled through the currency history of the late Middle Ages were really due to a similar cause. Prior to the discovery of the New World the precious metals were, over a long period, becoming progressively scarcer in Europe through natural wastage in the absence of adequate new supplies, and the drain to the East; with the result that from time to time the price level in England (for example) would be established on too high a level in relation to European prices. The resulting tendency of silver to flow abroad, being accentuated perhaps by some special temporary cause, would give rise to complaints of a "scarcity of currency," which really means an outflow of money faster than social organisation permits prices to fall. No doubt some of the debasements were helped by the fact that they profited incidentally a necessitous Exchequer. But they may have been, nevertheless,

the best available expedient for meeting the currency problem.¹ We shall look on Edward III.'s debase-ments of sterling money with a more tolerant eye if we regard them as a method of carrying into effect a preference for stability of internal prices over stability of external exchanges, celebrating that monarch as an enlightened forerunner of Professor Irving Fisher in advocacy of the "compensated dollar," only more happy than the latter in his opportunities to carry theory into practice.

The reader should notice, further, the different parts played by discount policy under the one régime and under the other. With the pre-war method discount policy is a vital part of the process for restoring equilibrium between internal and external prices. With the post-war method it is not equally indispensable, since the fluctuation of the exchanges can bring about equilibrium without its aid;—though it remains, of course, as an instrument for influencing the internal price level and through this the exchanges, if we desire to establish either the one or the other at a different level from that which would have prevailed otherwise.

III. *The Restoration of a Gold Standard.*

Our conclusions up to this point are, therefore, that, when stability of the internal price level and stability of the external exchanges are incompatible,

¹ Cf. Hawtrey, *Currency and Credit*, chap. xvii.

the former is generally preferable ; and that on occasions when the dilemma is acute, the preservation of the former at the expense of the latter is, fortunately perhaps, the line of least resistance.

The restoration of the gold standard (whether at the pre-war parity or at some other rate) certainly will not give us complete stability of internal prices and can only give us complete stability of the external exchanges if all other countries also restore the gold standard. The advisability of restoring it depends, therefore, on whether, on the whole, it will give us the best working compromise obtainable between the two ideals.

The advocates of gold, as against a more scientific standard, base their cause on the double contention, that in practice gold has provided and will provide a reasonably stable standard of value, and that in practice, since governing authorities lack wisdom as often as not, a managed currency will, sooner or later, come to grief. Conservatism and scepticism join arms—as they often do. Perhaps superstition comes in too ; for gold still enjoys the prestige of its smell and colour.

The considerable success with which gold maintained its stability of value in the changing world of the nineteenth century was certainly remarkable. I have applauded it in the first chapter. After the discoveries of Australia and California it began to depreciate dangerously, and before the exploitation

of South Africa it began to appreciate dangerously. Yet in each case it righted itself and retained its reputation.

But the conditions of the future are not those of the past. We have no sufficient ground for expecting the continuance of the special conditions which preserved a sort of balance before the war. For what are the underlying explanations of the good behaviour of gold during the nineteenth century ?

In the first place, it happened that progress in the discovery of gold mines roughly kept pace with progress in other directions—a correspondence which was not altogether a matter of chance, because the progress of that period, since it was characterised by the gradual opening up and exploitation of the world's surface, not unnaturally brought to light *pari passu* the remoter deposits of gold. But this stage of history is now almost at an end. A quarter of a century has passed by since the discovery of an important deposit. Material progress is more dependent now on the growth of scientific and technical knowledge, of which the application to gold-mining may be intermittent. Years may elapse without great improvement in the methods of extracting gold ; and then the genius of a chemist may realise past dreams and forgotten hoaxes, transmuting base into precious like Subtle, or extracting gold from sea-water as in the Bubble. Gold is liable to be either too dear or too cheap. In either case, it is too much to expect

that a succession of accidents will keep the metal steady.

But there was another type of influence which used to aid stability. The value of gold has not depended on the policy or the decisions of a single body of men ; and a sufficient proportion of the supply has been able to find its way, without any flooding of the market, into the Arts or into the hoards of Asia for its marginal value to be governed by a steady psychological estimation of the metal in relation to other things. This is what is meant by saying that gold has "intrinsic value" and is free from the dangers of a "managed" currency. The *independent variety* of the influences determining the value of gold has been in itself a steadying influence. The arbitrary and variable character of the proportion of gold reserves to liabilities maintained by many of the note-issuing banks of the world, so far from introducing an incalculable factor, was an element of stability. For when gold was relatively abundant and flowed towards them, it was absorbed by their allowing their ratio of gold reserves to rise slightly ; and when it was relatively scarce, the fact that they had no intention of ever utilising their gold reserves for any practical purpose, permitted most of them to view with equanimity a moderate weakening of their proportion. A great part of the flow of South African gold between the end of the Boer War and 1914 was able to find its way into the central gold reserves

of European and other countries with the minimum effect on prices.

But the war has effected a great change. Gold itself has become a "managed" currency. The West, as well as the East, has learnt to hoard gold; but the motives of the United States are not those of India. Now that most countries have abandoned the gold standard, the supply of the metal would, if the chief user of it restricted its holdings to its real needs, prove largely redundant. The United States has not been able to let gold fall to its "natural" value, because it could not face the resulting depreciation of its standard. It has been driven, therefore, to the costly policy of burying in the vaults of Washington what the miners of the Rand have laboriously brought to the surface. Consequently gold now stands at an "artificial" value, the future course of which almost entirely depends on the policy of the Federal Reserve Board of the United States. The value of gold is no longer the resultant of the chance gifts of Nature and the judgment of numerous authorities and individuals acting independently. Even if other countries gradually return to a gold basis, the position will not be greatly changed. The tendency to employ some variant of the gold-exchange standard and the probably permanent disappearance of gold from the pockets of the people are likely to mean that the strictly *necessary* gold reserves of the Central Banks of the gold-standard countries will fall

considerably short of the available supplies. The actual value of gold will depend, therefore, on the policy of three or four of the most powerful Central Banks, whether they act independently or in unison. If, on the other hand, pre-war conventions about the use of gold in reserves and in circulation were to be restored—which is, in my opinion, the much less probable alternative—there might be, as Professor Cassel has predicted, a serious shortage of gold leading to a progressive appreciation in its value.

Nor must we neglect the possibility of a partial demonetisation of gold by the United States through a closing of its mints to further receipts of gold. The present policy of the United States in accepting unlimited imports of gold can be justified, perhaps, as a temporary measure, intended to preserve tradition and to strengthen confidence through a transitional period. But, looked at as a permanent arrangement, it could hardly be judged otherwise than as a foolish expense. If the Federal Reserve Board intends to maintain the value of the dollar at a level which is irrespective of the inflow or outflow of gold, what object is there in continuing to accept at the mints gold which is not wanted, yet costs a heavy price? If the United States mints were to be closed to gold, everything, except the actual price of the metal, could continue precisely as before.

Confidence in the future stability of the value of gold depends therefore on the United States being

foolish enough to go on accepting gold which it does not want, and wise enough, having accepted it, to maintain it at a fixed value. This double event might be realised through the collaboration of a public understanding nothing with a Federal Reserve Board understanding everything. But the position is precarious; and not very attractive to any country which is still in a position to choose what its future standard is to be.

This discussion of the prospects of the stability of gold has partly answered by anticipation the second principal argument in favour of the restoration of an unqualified gold standard, namely that this is the only way of avoiding the dangers of a "managed" currency.

It is natural, after what we have experienced, that prudent people should desiderate a standard of value which is independent of Finance Ministers and State Banks. The present state of affairs has allowed to the ignorance and frivolity of statesmen an ample opportunity of bringing about ruinous consequences in the economic field. It is felt that the general-level of economic and financial education amongst statesmen and bankers is hardly such as to render innovations feasible or safe; that, in fact, a chief object of stabilising the exchanges is to strap down Ministers of Finance.

These are reasonable grounds of hesitation. But the experience on which they are based is by no means

fair to the capacities of statesmen and bankers. The non-metallic standards, of which we have experience, have been anything rather than scientific experiments coolly carried out. They have been a last resort, involuntarily adopted, as a result of war or inflationary taxation, when the State finances were already broken or the situation out of hand. Naturally in these circumstances such practices have been the accompaniment and the prelude of disaster. But we cannot argue from this to what can be achieved in normal times. 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.

If, indeed, a providence watched over gold, or if Nature had provided us with a stable standard ready-made, I would not, in an attempt after some slight improvement, hand over the management to the possible weakness or ignorance of Boards and Governments. But this is not the situation. We have no ready-made standard. Experience has shown that in emergencies Ministers of Finance cannot be strapped down. And—most important of all—in the modern world of paper currency and bank credit there is no escape from a “managed” currency, whether we wish it or not ;—convertibility into gold will not alter the fact that the value of gold itself depends on the policy of the Central Banks.

It is worth while to pause a moment over the last

sentence. It differs significantly from the doctrine of gold reserves which we learnt and taught before the war. We used to assume that no Central Bank would be so extravagant as to keep more gold than it required or so imprudent as to keep less. From time to time gold would flow out into the circulation or for export abroad; experience showed that the quantity required on these occasions bore some rough proportion to the Central Bank's liabilities; a decidedly higher proportion than this would be fixed on to provide for contingencies and to inspire confidence; and the creation of credit would be regulated largely by reference to the maintenance of this proportion. The Bank of England, for example, would allow itself to be swayed by the tides of gold, permitting the inflowing and outflowing streams to produce their "natural" consequences unchecked by any ideas as to preventing the effect on prices. Already before the war, the system was becoming precarious by reason of its artificiality. The "proportion" was by the lapse of time losing its relation to the facts and had become largely conventional. Some other figure, greater or less, would have done just as well.¹ The War broke down the convention; for the withdrawal of gold from actual circulation destroyed one of the elements of reality lying behind the convention, and the suspension of convertibility

¹ *Vide*, for what I wrote about this in 1914, *The Economic Journal*, xxiv. p. 621.

destroyed the other. It would have been absurd to regulate the bank rate by reference to a "proportion" which had lost all its significance; and in the course of the past ten years a new policy has been evolved. The bank rate is now employed, however incompletely and experimentally, to regulate the expansion and deflation of credit in the interests of business stability and the steadiness of prices. In so far as it is employed to procure stability of the dollar exchange, where this is inconsistent with stability of internal prices, we have a relic of pre-war policy and a compromise between discrepant aims.

Those who advocate the return to a gold standard do not always appreciate along what different lines our actual practice has been drifting. If we restore the gold standard, are we to return also to the pre-war conceptions of bank-rate, allowing the tides of gold to play what tricks they like with the internal price-level, and abandoning the attempt to moderate the disastrous influence of the credit-cycle on the stability of prices and employment? Or are we to continue and develop the experimental innovations of our present policy, ignoring the "bank ratio" and, if necessary, allowing unmoved a piling up of gold reserves far beyond our requirements or their depletion far below them?

In truth, the gold standard is already a barbarous relic. All of us, from the Governor of the Bank of England downwards, are now primarily interested in

preserving the stability of business, prices, and employment, and are not likely, when the choice is forced on us, deliberately to sacrifice these to the outworn dogma, which had its value once, of £3 : 17 : 10½ per ounce. Advocates of the ancient standard do not observe how remote it now is from the spirit and the requirements of the age. A regulated non-metallic standard has slipped in unnoticed. *It exists.* Whilst the economists dozed, the academic dream of a hundred years, doffing its cap and gown, clad in paper rags, has crept into the real world by means of the bad fairies—always so much more potent than the good—the wicked Ministers of Finance.

For these reasons enlightened advocates of the restoration of gold, such as Mr. Hawtrey, do not welcome it as the return of a “natural” currency, and intend, quite decidedly, that it shall be a “managed” one. They allow gold back only as a constitutional monarch, shorn of his ancient despotic powers and compelled to accept the advice of a Parliament of Banks. The adoption of the ideas present in the minds of those who drafted the Genoa Resolutions on Currency is an essential condition of Mr. Hawtrey’s adherence to gold. He contemplates “the practice of continuous co-operation among central banks of issue” (Res. 3), and an international convention, based on a gold exchange standard, and designed “with a view to preventing undue fluctuations

in the purchasing power of gold" (Res. 11).¹ But he is *not* in favour of resuming the gold standard irrespective of "whether the difficulties in regard to the future purchasing power of gold have been provided against or not." "It is not easy," he admits, "to promote international action, and should it fail, the wisest course for the time being might be to concentrate on the stabilisation of sterling in terms of commodities, rather than tie the pound to a metal, the vagaries of which cannot be foreseen."²

It is natural to ask, in face of advocacy of this kind, why it is necessary to drag in gold at all. Mr. Hawtrey lays no stress on the obvious support for his compromise, namely the force of sentiment and tradition, and the preference of Englishmen for shearing a monarch of his powers rather than of his head. But he adduces three other reasons: (1) that gold is required as a liquid reserve for the settlement of international balances of indebtedness; (2) that it enables an experiment to be made without cutting adrift from the old system; and (3) that the vested interests of gold producers must be considered. These objects, however, are so largely attained by my own suggestions in the following chapter, that I need not dwell on them here.

On the other hand, I see grave objections to reinstating gold in the pious hope that international co-operation will keep it in order. With the existing

¹ *Monetary Reconstruction*, p. 132.

² *Loc. cit.* p. 22.

distribution of the world's gold, the reinstatement of the gold standard means, inevitably, that we surrender the regulation of our price level and the handling of the credit cycle to the Federal Reserve Board of the United States. Even if the most intimate and cordial co-operation is established between the Board and the Bank of England, the preponderance of power will still belong to the former. The Board will be in a position to disregard the Bank. But if the Bank disregard the Board, it will render itself liable to be flooded with, or depleted of, gold, as the case may be. Moreover, we can be confident beforehand that there will be much suspicion amongst Americans (for that is their disposition) of any supposed attempt on the part of the Bank of England to dictate their policy or to influence American discount rates in the interests of Great Britain. We must also be prepared to incur our share of the vain expense of bottling up the world's redundant gold.

It would be rash in present circumstances to surrender our freedom of action to the Federal Reserve Board of the United States. We do not yet possess sufficient experience of its capacity to act in times of stress with courage and independence. The Federal Reserve Board is striving to free itself from the pressure of sectional interests; but we are not yet certain that it will wholly succeed. It is still liable to be overwhelmed by the impetuosity of a cheap money campaign. A suspicion of British influence

would, so far from strengthening the Board, greatly weaken its resistance to popular clamour. Nor is it certain, quite apart from weakness or mistakes, that the simultaneous application of the same policy will always be in the interests of both countries. The development of the credit cycle and the state of business may sometimes be widely different on the two sides of the Atlantic.

Therefore, since I regard the stability of prices, credit, and employment as of paramount importance, and since I feel no confidence that an old-fashioned gold standard will even give us the modicum of stability that it used to give, I reject the policy of restoring the gold standard on pre-war lines. At the same time I doubt the wisdom of attempting a "managed" gold standard jointly with the United States, on the lines recommended by Mr. Hawtrey, because it retains too many of the disadvantages of the old system without its advantages, and because it would make us too dependent on the policy and on the wishes of the Federal Reserve Board.

CHAPTER V

POSITIVE SUGGESTIONS FOR THE FUTURE REGULATION OF MONEY

A SOUND constructive scheme must provide—if it is to satisfy the arguments and the analysis of this book :

I. 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

II. 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.

I believe that in Great Britain the ideal system can be most nearly and most easily reached by an adaptation of the actual system which has grown up, half haphazard, since the war. After the general idea has been exhibited by an application in detail to the case of Great Britain, it will be sufficient to deal somewhat briefly with the modifications required in the case of other countries.

I. *Great Britain.*

The system actually in operation to-day is broadly as follows :

(1) The internal price level is mainly determined by the amount of credit created by the banks, chiefly the Big Five ; though in a depression, when the public are increasing their real balances, a greater amount of credit has to be created to support a given price level (in accordance with the theory explained above in Chapter III., p. 84) than is required in a boom, when real balances are being diminished.

The amount of credit, so created, is in its turn roughly measured by the volume of the banks' deposits—since variations in this total must correspond to variations in the total of their investments, bill-holdings, and advances. Now there is no necessary reason *a priori* why the proportion between the banks' deposits and their " cash in hand and at the Bank of England " should not fluctuate within fairly wide limits in accordance with circumstances. But in practice the banks usually work by rule of thumb and do not depart widely from their preconceived " proportions." ¹ In recent times their aggregate

¹ The Joint Stock banks have published monthly returns since January 1921. Excluding the half-yearly statement when a little " window-dressing " is temporarily arranged, the extreme range of fluctuation has been between 11.0 per cent and 11.9 per cent in the proportion of " cash " to deposits, and between 41.1 per cent and 50.1 per cent in the proportion of advances to deposits. These figures cover two and a half years of widely varying conditions. The " proportions " of individual banks differ amongst themselves, and the above is an average result, the steadiness of which is strengthened by the fact that each big bank is pretty steadfast in its own policy.

deposits have always been about nine times their "cash." Since this is what is generally considered a "safe" proportion, it is bad for a bank's reputation to fall below it, whilst on the other hand it is bad for its earning power to rise above it. Thus in one way or another the banks generally adjust their total creation of credit in one form or another (investments, bills, and advances) up to their capacity as measured by the above criterion; from which it follows that the volume of their "cash" in the shape of Bank and Currency Notes and Deposits at the Bank of England closely determines the volume of credit which they create.

In order to follow, therefore, the train of causation a stage further, we must consider what determines the volume of their "cash." Its amount can only be altered in one or other of three ways: (*a*) by the public requiring more or fewer notes in circulation, (*b*) by the Treasury borrowing more or less from the Currency Note Reserve, and (*c*) by the Bank of England increasing or diminishing its assets.¹

To complete the argument, one further factor, not yet mentioned, must be introduced, namely (*d*) the proportion of the banks' second-line reserve in the shape of their holdings of Treasury Bills, which can be regarded as cash at one remove. In determining what is a safe proportion of "cash," they pay some

¹ For the aggregate of its liabilities in the shape of deposits and of notes in circulation automatically depends on the volume of its assets.

regard to the amount of Treasury Bills which they hold, since by reducing this holding they can immediately increase their "cash" and compel the Treasury to borrow more either from the Currency Note Reserve or from the Bank of England. The ninefold proportion referred to above presumes a certain minimum holding of Treasury Bills, and might have to be modified if a sufficient volume of such Bills was not available. This factor (*d*) is, however, also important because the banks in their turn are open to pressure by the Treasury, whenever it draws to itself the resources of their depositors—whether by taxation or by offering them attractive longer-dated loans—and uses them to pay off, if not Ways and Means advances from the Bank of England (which reduces the banks' first-line reserve of cash), then alternatively Treasury Bills held by the banks themselves (which reduces their second-line reserve of bills).

Items (*a*), (*b*), (*c*), and (*d*) together, therefore, more or less settle the matter. For the purpose of the present argument, however, we need not pay much separate attention to (*a*) and (*b*), since their effect is, for the most part, reflected over again in (*c*) and (*d*). (*a*) depends partly on the volume of trade but mainly on the price level itself; and in practice fluctuations in (*a*) do not *directly* affect the banks' "cash,"—for if more notes are required under (*a*), more notes are issued, the Treasury borrowing a

corresponding additional amount from the Currency Note Reserve, in which case the Treasury either repays the Bank of England, which diminishes the Bank's assets and consequently the other banks' "cash," or withdraws an equivalent amount of Treasury Bills, which diminishes the other banks' second-line reserve; *i.e.* a change in (*a*) operates on the banks' resources through (*c*) and (*d*).¹ Whilst as for (*b*), a change in the amount of what the Treasury borrows from the Currency Note Reserve is reflected by a corresponding change in the opposite sense in what it borrows in Ways and Means Advances or in Treasury Bills.

Thus we can concentrate our attention on (*c*) and (*d*) as the main determining factors of the price level.

Now (*c*), namely the assets of the Bank of England, consist (so far as their variable part is concerned) of

- (i.) Ways and Means advances to the Treasury.
- (ii.) Gilt-edged and other investments.
- (iii.) Advances to its customers and bills of exchange.
- (iv.) Gold.

An increase in any of these items tends, therefore, to increase the other banks' "cash," thereby to stimulate the creation of credit, and hence to raise the price level; and contrariwise.

And (*d*), namely the banks' holdings of Treasury Bills, depend on the excess of the expenditure of the

¹ If the additional issue of notes is covered by transferring gold from the Bank of England, this is merely an alternative way of diminishing the Bank of England's assets.

Treasury over and above what it secures (i.) from the public by taxation and loans, (ii.) from the Bank of England in Ways and Means advances, and (iii.) by borrowing from the Currency Note Reserve.

It follows that the capacity of the Joint Stock banks to create credit is mainly governed by the policies and actions of the Bank of England and of the Treasury. When these are settled, (*a*), (*b*), (*c*), and (*d*) are settled.

How far can these two authorities control their own actions and how far must they remain passive agents? In my opinion the control, if they choose to exercise it, is mainly in their own hands. As regards the Treasury, the extent to which they draw money from the public to discharge floating debt clearly depends on the rate of interest and the type of loan which they are prepared to offer. A point might be reached when they could not fund further on any reasonable terms; but within fairly wide limits the policy of the Treasury can be whatever the Chancellor of the Exchequer and the House of Commons may decide. The Bank of England also is, within sufficiently wide limits, mistress of the situation if she acts in conjunction with the Treasury. She can increase or decrease at will her investments and her gold by buying or selling the one or the other. In the case of advances and of bills, whilst their volume is not so immediately or directly controllable, here also adequate control can be obtained

by varying the price charged, that is to say the bank rate.¹

Therefore it is broadly true to say that the level of prices, and hence the level of the exchanges, depends in the last resort on the policy of the Bank of England and of the Treasury in respect of the above particulars ;—though the other banks, if they strongly opposed the official policy, could thwart, or at least delay it to a certain extent—provided they were prepared to depart from their usual proportions.

(2) Cash, in the form of Bank or Currency Notes, is supplied *ad libitum*, *i.e.* in such quantities as are called for by the amount of credit created and the internal price level established under (1). That is to say, in practice ;—in theory, a limit to the issue of Currency Notes has been laid down, namely the maximum fiduciary issue actually attained in the preceding calendar year. Since this theoretical maximum was prescribed, it has never yet been actually

¹ It is often assumed that the bank rate is the *sole* governing factor. But the bank rate can only operate by its reaction on (c), namely, the Bank of England's assets. Formerly it acted pretty directly on two of the components of (c), namely, (c) (iii.) advances to customers and bills of exchange and (c) (iv.) gold. Now it acts only on one of them, namely, (c) (iii.). But changes in (c) (i.) the Bank's advances to the Treasury and (c) (ii.) the Bank's investments can often be nearly as potent in their effect on the creation of credit. Thus a low bank rate can be largely neutralised by a simultaneous reduction of (c) (i.) or (c) (ii.) and a high bank rate by an increase of these. Indeed the Bank of England can probably bring the money-market to heel more decisively by buying or selling securities than in any other way ; and the utility of bank rate, operated by itself and without assistance from deliberate variations in the volume of (c) (ii.), is lessened by the various limitations which exist in practice to its freedom of movement, and to the limits within which it can move, upwards and downwards.

operative ; and, as the rule springs from a doctrine now out of date and out of accordance with most responsible opinion, it is probable that, if it were becoming operative, it would be relaxed. This is a matter where the recommendations of the Cunliffe Committee call for urgent change, unless we desire deliberately to pursue still further a process of Deflation. A point must come when, a year of brisk trade and employment following one of depression, there will be an increased demand for currency, which must be met unless the revival is to be deliberately damped down.

Thus the tendency of to-day—rightly I think—is to watch and to control the creation of credit and to let the creation of currency follow suit, rather than, as formerly, to watch and to control the creation of currency and to let the creation of credit follow suit.

(3) The Bank of England's gold is immobilised. It neither buys nor sells. The gold plays no part in our system. Occasionally, however, the Bank may ship a consignment to the United States, to help the Treasury in meeting its dollar liabilities. The South African and other gold which finds its way here comes purely as a commodity to a convenient *entrepôt* centre, and is mostly re-exported.

(4) The foreign exchanges are unregulated and left to look after themselves. From day to day they fluctuate in accordance with the seasons and other irregular influences. Over longer periods they

depend, as we have seen, on the relative price levels established here and abroad by the respective credit policies adopted here and abroad. But whilst this is, for the most part, the actual state of affairs, it is not, as yet, the avowed or consistent policy of the responsible authorities. Fixity of the dollar exchange at the pre-war parity remains their aspiration; and it still may happen that the bank rate is raised for the purpose of influencing the exchange at a time when considerations of internal price level and credit policy point the other way.

This, in brief—I apologise to the reader if I have compressed the argument unduly—is the present state of affairs, one essentially different from our pre-war system. It will be observed that in practice we have already gone a long way towards the ideal of directing bank rate and credit policy by reference to the internal price level and other symptoms of under- or over-expansion of internal credit, rather than by reference to the pre-war criteria of the amount of cash in circulation (or of gold reserves in the banks) or the level of the dollar exchange.

I. Accordingly my first requirement in a good constructive scheme can be supplied merely by a development of our existing arrangements on more deliberate and self-conscious lines. Hitherto the Treasury and the Bank of England have looked forward to the stability of the dollar exchange

(preferably at the pre-war parity) as their objective. It is not clear whether they intend to stick to this irrespective of fluctuations in the value of the dollar (or of gold); whether, that is to say, they would sacrifice the stability of sterling prices to the stability of the dollar exchange in the event of the two proving to be incompatible. At any rate, my scheme would require that they should adopt the stability of sterling prices as their *primary* objective—though this would not prevent their aiming at exchange stability also as a secondary objective by co-operating with the Federal Reserve Board in a common policy. So long as the Federal Reserve Board was successful in keeping dollar prices steady the objective of keeping sterling prices steady would be identical with the objective of keeping the dollar sterling exchange steady. My recommendation does not involve more than a determination that, in the event of the Federal Reserve Board failing to keep dollar prices steady, sterling prices should not, if it could be helped, plunge with them merely for the sake of maintaining a fixed parity of exchange.

If the Bank of England, the Treasury, and the Big Five were to adopt this policy, to what criteria should they look respectively in regulating bank-rate, Government borrowing, and trade-advances? The first question is whether the criterion should be a precise, arithmetical formula or whether it should be sought in a general judgement of the situation

based on all the available data. The pioneer of price-stability as against exchange-stability, Professor Irving Fisher, advocated the former in the shape of his "compensated dollar," which was to be automatically adjusted by reference to an index number of prices without any play of judgement or discretion. He may have been influenced, however, by the advantage of propounding a method which could be grafted as easily as possible on to the pre-war system of gold-reserves and gold-ratios. In any case, I doubt the wisdom and the practicability of a system so cut and dried. If we wait until a price movement is actually afoot before applying remedial measures, we may be too late. "It is not the *past* rise in prices but the *future* rise that has to be counter-acted."¹ It is characteristic of the impetuosity of the credit cycle that price movements tend to be cumulative, each movement promoting, up to a certain point, a further movement in the same direction. Professor Fisher's method may be adapted to deal with long-period trends in the value of gold but not with the, often more injurious, short-period oscillations of the credit cycle. Nevertheless, whilst it would not be advisable to postpone action until it was called for by an actual movement of prices, it would promote confidence and furnish an objective standard of value, if, an official index number having been compiled of such a character as to register the

¹ Hawtrey, *Monetary Reconstruction*, p. 105.

price of a standard composite commodity, the authorities were to adopt this composite commodity as their standard of value in the sense that they would employ all their resources to prevent a movement of its price by more than a certain percentage in either direction away from the normal, just as before the war they employed all their resources to prevent a movement in the price of gold by more than a certain percentage. The precise composition of the standard composite commodity could be modified from time to time in accordance with changes in the relative economic importance of its various components.

As regards the criteria, other than the actual trend of prices, which should determine the action of the controlling authority, it is beyond the scope of this volume to deal adequately with the diagnosis and analysis of the credit cycle. The more deeply that our researches penetrate into this subject, the more accurately shall we understand the right time and method for controlling credit-expansion by bank-rate or otherwise. But in the meantime we have a considerable and growing body of general experience upon which those in authority can base their judgements. 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. The main point is that the *objective* of the authorities, pursued with such means as are at their command, should be the stability of prices.

It would at least be possible to avoid, for example, such action as has been taken lately (in Great Britain) whereby the supply of "cash" has been deflated at a time when real balances were becoming inflated,—action which has materially aggravated the severity of the late depression. We might be able to moderate very greatly the amplitude of the fluctuations if it was understood that the time to deflate the supply of cash is when real balances are falling, *i.e.* when prices are rising out of proportion to the increase, if any, in the volume of cash, and that the time to inflate the supply of cash is when real balances are rising, and not, as seems to be our present practice, the other way round.

II. How can we best combine this primary object with a maximum stability of the exchanges? Can we get the best of both worlds—stability of prices over long periods and stability of exchanges over short periods? It is the great advantage of the gold standard that it overcomes the excessive sensitiveness of the exchanges to temporary influences, which we analysed in Chapter III. Our object must be to secure this advantage, if we can, without committing

ourselves to follow big movements in the value of gold itself.

I believe that we can go a long way in this direction if the Bank of England will take over the duty of regulating the price of gold, just as it already regulates the rate of discount. "Regulate," but not "peg." The Bank of England should have a buying and a selling price for gold, just as it did before the war, and this price might remain unchanged for considerable periods, just as bank-rate does. But it would not be fixed or "pegged" once and for all, any more than bank-rate is fixed. The Bank's rate for gold would be announced every Thursday morning at the same time as its rate for discounting bills, with a difference between its buying and selling rates corresponding to the pre-war margin between £3 : 17 : 10½ per oz. and £3 : 17 : 9 per oz. ; except that, in order to obviate too frequent changes in the rate, the difference might be wider than 1½d. per oz.—say, ½ to 1 per cent. A willingness on the part of the Bank both to buy and to sell gold at rates fixed for the time being would keep the dollar-sterling exchange steady within corresponding limits, so that the exchange rate would not move with every breath of wind but only when the Bank had come to a considered judgement that a change was required for the sake of the stability of sterling prices.

If the bank rate and the gold rate in conjunction were leading to an excessive influx or an excessive

efflux of gold, the Bank of England would have to decide whether the flow was due to an internal or to an external movement away from stability. To fix our ideas, let us suppose that gold is flowing outwards. If this seemed to be due to a tendency of sterling to depreciate in terms of commodities, the correct remedy would be to raise the bank rate. If, on the other hand, it was due to a tendency of gold to appreciate in terms of commodities, the correct remedy would be to raise the gold rate (*i.e.* the buying price for gold). If, however, the flow could be explained by seasonal, or other passing influences, then it should be allowed to continue (assuming, of course, that the Bank's gold reserves were equal to any probable calls on them) unchecked, to be redressed later on by the corresponding reaction.

Two subsidiary suggestions may be made for strengthening the Bank's control :

(1) The service of the American debt will make it necessary for the British Treasury to buy nearly \$500,000 every working day. It is clear that the particular method adopted for purchasing these huge sums will greatly affect the short-period fluctuations of the exchange. I suggest that this duty should be entrusted to the Bank of England to be carried out by them with the express object of minimising those fluctuations in the exchange which are due to the daily and seasonal ebb and flow of the ordinary trade demand. In particular the proper distribution

of these purchases through the year might be so arranged as greatly to mitigate the normal seasonal fluctuation discussed in Chapter III. If the trade demand is concentrated in one half of the year the Treasury demand should be concentrated in the other half.

(2) It would effect an improvement in the technique of the system here proposed, without altering its fundamental characteristics, if the Bank of England were to quote a daily price, not only for the purchase and sale of gold for immediate delivery, but also for delivery three months forward. The difference, if any, between the cash and forward quotations might represent either a discount or a premium of the latter on the former, according as the bank desired money rates in London to stand below or above those in New York. The existence of the forward quotation of the Bank of England would afford a firm foundation for a free market in forward exchange, and would facilitate the movement of funds between London and New York for short periods, in much the same way as before the war, whilst at the same time keeping down to a minimum the actual movement of gold bullion backwards and forwards. I need not develop this point further, because it is only an application of the argument of Section III. of Chapter III. which will be most readily intelligible to the reader, if he will refer back to the previous argument.

There remains the question of the regulation of the Note Issue. My proposal here may appear shocking until the reader realises that, apart from its disregarding the conventions, it does not differ in substance from the existing state of affairs. The object of fixing the amount of gold to be held against a note issue is to set up a danger signal which cannot be easily disregarded, when a curtailment of credit and purchasing power is urgently required to maintain the legal tender money at its lawful parity. But this system, whilst far better than no system at all, is primitive in its ideas and is, in fact, a survival of an earlier evolutionary stage in the development of credit and currency. For it has two great disadvantages. In so far as we fix a minimum gold reserve against the note issue, the effect is to immobilise this quantity of gold and thus to reduce the amount actually available for use as a store of value to meet temporary or sudden deficits in the country's international balance of payments. And in so far as we regard an approach towards the prescribed minimum or a departure upwards from it as a barometer warning us to curtail credit or encouraging us to expand it, we are using a criterion which most people would now agree in considering second-rate for the purpose, because it cannot give the necessary warning *soon enough*. If gold movements are actually taking place, this means that the disequilibrium has proceeded a very long way ; and whilst this criterion

may pull us up in time to preserve convertibility on the one hand or to prevent an excessive flood of gold on the other, it will not do so in time to avoid an injurious oscillation of prices. This method belongs indeed to a period when the preservation of convertibility was all that any one thought about (all indeed that there was to think about so long as we were confined to an unregulated gold standard), and before the idea of utilising bank-rate as a means of keeping prices and employment steady had become practical politics.

We have scarcely realised how far our thoughts have travelled during the past five years. But to re-read the famous Cunliffe Report on Currency and Foreign Exchange after the War, published in 1918, brings vividly before one's mind what a great distance we have covered since then. This document was published three months before the Armistice. It was compiled long before the unpegging of sterling and the great break in the European exchanges in 1919, before the tremendous boom and crash of 1920-21, before the vast piling up of the world's gold in America, and without experience of the Federal Reserve policy in 1922-23 of burying this gold at Washington, withdrawing it from the exercise of its full effect on prices, and thereby, in effect, demonetising the metal. The Cunliffe Report is an unadulterated pre-war prescription—inevitably so considering that it was written after four years' interregnum of war, before

Peace was in sight, and without knowledge of the revolutionary and unforeseeable experiences of the past five years.

Of all the omissions from the Cunliffe Report the most noteworthy is the complete absence of any mention of the problem of the stability of the price-level; and it cheerfully explains how the pre-war system, which it aims at restoring, operated to bring back equilibrium by deliberately causing a "consequent slackening of employment." The Cunliffe Report belongs to an extinct and an almost forgotten order of ideas. Few think on these lines now; yet the Report remains the authorised declaration of our policy, and the Bank of England and the Treasury are said still to regard it as their marching orders.

Let us return to the regulation of note issue. If we agree that gold is not to be employed in the circulation, and that it is better to employ some other criterion than the ratio of gold reserves to note issue in deciding to raise or to lower the bank rate, it follows that the only employment for gold (nevertheless important) is as a store of value to be held as a war-chest against emergencies and as a means of rapidly correcting the influence of a temporarily adverse balance of international payments and thus maintaining a day-to-day stability of the sterling-dollar exchange. It is desirable, therefore, that the whole of the reserves should be under the control of the authority responsible for this, which, under

the above proposals, is the Bank of England. The volume of the paper money, on the other hand, would be consequential, as it is at present, on the state of trade and employment, bank-rate policy and Treasury Bill policy. The governors of the system would be bank-rate and Treasury Bill policy, the objects of government would be stability of trade, prices, and employment, and the volume of paper money would be a consequence of the first (just—I repeat—as it is at present) and an instrument of the second, the precise arithmetical level of which could not and need not be predicted. Nor would the amount of gold, which it would be prudent to hold as a reserve against international emergencies and temporary indebtedness, bear any logical or calculable relation to the volume of paper money;—for the two have no close or necessary connection with one another. Therefore I make the proposal—which may seem, but should not be, shocking—of separating entirely the gold reserve from the note issue. Once this principle is adopted, the regulations are matters of detail. The gold reserves of the country should be concentrated in the hands of the Bank of England, to be used for the purpose of avoiding short-period fluctuations in the exchange. The Currency Notes may, just as well as not—since the Treasury is to draw the profit from them—be issued by the Treasury, without the latter being subjected to any formal regulations (which are likely to be either inoperative or injurious) as to their

volume. Except in form, this régime would not differ materially from the existing state of affairs.

The reader will observe that I retain for gold an important rôle in our system. As an ultimate safeguard and as a reserve for sudden requirements, no superior medium is yet available. But I urge that it is possible to get the benefit of the advantages of gold, without irrevocably binding our legal-tender money to follow blindly all the vagaries of gold and future unforeseeable fluctuations in its real purchasing power.

II. *The United States.*

The above proposals are recommended to Great Britain and their details have been adapted to her case. But the principles underlying them remain just as true across the Atlantic. In the United States, as in Great Britain, the methods which are being actually pursued at the present time, half consciously and half unconsciously, are mainly on the lines I advocate. In practice the Federal Reserve Board often ignores the proportion of its gold reserve to its liabilities and is influenced, in determining its discount policy, by the object of maintaining stability in prices, trade, and employment. Out of convention and conservatism it accepts gold. Out of prudence and understanding it buries it. Indeed the theory and investigation of the credit cycle have been taken up so much more enthusiastically and pushed so

much further by the economists of the United States than by those of Great Britain, that it would be even more difficult for the Federal Reserve Board than for the Bank of England to ignore such ideas or to avoid being, half-consciously at least, influenced by them.

The theory on which the Federal Reserve Board is supposed to govern its discount policy, by reference to the influx and efflux of gold and the proportion of gold to liabilities, is as dead as mutton. It perished, and perished justly, as soon as the Federal Reserve Board began to ignore its ratio and to accept gold without allowing it to exercise its full influence,¹ merely because an expansion of credit and prices seemed at that moment undesirable. From that day gold was demonetised by almost the last country which still continued to do it lip-service, and a dollar standard was set up on the pedestal of the Golden Calf. For the past two years the United States has *pretended* to maintain a gold standard. *In fact* it has established a dollar standard; and, instead of ensuring that the value of the dollar shall conform to that of gold, it makes provision, at great expense, that the value of gold shall conform to that of the dollar. This is the way by which a rich

¹ The influx of gold could not be prevented from having *some* inflationary effect because its receipt automatically increased the balances of the member banks. This uncontrollable element cannot be avoided so long as the United States Mints are compelled to accept gold. But the gold was not allowed to exercise the multiplied influence which the pre-war system presumed.

country is able to combine new wisdom with old prejudice. It can enjoy the latest scientific improvements, devised in the economic laboratory of Harvard, whilst leaving Congress to believe that no rash departure will be permitted from the hard money consecrated by the wisdom and experience of Dungi, Darius, Constantine, Lord Liverpool, and Senator Aldrich.

No doubt it is worth the expense—for those that can afford it. The cost of the fiction to the United States is not more than £100,000,000 per annum and should not average in the long run above £50,000,000 per annum. But there is in all such fictions a certain instability. When the accumulations of gold heap up beyond a certain point the suspicions of Congressmen may be aroused. One cannot be quite certain that some Senator might not read and understand this book. Sooner or later the fiction will lose its value.

Indeed it is desirable that this should be so. The new methods will work more efficiently and more economically when they can be pursued consciously, deliberately, and openly. The economists of Harvard know more than those of Washington, and it will be well that in due course their surreptitious victory should swell into public triumph. At any rate those who are responsible for establishing the principles of British currency should not overlook the possibility that some day soon the Mints of the United States

may be closed to the acceptance of gold at a fixed dollar price.

Closing the Mints to the compulsory acceptance of gold need not affect the existing obligation of convertibility ;—the liability to encash notes in gold might still remain. Theoretically this might be regarded as a blemish on the perfection of the scheme. But, for the present at least, it is unlikely that such a provision would compel the United States to deflate,—which possibility is the only theoretical objection to it. On the other hand, the retention of convertibility would remain a safeguard satisfactory to old-fashioned people ; and would reduce to a minimum the new and controversial legislation required to effect the change. Many people might agree to relieve the Mint of the liability to accept gold which no one wants, who would be dismayed at any tampering with convertibility. Moreover, in certain quite possible circumstances, the obligation of convertibility might really prove to be a safeguard against inflation brought about by political pressure contrary to the judgement of the Federal Reserve Board ;—for we have not, as yet, sufficient experience as to the independence of the Federal Reserve system against the farmers, for example, or other compact interests possessing political influence.

Meanwhile Mr. Hoover and many banking authorities in England and America, who look to the dispersion through the world of a reasonable proportion

of Washington's gold, by the natural operation of trade and investment, as a desirable and probable development, much misunderstand the situation. At present the United States is open to accept gold at a price in terms of goods above its natural value (above the value it would have, that is to say, if it were allowed to affect credit and, through credit, prices in orthodox pre-war fashion); and so long as this is the case, gold must continue to flow there. The stream can be stopped (so long as a change in the gold-value of the dollar is ruled out of the question) only in one of two ways;—either by a fall in the value of the dollar or by an increase in the value of gold in the outside world. The former of these alternatives, namely the depreciation of the dollar through inflation in the United States, is that on which many English authorities have based their hopes. But it could only come about by a reversal or defeat of the present policy of the Federal Reserve Board. Moreover, the volume of redundant gold is now so great, and the capacity of the rest of the world for its absorption so much reduced, that the inflation would need to be prolonged and determined to produce the required result. Dollar prices would have to rise very high before America's impoverished customers, starving for real goods and having no use for barren metal, would relieve her of £200,000,000 worth of gold in preference to taking commodities. The banking authorities of the United States would be

likely to notice in good time that, if the gold is not wanted and must be got rid of, it would be much simpler just to reduce the dollar price of gold. The only way of selling redundant stocks of anything, whether gold or copper or wheat, is to abate the price.

The alternative method, namely the increase in the value of gold in the outside world, could scarcely be brought about unless some other country or countries stepped in to relieve the United States of the duty of burying unwanted gold. Great Britain, France, Italy, Holland, Sweden, Argentine, Japan, and many other countries have fully as much unoccupied gold as they require for an emergency store. Nor is there anything to prevent them from buying gold now if they prefer gold to other things.

The notion, that America can get rid of her gold by showing a greater readiness to make loans to foreign countries, is incomplete. This result will only follow if the loans are inflationary loans, not provided for by the reduction of expenditure and investment in other directions. Foreign investments formed out of real savings will no more denude the United States of her gold than they denude Great Britain of hers. But if the United States places a large amount of dollar purchasing power in the hands of foreigners, as a pure addition to the purchasing power previously in the hands of her own nationals, then no doubt prices will rise and we shall be back on the method

of depreciating the dollar, just discussed, by a normal inflationary process. Thus the invitation to the United States to deal with the problem of her gold by increasing her foreign investments will not be effective unless it is intended as an invitation to inflate.

I argue, therefore, that the same policy which is wise for Great Britain is wise for the United States, namely to aim at the stability of the commodity-value of the dollar rather than at stability of the gold-value of the dollar, and to effect the former if necessary by varying the gold-value of the dollar.

If Great Britain and the United States were both embarked on this policy and if both were successful, our secondary desideratum, namely the stability of the dollar-exchange standard, would follow as a consequence. I agree with Mr. Hawtrey that the ideal state of affairs is an intimate co-operation between the Federal Reserve Board and the Bank of England, as a result of which stability of prices and of exchange would be achieved at the same time. But I suggest that it is wiser and more practical that this should be allowed to develop out of experience and mutual advantage, without either side binding itself to the other. If the Bank of England aims primarily at the stability of sterling, and the Federal Reserve Board at the stability of dollars, each authority letting the other into its confidence so far

as may be, better results will be obtained than if sterling is unalterably fixed by law in terms of dollars and the Bank of England is limited to using its influence on the Federal Reserve Board to keep dollars steady. A collaboration which is not free on both sides is likely to lead to dissensions, especially if the business of keeping dollars steady involves a heavy expenditure in burying unwanted gold.

We have reached a stage in the evolution of money when a "managed" currency is inevitable, but we have not yet reached the point when the management can be entrusted to a single authority. The best we can do, therefore, is to have *two* managed currencies, sterling and dollars, with as close a collaboration as possible between the aims and methods of the managements.

III. *Other Countries.*

What course, in such an event, should other countries pursue? It is necessary to presume to begin with that we are dealing with countries which have not lost control of their currencies. But a stage can and should be reached before long at which nearly all countries have regained the control. In Russia, Poland, and Germany it is only necessary that the Governments should develop some other source of revenue than the inflationary or turn-over tax on the use of money discussed in Chapter II. In France and Italy it is only necessary that the

franc and the lira should be devaluated at a level at which the service of the internal debt is within the capacity of the taxpayer.

Control having been regained, there are probably no countries, other than Great Britain and the United States, which would be justified in attempting to set up an independent standard. Their wisest course would be to base their currencies either on sterling or on dollars by means of an exchange standard, fixing their exchanges in terms of one or the other (though preserving, perhaps, a discretion to vary in the event of a serious divergence between sterling and dollars), and maintaining stability by holding reserves of gold at home and balances in London and New York to meet short-period fluctuations, and by using bank-rate and other methods to regulate the volume of purchasing power, and thus to maintain stability of relative price level, over longer periods.

Perhaps the British Empire (apart from Canada) and the countries of Europe would adopt the sterling standard; whilst Canada and the other countries of North and South America would adopt the dollar standard. But each could choose freely, until, with the progress of knowledge and understanding, so perfect a harmony had been established between the two that the choice was a matter of indifference.

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