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CLARE'S  
MONEY MARKET  
PRIMER

AND KEY TO THE EXCHANGES

BY

JOHN SANGWAY

*Certificated Associate of the Institute of Bankers*




*FOURTH EDITION*

LONDON  
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1936

FIRST EDITION . . . . .	1891
SECOND EDITION . . . . .	1892
Reprinted . . . . .	1896
" . . . . .	1899
" . . . . .	1901
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" . . . . .	1920
" . . . . .	1921
" . . . . .	1923
THIRD EDITION . . . . .	1931
FOURTH EDITION . . . . .	1936


 SIR ISAAC PITMAN & SONS, LTD.  
 PITMAN HOUSE, PARKER STREET, KINGSWAY, LONDON, W.C.2  
 THE PITMAN PRESS, BATH  
 PITMAN HOUSE, LITTLE COLLINS STREET, MELBOURNE  
 ASSOCIATED COMPANIES  
 PITMAN PUBLISHING CORPORATION  
 2 WEST 45TH STREET, NEW YORK  
 SIR ISAAC PITMAN & SONS (CANADA), LTD.  
 (INCORPORATING THE COMMERCIAL TEXT BOOK COMPANY)  
 PITMAN HOUSE, 381-383 CHURCH STREET, TORONTO

## PREFACE TO FOURTH EDITION

THAT the Bank of England, even in George Clare's time, had attained an unquestioned position in the money market of this country is shown by the fact that, although the "market" looms large in the title to his now classical work, the first seventy pages of the book of one hundred and fifty were given up to the history, constitution, functions and operations of the Bank, while the discussion of the market proper was reserved for the third and final section of the book, that on the "Open Market," covering some seventeen pages only.

When it is remembered that Clare wrote over forty years ago, it is a remarkable testimony to his reasoning that the bulk of the principle remains true to-day. Because, therefore, of the sustained strength of his work, it has been deemed desirable to retain as much as possible of the original, and merely to add so as to bring the book up to date. To speak of revising is scarcely correct, or, at least, just; for little more has been necessary than to describe the happenings of the early twentieth century (punctuated, as it was, by that devastating financial calamity, the War), and to allow for the influence which such events had upon the condition of affairs as Clare saw it.

It has been thought desirable to omit the chapters on the Paris, Berlin and New York exchanges, so much of the old order having changed since Clare's time. His graphs also have been omitted,

for the figures of the past twenty years of artificial conditions would bear no comparison with those of the period prior to 1914.

A comparison between certain statistics of the years 1881 to 1890 and those of recent date would show that although the Bank of England is still the pivot of the money market, there have been changes of very considerable importance. Previously, the Bank stood out alone from a host of relatively small, unconnected units; nowadays it is a giant of the central banking sphere coincident with giants in the industrial and commercial spheres. It then dominated by reason of its greater strength, its monopoly and the lack of strength and of cohesion of its *confrères*. To-day it dominates purely as a control dominates the subsidiary parts of an engine, but it cannot function without them. Its earlier virtual monopoly of note issue meant the control of currency, credit and banking generally; to-day the Bank controls currency and credit only.

To speak of the London Money Market of the present day is not to speak of the Bank of England alone, or even of the Bank together with the joint-stock banks. There are other important constituents of this slightly indefinite but composite organization. In the days which Clare reviewed, from 1850 to 1890, the organization was much looser and the component parts less interdependent than in later years, particularly those of the twentieth century preceding 1914; but to-day, although the structure of the market is losing none of its composite nature, there is a gradual fading away of the definition between the individual

components. In other words, certain constituents of the market are tending to trespass on the sphere which was once regarded as the particular preserve of other constituents, e.g. in acceptance business. This is not to say that the latter are in danger of losing their identity, but that they tend to become less dominant in their particular spheres.

Like the expression "foreign exchanges," the term "money market" is applied at will to any of a number of conceptions, the chief of which are, perhaps, the nebulous place where the market's transactions are effected; the members of the financial community responsible for the being and existence of the market; and lastly, and most importantly, the volume of money which constitutes the market's commodity. Fortunately, a true description of the market must cover all these conceptions, so that everyone's individual ideas are met.

The geographical conception of the market may be disposed of briefly by stating that it lies within the area bounded, roughly, by an imaginary line passing on the western side of the Head Office of the Midland Bank in Poultry; north, to the south side of Finsbury Square; east, so as to include Old Broad Street, Bishopsgate and Gracechurch Street; south along King William Street; and back to Poultry. This area covers the Head Offices of the "Big Five" and other clearing bankers, the Bank of England, the Stock Exchange, the bill brokers and discount houses, acceptance houses, exchange brokers, merchant bankers, London offices of the Scottish and foreign and colonial

banks, and many of the most important insurance offices, which comprise the components mentioned earlier.

From the standpoint of this Primer, the most significant factor of the market is the commodity. It is not all the money of the country which is held in mind when the market is discussed or considered; in fact, it is the lesser part, that which bears on our financial relations with the money markets of the world, to which the importance of prime consideration is granted.

Without venturing upon any abstruse conception of the origin and nature of credit-money, we start from the plain fact that the banks generally are in possession of vast sums deposited with them by their customers. Of these sums a part, a small but fairly consistent proportion of the whole, is available for such employment as offers a degree of safety and liquidity second only to cash itself. This employment is found in the money market and the funds made available to the market by the Head Offices of the clearing banks form the principal supply of market money. To this must be added a nebulous amount coming into the market from owners, both at home and abroad, of large sums seeking temporary employment.

It only remains, for the present, to mention the essential characteristics of a successful international money market. These are the free and unfettered import and export of the international currency, gold; the existence of a highly organized discount market, a market in the international credit instrument, the bill of exchange; a central institution which can and will control the market

and act as the medium through which international transactions are ultimately effected.

Of this organization the Bank is the pivot and the keystone. It is the ultimate gold reserve of the country, and the only medium through which gold can be minted; it is the bankers' bank and the controlling institution in the discount market; it has a monopoly of note issue and controls the volume of credit. For this reason, therefore, the Bank, its history, status, functions and influence can deservedly be given first place in the following pages.

We have to acknowledge particular indebtedness to Mr. Maurice Megrahn, whose complete revision and extension of "Clare" for the Third Edition made our task easy, and we take the liberty of adopting his acknowledgments to the following—

- EINZIG, PAUL,           *The Fight for Financial Supremacy.* Macmillan, 1931.
- EINZIG, PAUL.       *International Gold Movements.* Macmillan, 1929.
- GREENGRASS, H. W. *The Discount Market in London.* Pitman, 1930.
- SCHACHT, H.           *The Stabilization of the Mark.* Allen & Unwin, 1927.
- SPALDING, W. F.      *The London Money Market.* Pitman, 1930.
- SPALDING, W. F.      *Tate's Modern Cambist.* Pitman, 1929.

and to Mr. H. E. Evitt, *Fellow of the Institute of Bankers*; Mr. J. Huskins, of the Ottoman Bank; and Mr. W. F. Spalding, *Fellow and Member of the Council of the Institute of Bankers*. To these names we must add that of Mr. C. A. Rowley, of the Westminster Bank, whose generous assistance and criticism have been invaluable.

J. S.

## PREFACE TO FIRST EDITION

IN the following pages an attempt is made to present, in brief compass and in plain untechnical language, a general view of the London Money Market, and of the elements that combine to determine the value of loanable capital in this country.

As the object aimed at is simply to make the reader acquainted with those rudimentary facts and principles, a knowledge of which is essential to the right understanding of an ordinary "money article," the writer makes no pretensions to originality, but has merely endeavoured to collect and arrange such of the widely-scattered information bearing on the subject as will, he believes, render those who "inwardly digest" it able to follow and appreciate the meaning of the City Editor's pros and cons.

The scope of the work is to point out and elucidate the influences that conduce to the rise or fall, firstly, of the Bank Rate of discount, and secondly, of the Market Rate. Beginning with the former, we pass in review each item of the weekly account issued by the Bank of England, noticing how the normal variations arise, how they are affected by the state of credit, and what evidence they afford of that ebb and flow in the demand for loanable capital, the movements of which are reflected in the ever-changing price of "money." Of these figures those which record the amount of cash held by the Banking Department are, of course, the

most significant ; and as it is well known that the relative weakness or strength of this item is the main incentive to action on the part of the Bank, the Reserve has been subjected to detailed analysis, with the result of demonstrating that there exists a much closer connexion than might be imagined between the Bank's gain or loss of gold on foreign account and the variations of the advertised rate.

In view of such connexion gold movements themselves claim attention, and, in order to gain a clear insight into their causes and antecedent conditions, the working of the Foreign Exchanges is next investigated. It is investigated, moreover, at some length, there being reason to believe that no branch of commercial knowledge is in general more imperfectly understood. By treating it, however, in a more practical manner than is usually the case, and by associating the enunciation of principles with illustrations of their application, the writer, who has actual experience to guide him, trusts he has succeeded in bringing the intricacies of the subject within the grasp of any ordinary intelligence.

Finally, the leading features of the open market are described and explained ; what loanable capital consists of, whence it comes, how it is disposed of, and how its value is settled, being, with other such, the questions to which it is sought to furnish a reply. . . .

From beginning to end the writer has confined himself, as far as possible, to statements of fact, and to the inferences that seem fairly deducible therefrom, leaving all matters of mere speculative theory to be dealt with by those who are better

able than himself to do them justice. Moreover, he has even resisted the temptation of attempting an answer to "What is money?"—a problem which seems almost as far from satisfactory and concise solution as the famous query propounded by "jesting Pilate."

# CONTENTS

	PAGE
PREFACE TO FOURTH EDITION . . . . .	V
PREFACE TO FIRST EDITION . . . . .	X
<small>CHAP.</small>	
I.—HISTORY OF THE BANK OF ENGLAND . . . . .	I
II.—THE BANK OF ENGLAND AND THE GOVERNMENT . . . . .	5
III.—THE BANK OF ENGLAND AND THE MONEY MARKET: Bank Rate; Bank Rate and Market Rate; Reasons for Changes in Bank Rate; The Bank Return . . . . .	10
IV.—THE ISSUE DEPARTMENT OF THE BANK OF ENGLAND: Fiduciary Issue; Position of Note in Credit System; Gold Coin and Bullion . . . . .	29
V.—THE BANKING DEPARTMENT OF THE BANK OF ENGLAND: Proprietors' Capital and Rest; Public Deposits; Other Deposits; Floating Money; Other Deposits and Gold Movements; Control of Money Market . . . . .	49
VI.—THE BANKING DEPARTMENT ( <i>contd.</i> ): Government Securities; Other Securities . . . . .	68
VII.—THE BANK OF ENGLAND RESERVE: Reserve the Basis of Credit; Disinterested Attitude of Bank; Proportion; Movements in Reserve; Crises and Borrowing from Bank; 1847, 1857, 1866, 1914 and 1931; Reserve and International Gold Movements . . . . .	73
VIII.—THE FOREIGN EXCHANGES: Par of Exchange; Mint Par; Variations from Mint Par; Gold Points; Foreign Exchange Quotations; Forward Exchange; Short and Long Rates . . . . .	99
IX.—THE FOREIGN EXCHANGES— <i>Bill Rates and the Price of Money</i> : Investment Demand; Interest Rates and the Exchanges; Gold Movements; The Exchange Equalisation Fund; Treasury Bills . . . . .	122

CHAP.		PAGE
X.	THE OPEN MARKET FOR MONEY IN LONDON: Short Loan Fund—Supply; Demand; Vari- ation in Rates; The Risk Factor in Rates; The Bill Broker; Loans to Stock Exchange	152
XI.	1914 AND AFTER— <i>The War and its Effects on the Money Market and the Exchanges</i> : Currency and Treasury Notes; The Currency and Bank Notes Act, 1928; Inflation; Deflation; Stabilization; Repudiation; Post-War In- dustrial Difficulties; Gold; Mobilization of Dollar Securities; Gold Standard Act, 1925; The Crisis of 1931; Discount Market; Foreign Exchanges; Looking Forward; The Committee on Finance and Industry	177
	INDEX . . . . .	235

## CHAPTER I

### HISTORY OF THE BANK OF ENGLAND

THE Charter of Incorporation of the Society denominated the Governor and Company of the Bank of England—the first joint-stock banking association established in this country and the foremost in stability, magnitude and importance of the great financial institutions of the world—dates more than two centuries back, from the 27th day of July, 1694; and, as “the Bank” is the parent of the modern banking system, a short account of the circumstances that led to its formation will not be out of place as an introduction to our subject.

In 1694 the Government of William III was in great straits for want of money to carry on the war with France. Six years earlier James II had been expelled from his throne and country, on the ground that he had broken the fundamental laws of the kingdom; but with the aid of Louis XIV, at whose court he had found refuge, he had since been making strenuous endeavours to evict his Protestant son-in-law, and to re-establish his own sovereignty and the dominion of the Church of Rome. William on his part was vigorous in defence of his crown and was freely seconded in his efforts by Parliament, which voted supplies with great liberality and imposed taxation to an extent hitherto unheard of. But though the country

already found its burden almost beyond endurance, more money was still an imperative necessity.

In these circumstances a question of principle was raised, that has since been revived on many similar occasions of extraordinary expenditure. Seeing, it was said, that posterity will reap the chief benefit of our struggle for popular rights and religious toleration, why not let posterity settle the bill? Why trouble to pay as we go? That a public loan would be both expedient and just, was, in fact, admitted by all; and the Chancellor of the Exchequer was but too willing to borrow. But an obstacle lay in the way, an obstacle that appeared insuperable. Where were lenders to be found? Was it likely that anyone would trust his money to a revolutionary government that had been established only six years and might be overturned as a result of the next campaign?

At this conjuncture, however, the strong religious and political convictions of a part of the community came to the help of the country. In the City of London there were many wealthy men—Dissenters mostly—who were willing, rather than see the land once more delivered into bondage, to place their whole fortunes at stake; and among these merchants a scheme now began to find favour that had been perseveringly put forward by a Scotsman, William Paterson, but to which they had hitherto turned a deaf ear. His plan was to apply the joint-stock principle to the business of banking and, out of the capital raised for that purpose, to grant a loan to the Government. The proposal, on discussion, speedily took definite shape and passed in due course from the City to

the Houses of Parliament, where it was settled and sanctioned.

It was proposed to raise £1,200,000 by public subscription and to *lend the whole* of it to the Government at 8 per cent interest, the lenders to be incorporated by Royal Charter<sup>1</sup> and to have power to issue notes on Government security to the extent of the sum lent. The idea of putting all their eggs into one basket was probably not quite relished by intending subscribers, but the capital was nevertheless soon raised. In those days good investments were, after all, a rarity; and the new undertaking, backed up as it was by the guarantee of a government that seemed honestly bent on paying its way, and supported by the best known merchants of the City of London, appealed with success to the sentiments and to the pockets of the capitalists and, by its happy combination of patriotism with interest at 8 per cent, gratified at once their love of country, their love of gain and their hatred of tyranny and Popery.

It is worthy of notice that this loan to the public of £1,200,000, besides being the foundation stone of the Bank of England, was also the starting-point in the history of the Funded Debt of this country.

In its inception the Bank of England was something more than a business enterprise. Not only was it a finance company; it was also a political organization. The Governor and Directors were all Whigs and so were most of the subscribers, the Tories as a body having abstained from any

<sup>1</sup> The Charter granted limited liability, which was at that time a highly valued and rarely conferred privilege.

support of the new-fangled scheme, which they viewed with suspicion and dislike.

During several generations (says Macaulay) the Bank of England was emphatically a Whig body. It was Whig, not accidentally, but necessarily. It must have instantly stopped payment if it had ceased to receive the interest on the sum which it had advanced to the government; and of that interest James would not have paid one farthing. . . . So closely was their interest bound up with the interest of the government that the greater the public danger the more ready were they to come to the rescue. In old times when the Treasury was empty, when the taxes came in slowly, and when the pay of the soldiers and sailors was in arrear, it had been necessary for the Chancellor of the Exchequer to go, hat in hand, up and down Cheapside and Cornhill, attended by the Lord Mayor and by the Aldermen, and to make up a sum by borrowing a hundred pounds from this hosier, and two hundred pounds from that ironmonger. Those times were over. The government, instead of laboriously scooping up supplies from numerous petty sources, could now draw whatever it required from an immense reservoir, which all those petty sources kept constantly replenished. It is hardly too much to say that, during many years, the weight of the Bank, which was constantly in the scale of the Whigs, almost counter-balanced the weight of the Church, which was as constantly in the scale of the Tories.

The note issue of the new bank was favoured by circumstances. The coinage being both deficient and hopelessly bad, there was a real want of circulating media; and, as no reasonable doubt could be entertained of the solvency of an institution possessing so wealthy a body of shareholders, its notes were from the very outset readily taken, and the new enterprise soon became an assured success.

## CHAPTER II

### THE BANK OF ENGLAND AND THE GOVERNMENT

THE first landmark in the history of the Bank is the Act of 1708, which made it unlawful for any association of more than six partners to carry on banking business in England and Wales and practically invested the Bank with a monopoly of joint-stock banking.<sup>1</sup> The injurious effects of this measure, which for over a century confined banking in England to the narrow limits of private enterprise, were submitted to by the country until 1826, when the Act was repealed, the Bank retaining the reduced privilege of being the only joint-stock bank of *issue* within sixty-five miles of St. Paul's. To our modern ideas this prerogative appears of little value; but in those days, when deposits were few and notes many, the exclusive monopoly of the metropolitan circulation conferred unquestioned predominance over all other banks.

The next notable intervention of Parliament was in 1844, when the drastic measure known as the "Bank Act" was made law. This Act regulated the power of issue of all banks in England and Wales, including the Bank of England. Its object was to effect the ultimate extinction of the "Country" note, to supplant it by the Bank of England note and to make the latter "as good as gold."

<sup>1</sup> As the Bank frequently obliged the government by lending to it when no one else would have lent, the government in return favoured the Bank by freeing it from the danger of threatened competition.

Its provisions as regards the Bank of England are referred to more fully hereafter.

Although the next piece of legislation intimately to affect the Bank was the Gold Standard Act, 1925, there were other enactments with which the Bank was concerned, and which, in fact, led naturally to the Currency and Bank Notes Act, 1928. These statutes resulted from the War of 1914-1918, and consist of the Currency and Bank Notes Act, 1914, the Currency and Bank Notes (Amendment) Act, 1914, the Finance Act, 1915, as regards Part IV, section 27. But they are not particularly relevant in the present connexion. The War of 1914-1918, by reason of its vast production for destructive purposes and its rude interruption of international financial relations, brought this country to a condition unprecedented in its experience and unthought of in its most extravagant economic dreams. In particular, the existing volume of currency was found quite inadequate to cope with the overwhelming increase in the volume of production and, for reasons which will be examined hereafter, the gold supply and reserve were found insufficient to meet the requirements of the gold standard. These two factors led, firstly, to the creation of a subsidiary currency (soon to become, in a sense, the primary one), and secondly, to the divorce of the bulk of the currency from gold.

From the standpoint of the Bank of England the Currency and Bank Notes Act, 1914, effected firstly, the convertibility of the Treasury note in gold at the Bank and, secondly, the payment of postal orders by the Bank in gold or other legal

tender coin. The Gold Standard Act, 1925, had a revolutionary effect. Its provisions may be summarized as follows—

- (a) the inconvertibility of the Bank of England note, but its maintenance as legal tender;
- (b) the inconvertibility of the currency note;
- (c) the prohibition of the free minting of gold bullion;
- (d) the requirement that the Bank should sell gold in 400 oz. bars only and at £3 17s. 10½d. per oz. troy of standard fineness.

The next Act was the Currency and Bank Notes Act, 1928, which may be regarded as a further piece of revolutionary legislation concerning the Bank, the first being the Bank Charter Act, 1844, and the second the Gold Standard Act, 1925. It was clear that the system whereby two issues of notes circulated concurrently could be a temporary measure only and that, at a suitable time, arrangements would have to be made for combining them—assuming that the new issue could not be disposed of in any other way. This combination was envisaged almost from the inauguration of the Treasury note issue; it was confirmed by the Cunliffe Committee in 1918 and materialized ten years later. This Act of 1928 provided, *inter alia*, for the issue by the Bank of notes for one pound and ten shillings; for the transfer to the Bank of the currency note issue; for the limitation of the fiduciary issue, and its cover; and for the concentration and continued concentration at the Bank of the gold holdings of the country.

Finally, in 1931, it became necessary to suspend

the working of the "gold bullion standard" set up by the Act of 1925, and the Bank was no longer under the obligation to sell bar gold to all comers.

From the day of its foundation to the present time the Bank of England has discharged a double function. It is the bank of the State. It transacts the entire banking business of the Government, receiving its revenue from the collectors all over the country, paying all outgoings, managing the public debt, issuing Treasury Bills and advancing money on "Ways and Means" when expenditure temporarily overtakes income.

But, although the Bank is thus in intimate connexion with the Government, it is far from being a state bank,<sup>1</sup> in the sense in which the term applies to such as the State Bank of the U.S.S.R., and yet, at the same time, it is something more than a private banking corporation like any of the "Big Five." Perhaps its position is best described as being midway between the two, partaking of the prestige of the one and of the liberty of action of the other. Yet legally it is a private, not a Government, institution.

It also stands in an exceptional relationship to other banks. Its unquestionable stability, "equal to that of the British Government," as Adam Smith said, has led them to entrust their reserves of cash to its guardianship.

Circumstances have likewise made the Bank of England the sole repository of our stock of bullion. It always held the bulk of the gold of the country,

<sup>1</sup> Except in so far as the management and regulation of the issue of notes, the guarding of the reserve and, latterly, the control of the foreign exchanges are concerned, in which matters the Bank may be regarded as acting on behalf of the State.

but early in the War the individual reserves of the banks were concentrated and the Bank has now power to require that all gold over a certain amount, not held for trade or export purposes, be sold to it. Until the Gold Standard Act, 1925, anyone had the right to take gold bullion to the Mint and ask for sovereigns in exchange at the rate of 77s. 10½d. per ounce standard; that Act, however, stopped the free mintage of gold and enacted that gold could be demanded from the Bank in bars of approximately 400 oz. troy only. The Gold Standard Act, 1931, suspended that provision. By the Act of 1844 the Bank was compelled to buy all that might be offered to it at the rate of 77s. 9d. per standard ounce.

The Bank of England is thus the focus of the monetary system of the country and, as the repository of the Government balance, the bullion reserve, and the ultimate banking reserve, is invested with a certain stateliness and dignity of standing which place it *hors de concours* and which restrain it from working, as other banks do, mainly with a view to dividend earning.

## CHAPTER III

### THE BANK OF ENGLAND AND THE MONEY MARKET

THE history of the relationship between the Bank of England and the London Money Market from 1694, the date of the Bank's inception, to the present time, is divided by the two main governing statutes, the Bank Charter Act of 1844 and the Currency and Bank Notes Act of 1928. These Acts, for a while at least, both decided the future status of the Bank at times when experience had taught that the existing status left something to be desired from the point of view of the Bank's position as the central monetary institution of this country. The object of the second of these statutes, unlike that of the first, was to meet a situation which had not arisen from the operation, policy or status of the Bank itself and, in all probability, such object might not have been achieved—or even much thought of—if it had not been for factors which were beyond the control of the Bank. It is true that a certain amount of criticism had been levelled against the constitution of the Bank and against its policy, but any results of such criticism must have taken considerably longer to materialize had not circumstances created a situation which broke all bounds and called for drastic remedy.

For almost a century and a half from the date of its birth the Bank of England was the undisputed monarch of the money market, but the

establishment of joint-stock banks in London, beginning with the London and Westminster Bank in 1834, brought powerful rivals into the field, who, by offering to pay interest on deposits—a practice against which the Bank resolutely set its face, and which, except, it seems, for foreign accounts, it yet refuses to countenance—attracted to themselves immense sums many times in excess of their capital and were thus enabled to contest its supremacy on nearly equal terms. From that time until to-day the relationship between the Bank and its joint-stock rivals has gradually changed, as has also the relationship of the Bank to the Government. There has been a change not only in the Bank's measure of control over the money market, but in the nature of its relation to the other factors of the market, and further, in its own political and international importance. The growth of productivity in this country and the great increase in prosperity up to the early years of the twentieth century gave increased power to the whole of the constituent members of the banking industry and, perhaps, to the Bank in particular; but although there has been what economists would term an "absolute" increase, this has not been shared equally between the Bank and its *confrères*, which have progressed more rapidly. At the same time, owing to the predominance of deposits over notes, and to the freedom of the relationship between the joint-stock banks and the Bank, the latter has, in a sense, lost its former very definite hold over the money market (although not its practical capacity for

enforcing its wishes) and yet has consolidated its position as the central bank of the country.

The Bank of England's influence in the London Money Market is exerted through what is known as the "short loan fund," and is applied by means of the "Bank Rate," and the "open market policy," as will later be shown. The functions of a central bank depend upon the standard upon which the currency of the country is based. If the standard is gold, then it is the duty of the central bank to conserve the reserve of gold; the same is true of the gold bullion standard, which from 1925 until 1931 was in force in this country. The gold standard means the free and unlimited minting of gold, and its free export; the gold bullion standard differs in that minting is not free (although it may be) and gold is not in circulation as money. In other words, the legal duty placed on the Bank of England under a gold bullion standard is to redeem notes in gold bullion only. The free working of the gold standard was suspended in 1916, and was reinstated in part in 1925 by the Gold Standard Act of that year, only to be suspended again in 1931. It is claimed for London that, apart from New York, it has had the only absolutely free gold market in the world; that gold could be obtained in any circumstances, circumstances in which obstacles would, on the Continent, be placed in the way of withdrawal for export. This reputation was lost during the War and up to 1925, when the *status quo ante* was in the main restored and foreigners were again certain of obtaining payment of their debts in gold, if they required it. But, as has been said, gold was not

in circulation. In 1931 the pre-1925 position regarding the sale of bullion was reverted to.

The currency laws of this country do not require that every note issued should be covered by gold; they allow of a fiduciary issue, the cover for which consists of Government debt, securities and silver. This issue is treated fully in the next chapter. Beyond a certain figure, every note issued must be covered by an equivalent amount of gold, and it follows that the note circulation of the country—notes in actual circulation and held by the banks and the Banking Department of the Bank of England—depends upon the gold held in the Issue Department of the Bank. This, again, is dependent on the influx and efflux of the metal to and from the country.

It is now necessary to indicate the relationship between the note circulation and the short loan fund. The sum total of the balances held with the banks in the country represents the immediate purchasing power of the community, but it is only a proportion of this amount which is withdrawn at any one time. So the banks do not find it necessary to keep the whole of this sum liquid and, in fact, they invest the greater part in securities, bills, advances to customers, etc. They nevertheless keep a certain part in cash, known as their cash reserve. This consists of notes, silver and copper held in their tills and in reserve, with which to meet the needs of their customers for the means of settling the ready-money transactions of every-day life. Secondly, they keep accounts at the Bank of England upon which considerable "cash" balances are maintained.

These two items comprise their main reserves and amount to about 10 per cent of their liabilities to customers on current and deposit account. Short loans account for a further 8 per cent and are loans made to the money market and Stock Exchange repayable after one, seven, or fourteen days, or other short periods.

A distinction between the bank's loans to customers, which appear in the balance sheet under the heading of advances, and loans to the money market is to be found in the rate charged. It may be said to be the almost invariable rule that advances to customers are charged at  $\frac{1}{2}$  per cent or 1 per cent over Bank Rate with minima of perhaps 4 per cent or 5 per cent, whereas loans to the market pay 1 per cent, or even  $1\frac{1}{2}$  per cent under Bank Rate for weekly and day-to-day money, and what they will fetch for longer fixtures and overnight money. Regular loans, known to the market as "good money," are ordinarily renewable at the given rates. Others are not necessarily so.

The "short loan" fund of the country may now be explained as the total of bankers' balances with the Bank of England, other than the bare minima kept as part of their reserves, together with the volume of money actually loaned for the short periods indicated.

These two are not independent of one another; there is, in fact, a certain relationship. The tradition and practice of the banks in this country of maintaining a cash ratio precludes their lending beyond a certain proportion of their liabilities, and they would not wish to lend much less. To some

extent, therefore, the total volume of balances with the bank is an indication of whether money is plentiful or scarce, "easy" or "tight." It will also be seen that as the extent to which banks can lend is dependent on the ratios which they maintain between the various methods of investment of the funds placed at their disposal by their customers, the depositors, the volume of loans can increase only with an increase in their deposits. As (excluding an increase due to inflation) a permanent increase from this source can only be gradual, arising from greater productivity, the fluctuation in the short loan fund in this respect is, within short periods at least, negligible.<sup>1</sup>

Returning to the bankers' balances with the Bank of England, these can only be increased by individual banks through favourable balances in the daily cheque clearings, by their allowing bills to run off, by their not permitting loans to be renewed, and so forth. A general increase in deposits, however, results from the purchase of gold by the Bank. We may reiterate that, normally, the Bank is empowered to increase the note circulation so long only as such increase is covered by gold. When, therefore, the Bank is able to acquire gold, it may pay for it either directly in notes or, which comes to the same thing, by a draft on itself. This draft is collected by the particular bank into which it is paid and thus goes to swell the volume of deposits held by the banks with the Bank of England. Notes are presumably paid into a clearing bank, finding ultimate

<sup>1</sup> No account is here taken of the relatively modern factor, the placing and withdrawal of foreign short-term balances.

expression in balances with the Bank. Thus the short loan fund would be augmented.

It is here necessary to digress somewhat in order to discuss the movements of gold to and from the Bank in normal times. There are, broadly, two sources from which the metal may be obtained, and one destination for which it may be lost. In the first place, the gold may be obtained in the London market, to which it has been sent by the producers; secondly, it may be sent to this country from abroad, either in settlement of international mercantile indebtedness, or as the result of some international financial operation. It may be withdrawn from the Bank for export as the result of either of the two considerations just given. Whether it will come to the Bank or be diverted, or whether it will be withdrawn, depends in normal times largely on the Bank Rate.

#### BANK RATE

“Bank Rate,” or the “Bank of England Minimum Rate of Discount,” is theoretically the lowest rate at which the Bank will discount approved bills of exchange, or make advances on security for short periods, and up to 1878 it was the actual minimum; but the Bank then adopted the practice, which has since been adhered to, of discounting for customers (those who keep their ordinary banking accounts there) at market rates, in order to place them on as favourable a footing as the customers of other banks.

Market rates are lower than the Bank Rate, and it follows from this that people (other than the Bank's customers) will not take bills to the

Bank for discount, or borrow from the Bank, if they can get the accommodation from one of the other banks. Again it follows that they will not resort to the Bank except under pressure, and to become effective the Bank Rate must be followed by the market rate; i.e. that pressure—the absence of cheaper money—must be applied. It need hardly be emphasized that the banks use every endeavour to avoid leaving money idle and, therefore, if funds are plentiful, they will lend at such low rates as the money will fetch rather than earn nothing at all; so that unless they choose to answer the call of the Bank of England, or unless funds are naturally low, the raising of the Bank Rate will have no effect and can only be made effective by making money more valuable. This means decreasing the supply and the Bank achieves this by becoming a large borrower itself—by selling securities or bills. The short loan fund is thus depleted, because the purchasers of securities or bills pay for them by draft on the joint-stock banks, which naturally reduces their balances with the Bank. The supply is shortened in relation to the demand and money rates rise; if they rise to a prohibitive extent or the banks refuse to lend at all, borrowers are compelled to go to the Bank—are forced “into the Bank” in market parlance—and Bank Rate is fully effective.

To appreciate the reasons for a rise or fall in the Bank Rate it is necessary to treat of the duties and functions of a central bank. First, however, the relationship between Bank Rate and market rate must be shown.

## BANK RATE AND MARKET RATE

The market rate of discount is, in so far as it can be precisely described, the rate at which bills can be discounted. In particular three months' bank acceptances and Treasury Bills are referred to. As there are two sources of demand for such bills, the price is governed by the operation of the two types of buyer—the joint-stock banks of the country and the Continent. These two are largely independent of one another, the English and Scottish banks carrying large portfolios (varying naturally from time to time, but always large), whereas a Continental demand springs up only as a result of better rates being obtainable in this country than abroad. The price the English banks are willing to pay for bills is dependent upon the price they have to pay for deposits<sup>1</sup> and on the supply of bills in relation to the demand. The demand may depend on a number of factors, governed by the banks' position, but genuine commercial bills cannot be arbitrarily manufactured, and the supply is, therefore, uncontrollable. The use of these bills appears to have a tendency to decrease irrespective of the volume of trade, but the shortage which for one reason or another followed the Great War has been counterbalanced by an enormous increase in British Government Treasury bills.

The relationship between the Bank Rate and the market rate may be said to be fairly constant in normal times. Such variation as there is arises from the effectiveness or lack of effectiveness of the Bank Rate. When the latter is more than usually wide of the market rate, it is said to be out of

<sup>1</sup> See p. 160

touch, this position arising when money is so plentiful as to force money rates down away from the Bank Rate; or the supply of bills so short that the discount rate cannot be maintained at its customary disparity from the Bank Rate.

On the other hand, the Bank Rate and the market rate may move close together—at such times, for example, as when money is tight and bills are plentiful, this situation giving rise to apathetic competition for the larger quantity of bills and sending the price down.

It is clear, therefore, that, at all times, the position is governed by the supply of and demand for money and bills respectively; that it is dependent upon the combined action of these four forces.

At the time of writing the banks' deposit rate is  $1\frac{1}{2}$  per cent below the Bank of England rate; the usual disparity is 2 per cent, though this might increase if the Bank Rate were to rise to a very high figure. So long as the banks are prepared to govern their deposit rate by reference to the Bank Rate, then the latter will affect the former, but this does not carry us quite far enough. The deposit rate does not absolutely govern the market rate of discount; it is, as has been shown, only a factor, and not the most important factor.

#### REASONS FOR CHANGES IN BANK RATE

The reasons for alterations in the Bank Rate lie in the functions of a central bank.<sup>1</sup> These are mainly two.

<sup>1</sup> It should be stated that a central bank may, if its constitution permit, undertake commercial banking—undesirable though this may be thought to be. It will be recalled that the Bank of England in 1930 went further in its policy of conducting only central banking business by disposing of its Western (London) Branch to the Royal Bank of Scotland.

- (a) The conservation and control of the gold reserve of the banking industry and the country—where the country is on a gold standard.
- (b) the control of the note issue.

These two have been shown to be interconnected, but from the point of view of changes in the Bank Rate, the reserve is the determining factor. As the note issue is dependent upon gold, the credit basis of the country is gold; an increase in the holding expanding the basis, a reduction restricting it; so that international gold movements may have a marked effect on the short loan fund. With this the Bank is not primarily concerned, but rather with the maintenance of an adequate ratio between its reserve and its liabilities. The conception of an *adequate* reserve has altered considerably in past decades, as is shown in the chapter on the "Banking Department." This is not a question to be discussed at the present juncture; it is sufficient to state that if the Bank deems it desirable to protect its reserve, the rate is raised, and when the need has passed, it is lowered. It is a feature of the movements in the rate that increases are usually made in stages of 1 per cent and decreases in stages of  $\frac{1}{2}$  per cent.

The Bank Rate is also used, although relatively rarely, for the purpose of off-setting an unduly speculative boom or of lending incentive to a movement in the direction of better trade by making money cheaper. In this sense, the reserve may be said to take second place, but, at the same time, it is safe to say that unless the Reserve position is satisfactory, the central bank would not take upon

itself, in the second case, the responsibility of risking a further depletion in the Reserve.

The proportion which the Reserve should at any time bear to deposit liabilities—the point, that is to say, at which it is considered that safety ends and danger begins—is determined not by any hard-and-fast rule, but by the circumstances of the moment and by contingencies within the knowledge of the Bank's directors, who are at all times in possession of a great deal more information than reaches the public.

Years of high average Reserve are years of low average Bank Rate, and years of high average Bank Rate are years of low average Reserve.

If one studies the movements in the annual average discount rate of the Bank of England from 1844 to 1935, one of the first points of outstanding significance noted is that the crises of 1847, 1857 and 1866 are clearly indicated, whereas that of 1914—the fourth occasion since 1844 on which the suspension of the Bank Charter Act has been imminent (though, unlike the other three, it did not in fact, though perhaps in effect, take place)<sup>1</sup>—shows no great divergence from the general trend. The highest average after 1866 was that of 1920.

Secondly, the narrow limits within which the average has moved since 1866 compare strikingly with the violent fluctuations which are indicated prior to that date. From 1845 to 1866 was the period of crises, as has already been indicated. The peaks are explained by the following events or situations.

The crisis of 1847 was the result of a number of

<sup>1</sup> Kirkaldy says that a few notes were issued in excess of the legal limit.

factors. It may be said to have begun with the failure of crops in the two years preceding, particularly the potato crop in Ireland. This necessitated the importation of a considerable volume of cereals, which was paid for by the export of specie. In spite of such export, no steps were taken by the Bank to counteract the effect or to stop the outflow, with the result that the reserve fell to a dangerously low level. The trouble was aggravated by commercial and financial failures and the reserve was further depleted, until the Act was suspended—though, in fact, no additional issue of notes actually became necessary.

In 1854, 1855, and 1856 the Crimean War had disastrous effects in that it created a feeling of unsettlement in the business community. It was on such a foundation that there fell the news of a crisis in America and, weakened by the failure of certain banks in Scotland, the position finally resulted in the suspension of the Act in 1857. On this occasion, notes were actually issued beyond the statutory limit.

In 1862, legislation provided for the formation of companies with limited liability. Like most new propositions with rosy prospects, the principle was abused and a great many companies were formed, 90 per cent of which failed during the next three years. In 1866, the failure of Overend Gurney & Co., a large City banking house, brought widespread confusion to the financial interests of the City and caused the third suspension of the Bank Act.

Between 1866 and 1914 there are six peaks, of relatively minor dimensions, viz. in 1873, 1878,

1882, 1890, 1907 and 1913. The payment by France of the war indemnity demanded by Germany caused an efflux of gold from this country in 1873. In 1878, the City of Glasgow Bank and the West of England Bank failed. In 1882, conditions were affected by the Boer War, the war in Egypt and a banking crisis in Paris. These were, however, successfully weathered. The next serious crisis occurred in 1890, when the house of Baring Brothers found itself in difficulties. The Bank Act was not suspended, for the situation was saved by prompt action on the part of the Bank, which came to the assistance of Barings, who, in fact, were solvent. In 1900 came the South African War and in 1907 the banking crisis in America. In 1913, the Balkan War gave rise to further financial unsettledness.

The period from 1914 to 1935 has four peaks of high average Bank Rate, those of 1916, 1920, 1926, and 1929. The first of these is accounted for by the rapid inflation which ensued as a result of the War. In 1916 England had, in effect, abandoned the gold standard. Our balance of trade was decidedly adverse and invisible exports had fallen off considerably.

The peak of 1920 was largely the result of an endeavour to stop the intense speculation, in goods of all kinds, which followed the termination of the War. That of 1926 was caused principally by the large efflux of gold in 1925 and similarly in 1929, when the Bank lost some £20 millions before the tide was turned. In 1931, when the loss of gold sent the country off the gold standard, the average was not outstandingly high though the rate was

6 per cent from the 21st September to the end of the year.

The periodicity of panics (1847, 1857 and 1866, as well as 1837 and 1825) formerly gave rise to a notion that, owing to the action of some undiscovered economic law, five fat years in the money market were to be followed by five lean years, and that panics moved in decennial cycles. There may be some question of psychology involved in the alternations of "booms" and "slumps," but the precise fact with which we are concerned is that the actual panics referred to were caused by a want of promptitude in taking steps to defend a dwindling reserve. The ratio, for instance, which the reserve bore to liabilities in 1844-46 was 50 $\frac{2}{3}$  per cent, and in 1847 fell to 33 per cent; in 1852-56 was 47 per cent, and in 1857 fell to 30 per cent; and in 1861-65 was 40 per cent, against 30 per cent for 1866. Since 1866 the average proportion was not until 1915 again suffered to fall so low, having been about 43 per cent. The War and post-War figure of the Reserve are indicated on page 82 and discussed toward the end of the chapter on the "Reserve."

#### THE BANK RETURN

By the Act of 1844 the Bank was required to transmit to the Commissioners of Stamps and Taxes for publication in the *London Gazette*—

An account of the amount of Bank of England Notes issued by the issue department of the Bank of England, and of gold coin and of gold and silver bullion respectively, and of securities in the said issue department, and also an account of the

capital stock, and the deposits, and of the money and securities belonging to the said governor and company in the banking department of the Bank of England.

This account, known as the "Bank Return," is laid before the directors at their weekly meeting on Thursday morning, and is afterwards made public. Its details are always interesting to men of business, and in critical times its appearance is awaited with anxious impatience, as the information it contains will either allay or aggravate apprehension of danger or difficulty. The Return also does duty as a balance sheet, which the Bank never publishes. The following is the one for the week ended 31st December, 1890—

## BANK OF ENGLAND

AN ACCOUNT pursuant to the Act 7th and 8th Victoria, cap. 32, for the Week ended on Wednesday, 31st December, 1890.

## ISSUE DEPARTMENT

Notes issued . . . . .	£39,193,345	Government debt . . . . .	£11,015,100
		Other securities . . . . .	5,434,900
		Gold coin and bullion . . . . .	22,743,345
	<hr/>		<hr/>
	£39,193,345		£39,193,345

## BANKING DEPARTMENT

Proprietors' capital . . . . .	£14,553,000	Government securities . . . . .	£9,806,433
Rest . . . . .	3,241,083	Other securities . . . . .	33,178,856
Public deposits <sup>1</sup> . . . . .	6,824,359	Notes . . . . .	14,079,175
Other deposits . . . . .	32,990,230	Gold and silver coin . . . . .	722,489
Seven-day and other bills . . . . .	178,281		
	<hr/>		<hr/>
	£57,786,953		£57,786,953

<sup>1</sup> Including Exchequer, Savings Banks, Commissioners of National Debt, and Dividend Accounts.

Dated 1st January, 1891.

F. MAY, CHIEF CASHIER.

In accordance with the above-quoted clause of the Bank Act, the items are arranged under the

two heads of Issue Department and Banking Department, the former giving particulars of the circulation and the latter of the general liabilities and assets.

It has been said that the Currency and Bank Notes Act of 1928 was a landmark in the history of the Bank of England. This was the statute under which the Bank assumed responsibility for that issue of notes which was formerly the care of the Treasury; owing to this Act the appearance of the Bank Return was changed. It was laid down that—

The form prescribed by Schedule A to the Bank Charter Act, 1844, for the account to be issued weekly by the Bank under Section six of that Act may be modified to such an extent as the Treasury, with the concurrence of the Bank, consider necessary, having regard to the provisions of this Act.

The following is the first return to be published after the Act came into force, that of 28th November, 1928—

#### BANK OF ENGLAND

AN ACCOUNT for the week ended on Wednesday, 28th November, 1928.

##### ISSUE DEPARTMENT

Notes issued :		Government Debt	£11,015,100
In Circulation	£367,001,148	Other Govt. Securities	233,568,550
In Banking Department	52,087,797	Other Securities	10,176,193
		Silver Coin	5,240,157
		<hr/>	
		Amount of Fiduciary	
		Issue	260,000,000
		Gold Coin and Bullion	159,088,945
			<hr/>
	<u>£419,088,945</u>		<u>£419,088,945</u>

Dated the 29th day of November, 1928.

C. P. MAHON, *Chief Cashier.*

## BANKING DEPARTMENT

Proprietors' Capital . . . . .	£14,553,000	Government Securities	£52,180,327
Rest . . . . .	3,254,001	Other Securities :	
Public Deposits (including Exchequer, Savings Banks, Commissioners of National Debt and Dividend Accounts) . . . . .	21,452,051	Discounts and Advances	£13,586,293
Other Deposits :		Securities	20,214,855
Bankers	£62,379,409	Notes . . . . .	52,087,797
Other Accounts	37,185,203	Gold and Silver Coin . . . . .	757,041
	<u>99,564,612</u>		
7-day and Other Bills . . . . .	2,649		
	<u>£138,826,313</u>		<u>£138,826,313</u>

Dated the 29th day of November, 1928.

C. P. MAHON, *Chief Cashier.*

Government Debt and Other Securities are shown as before; Other Government Securities are new, while Silver Coin takes the place of the old Silver Bullion which appeared in the early returns. These items totalled are described as the Amount of Fiduciary Issue. To this total is added Gold Coin and Bullion, the final total balancing that of Notes Issued, which, differently from heretofore, is now divided into Notes in Circulation and Notes in Banking Department. The statement concerning the Banking Department has not been changed in principle, but some of the items have been amplified; Other Deposits being broken up into Bankers and Other Accounts, Other Securities divided into Discounts and Advances, and Securities. The figures speak for themselves, but will be dealt with later.

This book is not concerned with the moral aspect of "War" finance; suffice it to say that from 1914, the Treasury issued notes independently

—though through the medium—of the Bank of England, notes for which the Bank was not responsible. This issue, which began in 1914 and at the end of the year had not reached serious proportions, speaking relatively, had risen by 1920 to the colossal figure of nearly £370 millions gross. It was necessitated by the enormous increase in production due to the War. The output of every kind of material necessary to the prosecution of a war assumed incredible proportions and the existing currency was insufficient for the huge volume of goods and services. Unfortunately, such goods were manufactured largely to be destroyed—in other words, notes were put into circulation to meet a production which was to be wasted in a short period, and not against a genuine increase of trade, the consequence being the inflation of the currency. The cover for such currency was not, and could not be, gold. At first, a moderate amount of gold was held as cover, but in 1924 this was transferred to the Bank of England. Apart from a negligible amount of silver and a more appreciable amount of Bank of England notes, the reserve consisted of Government Securities. The fiduciary issue in December, 1914, was practically £20 millions; in 1920, it had risen to almost £320 millions and at the time the issue was taken over by the Bank, it was £230 millions.

## CHAPTER IV

### THE ISSUE DEPARTMENT OF THE BANK OF ENGLAND

WHEN the British public speculates and loses, it is apt to lay the blame not so much on its own want of prudence as on the shortcomings of others. Usually the Government is made the scapegoat; but sometimes public opinion is very severe upon company promoters and financiers, at other times upon the banking system, and so on.

Such was the case prior to 1844. In the crash that followed on a speculation in corn or stocks some of the provincial bankers were generally to be found among the victims; and the unfortunate holders of their notes, seeing themselves in possession of mere worthless pieces of paper, raised the specious cry of "Over-issue," and demanded Government interference. The grievance was taken up by the country. The banks, it was maintained, had been at the bottom of all the mischief; for, by putting into circulation more paper than was required for the transaction of business, they had produced a redundant currency, leading to high prices, speculation, and crisis. On the other side it was contended, however, that the theory of "over-issue" was a mistake, and that there could be no excessive issue of paper money so long as it was convertible at will into coin; or, in other words that it was impossible to make a man carry a ten-pound note about with him in his pocket if he only

wanted £5 in paper. Only make sure, they said, that every note issued shall be paid on presentation, and the circulation may safely be left to take care of itself.

This latter was the common-sense view, but, nevertheless, it was upon the assumption, then entertained by business men of great experience, that excessive issues of bank notes were the main cause of the continually recurring panics, that the provisions of the Bank Act of 1844 were evolved.

Up to that time every banker had the right to issue notes to any extent, the sole condition imposed by law being that he should pay them in cash on demand, or, in default, become bankrupt. But whether or not he maintained a sufficient reserve of cash to ensure convertibility was left entirely to his own judgment and sense of rectitude, the consequence being that in many instances bankers grossly abused their privilege, and, when opportunity offered, increased their issues to an unjustifiable extent.

It was accordingly determined by Sir Robert Peel to assert the broad principle that the right of regulating the issue of currency rests with the State (on the ground that, as bank notes formed part of the national currency, and were practically irrefusable, it was proper to treat them as being not private, but public, instruments), and to overhaul the entire system of note issue, or, as the Act says, "to regulate the issue of bills or notes payable on demand." Adopting a suggestion of Lord Overstone, who was then the greatest living authority on banking, Peel began by ordering the Bank of England for the future to keep its

business as a bank of issue wholly distinct from the general banking business, and to operate in a separate department which he entitled "The Issue Department of the Bank of England." There was to be no mixing of accounts, but, in the weekly statement rendered to the Government, the liabilities and assets of the two departments were to be shown apart.

As a liability, the new department was to take over all the Bank of England notes then in circulation, and, as assets, securities to the amount of fourteen millions and precious metals for the balance. It will be appreciated that for 150 years the Bank had been at liberty to issue as many notes as it pleased against what cash it pleased, and the practical effect of the Act was to limit the profit-earning part of the issue.

The issues of other banks (of England and Wales) were treated with a view to eventual extinction. No new bank of issue was thenceforth to be established, and those then existing were forbidden, under pain of heavy penalties, to exceed a certain maximum, corresponding to the average amount which they were able, respectively, to keep in circulation in the early part of 1844. The total amount so authorized was £8,631,647, divided amongst 280 banks. It was doubtless thought that these issues would have been absorbed more quickly than has been the case; and in this respect the Act may almost be said to have failed. The last English private issue to lapse was that of Fox, Fowler & Co. in 1921. A bank that suspended its issue could not afterwards resume it, and the privilege was also to be forfeited by any

that became bankrupt. It had already been enacted, too, that if a country joint-stock bank opened an office in London it should lose its right of issue.

The elaborate care taken by Parliament to protect the interest of the note holder, and the enormous importance attached to the convertibility of the note, as distinguished from a banker's other liabilities, mark a stage in the development of banking which has been left far behind. To understand how differently the note was then regarded, it must be borne in mind that in those days a banker's note circulation was his principal liability, and that deposits were in comparison but a very small item. In February, 1820, to give an instance, the circulation of the Bank of England amounted to £23,000,000, and the total deposits to £4,000,000; while in February, 1890, the figures were: circulation, £23,000,000; deposits, £35,000,000. In June, 1914, the circulation was in the neighbourhood of £29 millions, deposits having mounted to £56 millions. The figures for the latter part of 1914 and subsequent years cannot truly be compared with those of previous years on account of the serious inflation which took place during and after the War, and of the fact that there had come into existence a new currency, the Treasury Note, which altered the complexion of the "national" account.

From the passing of the Bank Charter Act to the Great War a vast change came over banking. The circulation of "country" notes as a whole has declined and, at the same time, the liability of bankers on current and deposit account has

increased by leaps and bounds. Thus, in 1895 the figures for the joint-stock and private banks of England and Wales were: notes, £412,600; deposits, £527 millions. In 1914 the figures were £58,990 and £928 millions. In 1928 the deposits amounted to £1982 millions, while notes had ceased to exist. (It must be remembered that there are certain issues in the Isle of Man which appear in the balance sheets of some of the English joint-stock banks.)

Nowadays, therefore, deposits are the all-important element in banking, and the liability on notes a matter of relative insignificance; but, when the Bank Act was passed, people thought just the reverse, and held the opinion that, while special legislation was necessary to insure the note-holder from loss, the ordinary law of bankruptcy was a sufficient protection for the banker's other creditors.

#### FIDUCIARY ISSUE

How Sir Robert Peel arrived at the seemingly arbitrary figure of £14,000,000 as a basis of the Bank's issue against securities does not appear; but, as the average issue during the century had never fallen short of that sum, he probably fixed upon it as a safe minimum which the Bank might count upon keeping in circulation in all ordinary circumstances. The chief item in that amount was the debt owing to the Bank by the public, which, in the course of the 150 years that had elapsed since the date of the first loan, had been increased by sundry additional borrowings to a total of £11,015,100. This did not exist as stock,

but was simply a book debt on which the Government paid the Bank interest. The difference consisted of interest-bearing securities. It was further provided in the Act that, in the event of any of the other banks forfeiting its right of issue, the Bank might be allowed on application to increase its own issue against securities to the extent of two-thirds of that which had lapsed. Since that time all other issues in England and Wales (apart from the Isle of Man and the Channel Islands) have from various causes been suffered to fall through, and the Bank had increased its fiduciary issue to £19,750,000, prior to the special increase to £260,000,000 in 1928.

The essence of the Act is contained in the clause that directs the Issue Department to hold the equivalent, in gold coin or in gold or silver bullion, of every note created beyond the authorized issue against securities. Up to £11,015,100 the note issue was guaranteed by the Government, corresponding in every way to a State issue, and for a further sum now amounting to £248,984,000 the Issue Department itself was responsible and held convertible securities against it; but for every additional note that the Issue Department put forth beyond this £260,000,000, standard gold to the weight of 616.37 grains had to be deposited in the vaults. This Department was automatic in its function, which was to receive gold, issue notes against it and, fundamentally, to deliver gold against notes returned, the notes being cancelled.

The fiduciary issue has changed considerably in composition, amount and cover, and its amount to-day is not explained alone by the augmentation

due to the lapsing of issues of other banks in England and Wales. In the early years of the War, it was seen that the possible issue of the Bank—under existing law—was inadequate to cope with the volume of currency which war production had made necessary. The Government might have suspended the Bank Charter Act once more, and suspended it indefinitely. But the Government was the great creator of the mass of material of all kinds which caused the need for a vastly increased volume of currency; such manufactures had largely to be paid for by the Government, as had moreover, such commodities as were rationed and purchased in bulk by the Government. The Government provided, therefore, the means of payment, using the Bank as a convenient medium, but assuming the responsibility itself.

Clearly, the control of the issue by the Treasury could be only a temporary measure; it was recognized that sooner or later provision would have to be made for the centralization of all note issues under one control. This materialized in 1928, as a result of the passing of the Currency and Bank Notes Act, 1928,<sup>1</sup> which statute provided *inter alia* for—

(a) the issue by the Bank of notes for one pound and ten shillings;

(b) the amount, present and future, of the fiduciary issue;

(c) the cover for such issue;

(d) the redemption of currency notes and their replacement by Bank of England notes;

(e) the transfer to the Bank of part of the assets of the Currency Note Redemption Account;

<sup>1</sup> See p. 191

(f) the payment to the Treasury of the profits of issue, and the release of the Bank from liability to stamp duty;

(g) the modification of the weekly return;

(h) the control and custody (by the Bank) of gold reserves.

The issue of notes for one pound and ten shillings meant the repeal of the provision of the Bank of England Act, 1833, under which notes of the small denominations were not legal tender.

The fiduciary issue was fixed at £260,000,000. a figure conveniently near the amount then current and much below the peak issues of a few years earlier. The Act provides that the issue may be increased by the permission of the Treasury on representation by the Bank that such increase is expedient. Such increase must, however, be limited to a definite figure and to "such period not exceeding six months, as the Treasury think proper." The Treasury minute authorizing an increase must be laid before both Houses of Parliament, and any series of renewals of the Treasury authority may be extended for a total of two years only, except as otherwise determined by Parliament.

The Bank may request the Treasury to reduce the issue; whether a reduction takes place is, however, in control of the Treasury, which is empowered to determine the period for which the reduction shall take effect.

The backing for the fiduciary issue is governed by the section which reads: "In addition to the gold coin and bullion for the time being in the issue department, the Bank shall from time to

time appropriate to and hold in the issue department securities of an amount in value sufficient to cover the fiduciary note issue for the time being"; but such securities may include silver coin to an amount not exceeding five and one-half million pounds.

Section 11 of the Act of 1928 (*vide* p. 195) is an interesting commentary on the post-War gold position. While, up to 1914, there was no movement of importance to record, the position changed in that year. It is probable that the possibility of war gave rise on the Continent to a demand for gold; at least, the fact is that a considerable amount left England during the early months of 1914. At the same time, the Continent was converting every possible foreign holding into gold, which action, combined with adverse conditions in New York, brought gold from that city. This situation was not, however, to last long. The outbreak of war made gold shipments difficult, hazardous even, and expensive; moreover, with the progress of the War, this country and its allies were forced to rely more and more on the United States for material of all kinds. The means of payment were three: gold, American securities and loans from America. The net result of payment and unsettled indebtedness was that America became the gold granary of the world and that Europe was left with unprecedented debts to the United States. Thus, gold, formerly moving from capital to capital in adjustment of exchanges, became something to hold on to as long as possible, and finally to hoard as a speculation or as the only safe form of wealth in an uncertain world.

The composition of the cover for the present

fiduciary issue is different in two respects only from that of the issue of pre-War days. Firstly, no silver bullion was previously held; for, though the Act of 1844 gave power to hold it to the amount of one-fourth of the gold, silver could not be legally tendered in payment of a £5 note. As has been shown above, the cover may now consist of silver coin to the extent of £5,500,000. In fact, the amount has dwindled from about  $5\frac{1}{4}$  millions in 1928 to about  $1\frac{1}{2}$  millions in 1935. Secondly, the cover may comprise Other Securities, by which is meant commercial bills.

On the circulation against securities there used to be a profit of about 3 per cent (which shrank, however, after deduction of the heavy working expenses and of a certain proportion paid to the Government for the privilege of issue, to a net gain of from £50,000 to £100,000 per annum), but every note issued against gold meant (and still means) an actual loss, because of the expense of printing the note and of the custody of the gold. Under the Act of 1928, however, the Treasury now takes the profits of the Issue Department and the Bank no longer pays anything in consideration of its exemption from stamp duty on its notes.

It is usually taken for granted that the assets of the Issue Department are specially hypothecated to the service of the issue, and, to the ordinary reader, the language of the Act of 1844 sounds clear on the point—

The whole amount of Bank of England notes then (31st August, 1844) in circulation . . . shall be deemed to be issued on the credit of such securities, coin, and bullion so appropriated and set apart to the said issue department.

Nevertheless, it has been held on good authority that the object of the Act is not to secure the note holder, but to place limits to the issue,<sup>1</sup> and that, if the Bank failed, all its creditors would fare alike, the note holders having no advantage over the depositors. Though interesting in theory, the question is, of course, of no practical importance. A further interesting point in this connexion is Einzig's statement to the effect ". . . that in practice the gold reserve is no longer considered as security for the internal note circulation and is available to a greater extent than ever before for the purpose of meeting international requirements."<sup>2</sup>

The Bank Act (that is, the provision regarding the gold cover) has been suspended on three occasions, namely, in the panic years 1847, 1857 and 1866. The Banking Department, having on these occasions suffered its reserve of cash to sink too low, had to apply for permission to borrow notes from the Issue Department, and the Act was temporarily suspended in order that the latter might increase its issue against securities. In the statutes regulating the note issue of the former Imperial Bank of Germany, which was modelled somewhat on the lines of the Bank of England, this contingency was specially provided for. Like the Bank of England, the Reichsbank issued a fixed amount of notes against securities, but might at any time exceed the limit on payment to the government of a fine of 5 per cent per annum on

<sup>1</sup> Such is undoubtedly the effect of the measures passed in 1845, which dealt with the Irish and Scottish banks, and this argument is based on the assumption that the three Bank Acts were one in intent and purpose

<sup>2</sup> *The Fight for Financial Supremacy* (1930), p. 44.

the excess issue. In all ordinary circumstances this tax acted as an effective check; but the reserve of power was useful to fall back upon in an emergency.<sup>1</sup>

The position concerning the fiduciary issue is still very much where it was; that is to say, the Bank is not able to act without the consent of the Treasury and then only within prescribed limits. In fact, the Currency and Bank Notes Act, 1928, did little to bring British "crisis" regulations into conformity with Continental practice, which latter has not infrequently been advocated. There would seem, however, to be no material difference between the two methods of currency issue beyond the permitted fiduciary or reserve limits. There may, nevertheless, be a certain difference in effect, so far as the public is concerned, the English method entailing a more public advertisement of the fact that the ordinary prescription has failed; but inasmuch as the effect abroad is the more important, and as foreign countries are scarcely likely to be deceived by either method of excess currency provision, any distinction is practically negligible.

#### POSITION OF NOTE IN CREDIT SYSTEM

The Bank of England note was made legal tender in England and Wales (not Scotland or Ireland) in 1833. Up to 1928 it might be legally tendered in payment of sums above £5 everywhere except at the Bank itself—that is to say, the Bank of England could not compel its creditors to take its

<sup>1</sup> Clare, Second Edition: A modification in that direction of the Act of 1844 could not fail to be beneficial in times of pressure. The mere knowledge, in fact, that the Bank possessed ability to increase the currency in case of need would remove all cause for uneasiness.

own notes. Since the passing of the Currency and Bank Notes Act, 1928, however, Bank of England notes for £1 and 10s. have been legal tender to any amount and at any branch of the Bank.

The active circulation (i.e. the notes outside the walls of the establishment, and actually in the hands of the public) has shown no tendency to keep pace with increasing trade or increasing population, but rather the reverse. From 1876 to 1914 the average was—

	Notes	Population (England and Wales)
1876-8	£27.9 millions	24.7 millions
1879-81	27.5 „	25.7 „
1882-4	25.6 „	26.6 „
1885-7	24.6 „	27.5 „
1888-90	24.4 „	28.4 „
1891-3	25.6 „	29.4 „
1894-6	25.9 „	30.3 „
1897-9	27.5 „	31.3 „
1900-2	29.5 „	32.6 „
1903-5	28.7 „	33.8 „
1906-8	28.9 „	34.9 „
1909-11	28.7 „	35.8 „
1912-14	29.7 „	36.6 „

While the population steadily increased the note circulation was very little more in 1914 than in the first period under review. It would seem, therefore, that the note had become of relatively less importance as a currency medium up to 1914. From then on, the note circulation of the country was affected by two factors, both arising from the same cause. In the first place, war expenditure

was met by an inflated currency which brought about a rise in the price level, and thus the circulation of the Bank of England was increased in what might be termed an artificial manner. Secondly, a new issuing authority, the Treasury, came into existence, and for many years—until 1928 in fact—there were two issues, which, although independent, were supplementary, by reason of the fact that they served different purposes. The “Treasury” or “Currency” note would not have existed if gold could have been in circulation, and it superseded the sovereign, which disappeared from circulation during the War. The Bank of England note served, until 1928, the same purpose as it had previously served, as bankers’ reserve and for payments of £5 and upwards. The amalgamation of the two issues took place as a result of the Currency and Bank Notes Act of 1928, giving the Bank of England figures from that date a new complexion, bearing no clear relation to that of their predecessors and offering no useful comparison.

When, therefore, it is desired to relate the present position of the Bank of England circulation to that existing in 1913, it is necessary to remember that the amount was swollen.

(a) directly, by the absorption of the Treasury note issue; and

(b) indirectly, through the rise in prices due to inflation, which affected the Bank’s own issue (apart from the Treasury note issue) as it affected bankers’ deposits.

From trade the note has been largely ousted by cheques, which, now that every trader and an

ever-increasing number of private individuals as well have banking accounts, form the actual trading currency of the country; and for ordinary purposes the £5 note suits neither the customers of the banks, who prefer to pay by cheque, nor the man who has no banking account, for whom the unit is too large. The difficulty of obtaining change is also an obstacle to its current use.

The employment of the Bank of England note of £5 and higher denominations is now almost restricted to two purposes. It serves, firstly, as a substitute for gold in bankers' till-money; and, secondly, as a medium for effecting payments of £5 and upwards, principally, but not largely, in circumstances in which a cheque might not be taken (e.g. travelling expenses, hotel bills, etc.).

In former times the changes in the amount of notes in circulation were closely watched. A rise at Christmas and in the holiday season was to be expected, but any abnormal increase was a sure sign of danger, indicating, perhaps, that bankers were converting securities into cash—strengthening their reserves in anticipation of a “run.” The seasonal influences remain, but the strength of the modern banking system seems proof against any suspicions which might arise from abnormal changes. A threat to any part of it could only be a threat to the whole. It is, however, illustrative of the fact that impending crisis always leads to some extra demand for tangible currency that from 29th July, 1914, to 5th August of that year the circulation rose from £29,706,000 to £36,105,000.

## GOLD COIN AND BULLION

The remaining item in the account of the Issue Department is that of "Gold Coin and Bullion," the amount of which corresponded to and regulated the balance of the issue in excess of £19,750,000—now in excess of £260,000,000.

It has already been pointed out that the profit on the circulation arises from the portion that is based on securities, the remainder being in the nature of a receipt for gold deposited, which the Bank must preserve intact until (the gold standard being in operation) it is reclaimed by note holders. The Issue Department, as agent for the Government, has consequently no incentive to acquire gold or to increase its issue against it, and, if it regarded only the question of profits, might possibly be averse to so doing, for the only advantage the Issue Department derives from the notes against gold is that the gold held against them helps to secure the convertibility of the fiduciary issue. But it is not a free agent. So far as the issue against gold is concerned, the law makes it the servant of the public, and compels it to take at a fixed price all the gold that may be offered. The Act of 1844 provided that all persons shall be entitled to demand from the Issue Department "Bank of England Notes in exchange for gold bullion, at the rate of £3 17s. 9d. per ounce of standard gold," the person tendering the gold to bear the expense of melting and assaying it; and until 1925 not only was it the Bank's duty to give notes for gold, but also to give gold for notes whenever required. The holder of the gold was not, until 1925, bound to go to the Bank, however.

The coinage of gold being gratuitous in this country, he might, if he so pleased, deliver it (if of sufficient amount) direct to the Master of the Mint, who would in due time return it in the shape of sovereigns, at the rate of 1869 sovereigns for every 480 ounces metal of standard fineness ( $\frac{1}{12}$  pure gold,  $\frac{1}{12}$  alloy), equivalent to a price of £3 17s. 10½d. per ounce. This was known as the Mint price of gold, and was 1½d. per ounce higher than the Bank price; but, notwithstanding this difference, all imports of gold were, as a matter of course, lodged in the Bank,<sup>1</sup> the reason being that the importer in this case received his money at once, while if he went to the Mint his gold would have to wait its turn, and an uncertain loss of interest would be incurred.<sup>2</sup>

This margin of 1½d. per ounce went into the Bank's pocket, but, strictly speaking, was not profit. It was rather a compensation paid to the Bank for the trouble and expense of sending the bars to the Mint in case it should be required to convert them into coin. Naturally, no more bars were minted than was found necessary, the Bank keeping them in stock as far as possible in the shape in which they were received.

In selling gold the Bank was guided by the same consideration that would influence any other dealer. The law insisted that it should pay out

<sup>1</sup> Unless there should be a demand for export, in which case arrivals are more likely to be sold in the market for reshipment.

<sup>2</sup> The time allowance on gold taken to the Mint was said to be 20 days and as 1½d. per ounce is just equal to 20 days interest at 3 per cent, the result was much the same whether bullion were sent to the Mint or sold to the Bank. In practice, however, the gold coined at the Mint was received exclusively from the Bank of England, as no private trader ever sent any.

sovereigns to the holders of notes when required, but beyond that left it at liberty to make its own bargain. If an exporter wished to make a shipment of gold to a foreign country, it might not answer his purpose to send sovereigns, and in that case he would ask the Bank to give him bar gold, which was more convenient for export<sup>1</sup>, and, in fact, formed an international currency, balancing differences of international indebtedness.

The Bank was always prepared to cash its notes in bars instead of sovereigns, if desired, and usually treated them as being of equal value, charging the Mint price of 77s. 10½d. per ounce, which left 1½d. per ounce, or 3s. 2½d. per cent, profit; but if the demand was very pressing, the Bank took advantage of it just as another seller would, and put up the price to 77s. 11d. The difference appears trivial, but as the margin on bullion transactions is calculated with extreme nicety<sup>2</sup>, an advance of ½d. per ounce, or one-half per mille, frequently sufficed to hinder an inconvenient withdrawal. Beyond 77s. 11d. it was not safe to go, because, rather than pay more, exporters might find it advantageous to send sovereigns out of the country to be melted, and the Bank would have to replace them by minting bars<sup>3</sup>.

This position was changed, as has already been shown, by the Gold Standard Act, 1925, which made the currency and bank note inconvertible, prohibited the free minting of gold and altered

<sup>1</sup> Bar gold is less liable to loss by friction than specie.

<sup>2</sup> The profits made in bullion business are smaller, because more certain, than in most other trades. Being an exceptionally transferable article, gold moves as soon as the least profit is shown.

<sup>3</sup> See also pp. 9 and 95.

the provisions under which gold could be sold by the Bank. Gold could not be demanded for notes except in bars of approximately 400 oz. troy (fine), the price being as before, viz. £3 17s. 10½d. per standard ounce. Since 1931 the Bank is no longer bound to sell gold at all.

To the Issue Department the flow of gold from and into the country is a matter of indifference. If gold comes into the Bank its printing presses strike off so many more notes; if gold goes out, notes return and are cancelled. In either case its account balances as before, and its position remains the same.

So utterly improbable is the contingency of a "run" on this Department as to be hardly worthy of serious consideration. It might, no doubt, occur in the event of foreign invasion, and, as a matter of fact, did once happen in the eighteenth century, when the news reached London that the Highlanders, under the Pretender, had advanced as far as Derby. But, apart from this exceptional instance, public confidence in the note has never been shaken; and in time of panic even, when every other "promise to pay" is discredited, the circulation, instead of falling off, invariably increases.

Supposing, however, for the sake of argument, that some unforeseen circumstance should give rise to a "run," it may well be asked how the Issue Department could possibly pay the holders of all its notes in gold, seeing that £260 millions of the money are locked up in securities, Government debt and silver.

To this it has been answered that, in an emergency, the Bank would have no difficulty in

realizing its Other Securities, and might then get the Government debt converted into stock, and sell that, taking its own notes in payment. Apparently this is the only explanation possible; but, as it is based on the assumption that buyers could be found for over £200 millions of securities at a time when the Bank of England itself was in danger, it may be taken for what it is worth. In such an emergency it would, of course, be the duty of the Government to intervene.

## CHAPTER V

### THE BANKING DEPARTMENT OF THE BANK OF ENGLAND

THE Banking Department of the Bank of England is simply a bank like any other, and differs in no essential particular from its neighbours.<sup>1</sup> Like them, it transacts ordinary banking business for the public (though to a decreasing extent) and, like them, it is carried on by the directors without Government interference (except in so far as it acts for the Government), for the benefit of the shareholders.

In only one respect is its management affected by special legislation. As the Bank is the custodian of vast sums of public money, it is reasonable that the Government and the public should have opportunity of knowing how that money is dealt with; and the Bank Act, therefore, requires that the Banking Department, as well as the Issue Department, shall publish a weekly statement of liabilities and assets—a condition that has been imposed on no other bank.

The first place in this Return is given to the items of —

#### PROPRIETORS' CAPITAL AND REST

The strength of the Bank, and the source of the unbounded confidence placed in its stability, was

<sup>1</sup> The words "exclusive privileges of *banking*" appear to have been retained in the Bank Act for the sake of conformity with previous statutes, as the Bank neither possesses nor lays claim to any exclusive privileges whatsoever, other than those which appertain to and are comprised in its function of banker and agent for the Government. At the outset it possessed the prerogatives of limited liability and of immunity from competition.

the enormous amount of the capital, £14,553,000, which, at the end of the nineteenth century, was not only far larger than that of any other bank in the world, but even exceeded the united capital of the state banks of France and Germany. And yet, vast as this sum appeared, it was not the whole extent of the resources; for, in addition, a Rest or reserve fund of undivided profits had been accumulated to the extent of upwards of three millions more,<sup>1</sup> so that the actual working capital was over seventeen and a half millions.

The chief object of capital to a bank is to give confidence and, in a sense, security, to depositors<sup>2</sup> and, in this respect, the security offered by the Bank of England was then unparalleled. Thus, on the 2nd July, 1890, the capital and reserve amounted to £17·7 millions against total deposits of £34·3 millions, a proportion of over *fifty* per cent; while the balance sheet as at 30th June, 1890, of the next largest English bank, the London and Westminster, showed capital and reserve £4·5 millions, against £25 millions of deposits, a proportion of less than 20 per cent.

Successive amalgamations and absorptions amongst the deposit banks have removed the former preponderance of capital. Considering the two banks at the present time (although the "Westminster" is no longer the next largest), the relative positions, from the point of view of their proportion to each other, have not altered much.

<sup>1</sup> It was decided long ago by the Court of Proprietors that the Rest should never be allowed to fall below three millions.

<sup>2</sup> "Clare," Second Edition: It is because the chief depositor is the nation itself that the Bank needs keep so large a capital. It must show the public not only that it is safe, but that it is safe beyond all question.

Absolutely, there has been a vast change. The respective figures as at 26th December, 1934, in the case of the Bank of England, and 31st December, 1934, in the case of Westminster Bank Ltd., are as follows—

	Capital and Reserve	Deposits	Proportion
Bank of England . . . . .	£17,989,737	£135,422,521	13 %
Westminster Bank Ltd. . . . .	£18,640,314	£305,653,206	6 %

It will be seen that, although in each case the proportion of capital and reserve to deposit liabilities has declined to about one-third of the figure for 1890, yet the relationship between the two banks in this respect is about the same.

It must be remembered that the deposits of the Bank of England and the other banks have increased not so much through a natural growth, or increased use of banking facilities, as through the inflation which commenced in the days of the War.

In one sense, however, the relative magnitude of the Bank's capital is a disadvantage, for its profit, though amounting to nearly a million and a half per annum, means, when yield is considered, only the modest return of 12 per cent, a result which compares unfavourably with the handsome dividends distributed by most of the Bank's younger rivals, who, not being burdened with a load that presses so heavily upon them, have, in this respect, been able to outstrip it in the race. Of course, if the prices of the stocks are taken into consideration, the yields fall within a much narrower range.

## PUBLIC DEPOSITS

The largest and most important account in the Bank's books, and the largest probably that any bank has ever possessed, is that of the British Government.

The public income, as it is collected day by day by the Customs and Excise and Inland Revenue officers throughout the country, is paid in at the branches of the Bank of England; on the other hand, the payments that the Government has to make to the Army and Navy and to the Civil Service are all effected ultimately from balances with the Bank. The Bank manages the National Debt and pays the interest thereon, and for this duty receives special remuneration.

To a banker this is an ideal account; for all its variations can be easily calculated, a handsome balance is always kept, and there is not the least fear of the Government's withdrawing its money in a panic.

Besides the Exchequer account, the Public Deposits comprise the balances standing to the credit of the Secretary of State for India, of the National Debt Commissioners, and of other "official" accounts.

From the point of view of the money market, the most interesting feature of the fluctuations is the large increase in the balance when taxes such as income tax, are paid, and the fall when interest on Government securities falls due.

The transference of a large sum of money from the pockets of outsiders to the coffers of the Bank normally acts upon the value of money, not only contributing to bring about the decline in the official

quotation, which, prior to the disturbing influence of the War, usually took place at this time, but materially influencing the market rate, by narrowing down the margin which exists between that and Bank Rate. As a rule the outside market has no difficulty in outbidding the Bank, and the success of its competition depends on its ability to do so. Thus, while the average Bank Rate for the ten years 1881 to 1890 was £3 9s. 8d. per cent, that of the market for best three months' bank bills was only £2 14s. per cent, a difference of 15s. 8d. But the temporary impoverishment of the market, combined with the augmentation of the Bank's strength, had (under normal conditions, be it remembered) a striking effect on this margin. On the other hand, when large Government dividend payments made money plentiful, the average variation was exceeded. Should the Government balance at any time be insufficient to meet these disbursements in respect of interest or otherwise, the deficiency is met by "Ways and Means" advances or an issue of Treasury Bills, the Government repaying the loan out of future revenue. An increase in the item of Government Securities is consequently a common occurrence at about the turn of the year.

Up to 1914 the volume of Public Deposits showed no material change, nothing but a very gradual increase each year, on the average, with occasional setbacks. In 1914, however, the average had risen from £13 millions to £19·5 millions; in 1915, £85 millions were reached and for the next five years the averages were, in millions, £55, £50, £36, £24, £19. Since then, they have been relatively

stable at £15 millions approximately. The reason for the remarkable change during the years of the War is that the Government account was swollen by the receipt of funds invested in the loans floated for the purpose of financing the War, in Exchequer Bonds and Treasury Bills, and by the proceeds of greatly increased taxation.

#### OTHER DEPOSITS

The whole of the Bank's liabilities to the general public (with the exception of a small amount of Seven Day and Other Bills, which were shown separately but no longer appear) used to be grouped together under the head of Other Deposits. These consist of balances standing to the credit of its customers in London, Manchester, Liverpool, Birmingham, etc., and correspond to the "Current Accounts" (rather than to the "Deposit Accounts") of other banks.

Since November, 1928, Other Deposits have been subdivided into "Bankers" and "Other Accounts." In a rough sort of way, the "Other Deposits, Bankers," may be said to be a measure of the supply of loanable capital, and to all who are conversant with the constitution of the money market every change in this item has a significant meaning. If they rise beyond the usual average, the augmentation is regarded, in the absence of other known causes, as an indication that the supply of money in the open market exceeds for the time being the effective demand. On the other hand, a fall below the average points to scarcity, and is the usual forerunner of an advance in outside quotations.

This connexion between Other Deposits and the market rate arises from the fact that the Bank of England is the bankers' bank, and that the Other Deposits include, in addition to the balances of many great corporations and wealthy firms, the cash balances of the whole of the London clearing bankers. Each of the clearing banks, of which there are eleven, keeps an account at the Bank, and the differences arising out of the daily clearings are settled by transfers from one to another in the Bank's books.

But in addition the London bankers also entrust to the Bank's keeping the amount of cash that experience has taught them the necessity of holding in reserve to meet any sudden demand that may be sprung upon them. A more natural system, one would imagine, would be to look after their reserves themselves; but it is one of the peculiarities of English banking that no establishment in the country, except the Bank of England, takes charge of its own reserve. Wherever possible the responsibility is shifted on to someone else. Such cash as is necessary for daily requirements is kept on hand, but the uninvested surplus that must be set aside to provide for unexpected withdrawals is consigned to the care of some other bank. The branch banks look to the head office; the head office relies on the balance at the Bank of England.

The Bank has therefore the responsibility of looking after what is really the ultimate banking-reserve of the whole country, and the Other Deposits or, at any rate, that part of them belonging to bankers, are as far as actual cash goes the only source from which a supply can be obtained

to satisfy any immediate need. In whatever part of the country an urgent demand for cash should spring up, it can be met only by trenching on the one central fund.

If the bankers' balances were reducible into nothing more than the provision for clearing differences and a reserve, they would, from their very nature, be all but free from fluctuation. The total under the former head would not vary, as the whole of the debits on any given day's transactions equal the whole of the credits, leaving the difference the same; and the reserve also would, when business and credit were in normal condition, be liable to little change.

#### FLOATING MONEY

As a matter of fact, however, the bankers' balances do vary very considerably, and the disturbing cause is to be found in a third element, that of floating money. There are times when a banker has more money to dispose of than he knows what to do with. When dividends are paid, for instance, the market may become full to overflowing, and the ordinary outlets are insufficient to carry off the supply. All the bills that can be found are eagerly bought up, and loans tend to increase, but there still remains a margin awaiting investment, and it is this margin of idle money which swells the Other Deposits until suitable employment can be found for it. The same thing occurs in periods of business stagnation, when, as at present, trade conditions are so bad that borrowing is restricted because the money cannot be used; and in fact whenever the demand

is slack, or the supply excessive. At all such times the Other Deposits are sure to increase, and the increase is ordinarily attended by lower rates.

Other Deposits, at the present time, stand at something over £130 millions, having increased from an average of, say, £25 millions in the years 1881-1891, to £37 millions in the years 1891-1900; to £42 millions 1901-1913, to £111 millions 1914-1919 and to £114 millions in the years 1920-1927.

How much of this belongs to bankers, and how much to the other customers of the bank, has not, until recently, been known by the public since 1877. A return was formerly made to the Government in which the bankers' balances were shown apart, but its publication was discontinued after 1877. In that year, the balances of other customers amounted approximately to £11 millions, the difference being bankers' balances—roughly one-half. Nowadays, the proportion of bankers' to other deposits is approximately as  $2\frac{1}{2} : 1$ .

The most marked feature in the regular movements of this item is a large and sudden increase at the turn of the half-year. On the 30th June and 31st December, the banks are in the habit of calling in money from the market in order that the item of "Cash" may make a good showing in the published balance sheet and this money finds its way into the Bank to swell the Other Deposits, thus causing an abnormal increase. After the accumulation has served its purpose it is rapidly dispersed again. In illustration of this may be mentioned the fact that in recent times the balance with the Bank of one of the clearing banks doubled itself over the turn of the year and fell to

about its original figure within a week. The dignity of our mighty financial institutions is not (or was not) above a little harmless window-dressing!

Another rise is caused by dividend payments in respect of Government stocks, while payments to the Government on account of taxes are responsible for a decrease.

These fluctuations are all such as recur with regularity year after year, but there are also others of less frequent occurrence which call for notice. Times of difficulty and crisis have in recent years always been accompanied by a great and rapid advance under this head. At such conjunctures bankers immediately set about strengthening their reserves.

The year 1875, which was made memorable by the failure of the Manchester firm of Collie, and by other mercantile disasters, will serve as an example. In six weeks the Other Deposits registered an increase of  $\pounds 8\frac{1}{4}$  millions, and of this sum no less than  $\pounds 7$  millions were paid in by bankers, who nearly doubled their balances. The remaining  $\pounds 1\frac{1}{4}$  millions may possibly have been money that was transferred by its owners from the custody of other banks to that of the Bank of England.

Another example is found in 1878, the year of the City of Glasgow Bank collapse, there being an increase of  $\pounds 7\frac{1}{4}$  millions in three weeks.

In November, 1890, when it became known that the Barings were in difficulties, the Other Deposits ran up in seven days from the already high figure of  $\pounds 30\cdot3$  millions to  $\pounds 36\cdot4$  millions, which up to that time was the highest point recorded.

War rumours produce much the same effect. In the early part of 1885 a dispute with Russia, in

connexion with the delimitation of the Afghan frontier, gave rise to considerable uneasiness, and the Other Deposits, which in February stood at less than £24 millions, had risen by July to as much as £34½ millions. Business had meanwhile come almost to a standstill, and the large cash reserves that bankers had gathered together hung on their hands for want of employment long after all dangers of war had passed away. Money was in consequence "a drug in the market," and for six months, from the middle of May, could be borrowed from day to day at an average price of less than 10s. per cent per annum.

The year 1914 provides us with yet another example of an increase in Other Deposits as a result of crisis. The average for 1913 was £41·5 millions; in 1914 they had risen to £80 millions, and in 1915 to £103 millions. But it must not be imagined that such increases were solely due to the strengthening, by bankers, of their reserves. A period of inflation had commenced, which raised the figures artificially beyond what they would otherwise have been.

One of the features of the world-wide uneasiness of the last decade has been the tendency of money to move from one capital to another in search of a safe home rather than favourable rates. This may mean merely the transfer of existing balances to foreign ownership with no effect on the total of deposits, but when gold is transferred an addition to Other Deposits may, but not necessarily does, result.

One other point in connexion with the bankers' balances remains to be mentioned.

## OTHER DEPOSITS AND GOLD MOVEMENTS

Under the normal working of the gold standard, when gold is moving from this country, say, to the Continent, the only practical way (without abandoning the standard) in which the Bank can counteract the outflow is to raise the value of money above the general Continental level. This not only tends to make the export unprofitable, but at the same time induces bankers in other countries to buy up London paper for temporary investment, thus turning the exchanges in our favour, and, eventually bringing gold from abroad to replace that which has been lost.

The success of this measure always depends, however, on the extent to which it is seconded by the open market. Continental bankers who have floating funds to invest care nothing for the rate that the Bank of England is supposed to charge. In bidding for bills their competitors are not the Bank of England, but the dealers in the open market, and it is the market rate alone that affects their calculations. If the London market is above their home market, other things being equal, they will buy freely, but a high Bank Rate alone will produce no effect.

For the Bank, then, to declare that money, for which 4 per cent was asked yesterday, shall to-day be worth 5 per cent, is of no avail unless other big dealers concur, and fix their charge accordingly. It is of course to the advantage of other lenders to raise their price, if feasible, and, to a certain extent, they are almost forced to follow the Bank, because, as we have already seen, the interest they pay to their depositors is regulated by the official rate,

and, as they have to give more when the rate advances, they must also charge more. But the price of money in the open market does not depend solely on this or similar considerations; it is like that of other commodities, adjusted by the equation of supply to demand.

With demand we have here nothing to do; but, so far as supply goes, a test of strength is afforded by the amount of the Other Deposits: Bankers. If this item stands at a low figure, the supply is short, and the market will as a general rule keep well up to the Bank, responding readily to the latter's initiative. If, on the other hand, the Other Deposits are high, indicating a supply in excess of requirements, then the pressure of this margin of unlent money will cause lenders to lower rates in their anxiety to use up the funds under their control, and the Bank will be powerless to influence outside quotations without taking steps to deplete the supply in the market. The larger the margin of idle money in such cases the larger will be the disparity between official and unofficial quotations.

#### CONTROL OF MONEY MARKET

The efficiency, therefore, of a high Bank Rate in putting a stop to an efflux of gold varies inversely with the amount of surplus funds at the disposal of the market, being greatest when the Other Deposits are at their lowest, and vice versa; and although, generally speaking, an export tends naturally to bring about an advance in rates, because an export of gold, besides reducing the reserve, also causes a contraction of the available stock of market money, yet sometimes the market

could afford to let two or three millions go without feeling the loss. In such circumstances a high Bank Rate is comparatively useless, and the reserve would soon fall to a dangerously low point unless other means could be found to protect it.

Repeated advances of the rate would no doubt have the effect, in the end, of screwing the market up to the desired level, but there is a limit to the Bank's powers in this direction, because an unusually high rate would, unless justified by a crisis, cause an outcry throughout the country; and as this would be distasteful to the Bank, the movements are generally confined within narrow limits, 5 per cent being, as a general rule, the maximum. If 5 per cent fails to arrest the export, other measures may have to be resorted to. The Reichsbank, in such a case, would possibly give exporters to understand that they must be prepared to incur the consequences of its displeasure if the withdrawals were persisted in. This the Bank cannot do; nor can it put a premium on its gold, as the Bank of France did before the law of June, 1928, made France a free gold country, after the disorganization of the War. And yet the outflow must be stopped somehow.

Whenever, then, it becomes evident that the market is hindered from following the Bank by the pressure of a margin of money for which no suitable employment can be found, or when an advance in the official rate is not desirable or not likely to be effective, the Bank goes straight to the root of the difficulty, and gets rid of the incubus by the simple but peculiar expedient of borrowing the surplus herself. This, known as the operation

of "the open market policy," was formerly effected by selling Consols for "cash," and buying them back for the "account." The "account" price, at which they were bought back, was of course higher than the "cash price" at which they were sold (because it included a larger proportion of the accruing dividend), and the difference between the two prices represented the interest paid for the loan.

As the buyers "for cash" gave cheques on their bankers in payment, the bankers' balances at the Bank were to that extent reduced; consequently the Other Deposits fell, and, as the owners of those deposits had less to lend than they had before, the market at once hardened, and the Bank succeeded in its object of raising the price of money above the Continental level, and of tempting foreign capital over.

Since 1914 this method has not been possible, because Consols could not be bought for the account. As an alternative, the Bank achieves the same result either by buying securities outright or by so arranging its tenders for Treasury Bills as to govern the volume of funds in the market.

For the last few years, Bank Rate having been unaltered at 2 per cent since June, 1932, the Bank has exercised control through this means, somewhat jocularly described by the market as the "hidden hand." In addition, she has been known, when occasion demanded it, to indicate to the market her desire for, say, a certain stiffening of rates, as an alternative to the use of the discount rate, and the market, recognizing always the

importance of co-operation (and of keeping on good terms with the Bank), has done its best to assist.

This would have the effect of making the money market more attractive to the foreigner, without imposing any marked burden on the industry of this country. Such an exercise of control or persuasion might occur if the raising of a foreign market rate tended to lessen the advantageousness of London in comparison with the foreign centre, the lever of the Bank Rate being used only reluctantly because an advance in that rate usually carries with it an advance in the rates for loans to industry. In this connexion, it may be remarked that the avowed cheap money policy of the Government in recent years is intended to assist industry as well as the tax payer.

In illustration of the attraction of funds to London, without a rise in the Bank Rate, through the market rate of discount, the following "City Notes" comment from *The Times* of 27th January, 1931, may be given—

A further substantial withdrawal of gold from the Bank of England for shipment to France, the knowledge that more will be taken to-day, and the realization that the persistent drain on the gold reserves of the country cannot continue indefinitely without something unpleasant happening, caused the Money Market to tackle seriously the question of rates yesterday. The rate for three months bills was put up to  $2\frac{7}{16}$  to  $2\frac{1}{2}$  per cent. Although this is not high enough—with the official rate at 3 per cent—it sufficed to tempt a certain amount of American buying of bills and to move the New York exchange in our favour slightly. The Paris exchange also moved in favour of sterling, the closing rate being 123·89f. with francs rather offered. Thus once again the effectiveness of the rate as a weapon to influence the exchanges has been demonstrated.

Another way of controlling the market has been often suggested. The Bank, it is said, could easily make herself mistress of the situation by offering to pay interest on deposits. As a great part of the money lying with other banks is deposited as much for the sake of security as of profit, there is no doubt that a very low rate of interest would suffice, when backed by the name and prestige of the Bank of England, to tempt much of it over. There would then be no difficulty in making the Bank Rate effective, for whenever the market fell away, the Bank could always pull it up again by advancing the deposit rate, and thus exhausting external supplies.

To this course there are, however, some obvious objections. In the first place it would be a reversal of the Bank's traditional policy, which subordinates profit to perfect safety. But perfect safety, it is clear, is not compatible with the possession of a vast sum of money, repayable at a day or two's notice, and if the Bank is already able to obtain the loan of over £100 millions of money without paying a shilling for it, what would the deposits amount to if interest were offered? The Bank, it must be remembered, is the repository of the nation's balance, and cannot afford to expose itself to the risk of a "run" in the event of a crisis. As matters stand at present, there is no such risk if ordinary precautions are taken, for, as we have already seen, the deposits *increase* in time of panic; but whether such would still be the case when the depositors were a large and mixed body is another question.

Then again, the Bank, by competing with its neighbours for deposits, and thus robbing them

of a lucrative part of their business, would not only give offence to its best customers, but would probably add little to its own earnings. Other banks make deposits pay because they invest the greater part of the money in interest-bearing securities, and retain only a small proportion to meet withdrawals; but the Bank, prior to the War, at any rate, made, and again makes, a practice of keeping about 40 per cent in reserve, and would thus, while giving interest on all it received, be earning on only about a half; besides which, a large portion of the £100 millions, of which the Bank now enjoys the use free of interest, would no doubt be at once transferred from Current Account to Deposit Account, swelling the total on which interest would have to be paid.

Other Deposits: Other Accounts might certainly be increased at the expense of Other Deposits: Bankers (i.e. the banks). It is, however, difficult to see how Other Deposits as a whole could be very materially increased without a radical change in the whole banking system (other than by further inflation). That objection, therefore, must not be taken too seriously. In any case, the outstanding difficulty undoubtedly would be the provision and protection of an adequate reserve.

Practically, the Bank is just able, by the exercise of constant care, to preserve the balance between imports and exports of gold, and whatever peculiarities its present system may have, such as the forcing up of rates by borrowing and paying interest for money which it does not want, that system seems to compare favourably with the alternative proposal of allowing interest on de-

posits, and, until a better mechanism can be devised, we are likely to see the Bank continuing to use the bankers' balances as a lever by which to lift the market.

## CHAPTER VI

### THE BANKING DEPARTMENT (CONTD.)

UNDER the headings of Government Securities and Other Securities the Bank states the total values of its investments.

#### GOVERNMENT SECURITIES

These comprise, as their name sufficiently indicates, all those (such as Consols, War Stock, and Treasury Bills), which yield an income guaranteed by the British Government. Treasury Bills discounted for the market are, however, included in Other Securities: Discounts and Advances.

Little importance attaches to changes in this item, but as they sometimes throw a side-light on the state of the market it is well to know their meaning.

At times, for instance, there is a sudden increase, which represents the security given by the Treasury to cover temporary advances obtained from the Bank. As the balance standing to the credit of the Government is sometimes insufficient to meet dividend and other payments then falling due, the deficiency is borrowed from the Bank and is afterwards repaid out of the revenue collected in the course of the few following weeks.

A movement in the Government Securities points to changes in the Bank's investments, and sometimes produces a passing effect on outside rates. If the Bank, for example, allows a parcel of its Treasury Bills to run off without renewing them, the new allotment will fall to be paid for by

the market and will tend to make money scarcer and, consequently, dearer.

Further, Government Securities may be affected indirectly by gold movements through the policy of the Bank in supporting the market by the purchase of securities at times of heavy withdrawals of gold. An example of this is to be found in the figures for June, July, August and September, 1929, a period of huge withdrawals of gold by France. From the middle of June to the commencement of October over £35 millions was withdrawn, and in that period Government Securities rose from £35 millions to £76 millions.

The sale and re-purchase of Government Securities has been already referred to as a chief means of exhausting external supplies.

#### OTHER SECURITIES

The general investments of the Bank, its stock of bills of exchange held under discount, and the sums due by billbrokers and others for advances made to them against security, together make up, with other miscellaneous assets, including branch premises, the large total that figures on the credit side of the Return as Other Securities. Discounts and Advances were not shown separately until November, 1928. Formerly a return was made to Parliament in which the loans and discounts were distinguished from other assets, but this information was not supplied after 1875. In that department, the Bank's business appeared at that time to be falling off. The discount figures reached their peak (nearly £10 millions) in 1866 and gradually fell off to £4 millions in 1875. The averages for

1874-75 were about the same and were £3 millions less than that for 1873. In 1890, conjecture estimated the average contents of the bill case at a comparatively low figure. In 1934 the average was about £7·8 millions, with peaks of £25 millions and £17 millions at the beginning of January and July. These huge increases are attributable to "window-dressing" calls by the banks having forced the brokers to the Bank of England. These figures compare with a total of some £400 millions of Discounts and Short Loans by the Clearing Banks. The market is almost invariably able to underbid the Bank, and it may be laid down as a general rule that buyers and sellers of bills apply at Threadneedle Street only in exceptional circumstances, such, for instance, as when the market is bare, and an advance of the official rate anticipated. Dealers may then be unwilling to increase their commitments except with the proviso "subject to Thursday's rate," and those in search of accommodation may prefer to take their chance at the Bank.

The bulk of the Bank's ordinary business with borrowers takes the shape not of discounts, but of short loans against the deposit of the best class of stock exchange securities or of approved bills of exchange. Money is not lent from day to day (but for periods of not less than seven days), or against produce. Whenever there is a pressure for money in the open market, whenever demand exceeds supply, e.g. when on the occasion of tax payments, money tends to be tight, the Other Securities are increased by transactions of this class, showing that the Bank has been called upon to fill up the void.

A simultaneous increase of both Other Securities and Other Deposits is sometimes seen, and is taken to indicate (unless preparation is being made for dividend payments, etc.) that bankers are calling in funds and strengthening their balances as a precautionary measure. This is a feature of the Return whenever any uneasiness is felt in the market, and the gravity of the impending danger may be gauged by the extent of the movement.

In 1866, on the failure of Overend Gurney & Co. the Other Securities rose from

£20·8 millions on 9th May,

to £30·9 „ 16th „

being an increase of £10 millions in seven days; in 1875, when A. Collie & Co. failed, from

£18·3 millions on 16th June,

to £25·5 „ 30th „ ;

in 1878, on the suspension of the City of Glasgow Bank, from

£17·3 millions on 25th Sept.,

to £23 „ 16th Oct.,

and in November, 1890, (the Baring difficulties), from

£21·5 millions on the 12th,

to £32·1 „ „ 19th.

The Bank, it will be seen, lends with the greatest freedom on such occasions, this being the best way of allaying the feeling of panic; but as the borrowers are only actuated by a desire to be “on the safe side,” the money is not really wanted, and the greater part of it is usually left in the hands of the Bank, explaining the advance of the Other Deposits.

In 1914, when war was declared between this country and Germany, Other Securities rose as follows—

July 15th	. £33,623,000	August 26th	£109,905,000
„ 22nd	. £33,633,000	September 2nd	£121,821,000
„ 29th	. £47,308,000	„ 9th	£116,923,000
August 5th	. £65,352,000	„ 16th	£113,792,000
„ 12th	. £70,787,000	„ 23rd	£110,733,000
„ 19th	. £94,726,000		

## CHAPTER VII

### THE BANK OF ENGLAND RESERVE

THE total amount of Notes and Coin, or cash in hand, held in the Banking Department, constitutes what is known as the "Reserve."

These are the vital figures of the Return. When the country was on a gold basis, the very existence of the Bank depended on the maintenance of sufficient cash to satisfy the claims of depositors, for the whole of the deposits were practically debts payable in gold on demand and the Bank had to fulfil its obligation to repay when called upon, or the note would become in fact inconvertible. The Note issue is, of course, now inconvertible, by Statute, and the Reserve implies an adequate supply of notes, valid as legal tender at the Bank itself and not exchangeable for gold. Between the proportionate strength of the Reserve and the price that the Bank charges for loans there exists, too, an intimate connection, and the Reserve is in fact both the basis of the Bank's credit and the key to the Bank Rate.

As the idea sometimes crops up that the Reserve secures the note holder as well as the depositor, and that an export of gold is bad for the country, because it must impair the ability of the Bank to cash its notes on presentation, it may be well to point out before going further that the convertibility of the note has nothing whatever to do with the Banking Department, and the "Reserve" is a *banking* reserve, maintained solely for the

purpose of cashing depositors' cheques. The misconception arises from confounding the functions of two distinct funds—namely, the Banking Department's cash reserve against deposits, and the Issue Department's stock of gold appropriated to the service of the note. Perhaps the fact that the Reserve is habitually spoken of as gold, while the Bank's entire stock of metal (with the exception of a small proportion of coin required for till money) is held by the Issue Department against notes issued, may partially account for the confusion. It is obvious, too, on examining the Return that a withdrawal of bullion must diminish the stock in the Issue Department, but why at the same time it should also affect the cash in the Banking Department does not at first sight appear at all clear.

The difficulty disappears, however, on considering the means employed to take gold from the Bank. Theoretically, the usual course was to obtain credit with a London banker by discounting bills, or selling securities, etc., to make use of that credit by asking for Bank of England notes, and to convert the notes into gold at the Issue Department. The gold was actually paid out by the Issue Department, but the notes which give power to demand that gold were bound to come out of the Reserve of the Banking Department. The reason was that London bankers kept comparatively little cash on hand, but relied on their balance at the Bank to meet any exceptional demand. Consequently, the banker who was called upon to furnish the notes required for a large gold withdrawal drew on his balance at the Bank, the trans-

action taking the form of a debit to his account, a debit to Notes in the Banking Department, a reduction of the Issue Department item Notes in Banking Department, and an equivalent reduction in Gold Coin and Bullion.

For the sake of illustration we will take a specimen Return and, assuming a gold export of, say, five millions to take place, and the bankers to have made up their balances at the Bank by calling in money from the brokers (who have provided it by borrowing at the Bank, causing a corresponding increase in the Other Securities), will see what change is thereby produced.

The Return commences as follows—

## ISSUE DEPARTMENT

Notes issued :		Government Debt . . . . .	£11,015,100
In Circulation . . . . .	£345,580,773	Other Government	
In Banking Department . . . . .	65,390,738	Securities . . . . .	233,599,941
		Other Securities . . . . .	10,924,483
		Silver Coin . . . . .	4,460,476
			<hr/>
		Amount of Fiduciary	
		Issue . . . . .	260,000,000
		Gold Coin and Bullion	150,971,511
			<hr/>
	<u>£410,971,511</u>		<u>£410,971,511</u>

## BANKING DEPARTMENT

Capital . . . . .	£14,553,000	Government Securities	£38,581,563
Rest . . . . .	3,653,974	Other Securities :	
Public Deposits <sup>1</sup> . . . . .	13,871,221	Discounts and	
Other Deposits :		Advances . . . . .	4,732,768
Bankers . . . . .	59,167,021	Securities . . . . .	16,293,348
Other Accounts . . . . .	34,416,671	Notes . . . . .	65,390,738
7-Day and Other Bills . . . . .	3,519	Gold and Silver Coin	666,989
			<hr/>
	<u>£125,665,406</u>		<u>£125,665,406</u>

<sup>1</sup> Including Exchequer, Savings Banks, Commissioners of National Debt and Dividend Accounts.

and after the imaginary withdrawal would appear (in abbreviation) thus—

## MONEY MARKET PRIMER

## ISSUE DEPARTMENT

Notes issued . . .	406 millions	Securities . . .	260 millions
		Gold . . .	146 millions
	<u>406 millions</u>		<u>406 millions</u>

## BANKING DEPARTMENT

Capital and Rest . . .	18 millions	Government	
Deposits . . .	107 millions	Securities . . .	38 millions
		Other Securities . . .	26 millions
		Notes . . .	60 millions
		Coin . . .	1 million
	<u>125 millions</u>		<u>125 millions</u>

It is evident that the means possessed by the Banking Department to pay its creditors in *cash* on demand have been reduced from  $\frac{66}{107}$  or 62 per cent to  $\frac{61}{107}$  or 57 per cent; but the Issue Department is no worse off for the withdrawal, having simply performed the mechanical function of giving up against return of its notes a portion of the gold which it was taking charge of on behalf of the public.

The result of an export of gold is thus shown to be a reduction of the Reserve, and a consequent falling-off in the power of the Bank to pay its debts; and to this fact is due the great importance that is attributed to the movements of the metal.

## RESERVE THE BASIS OF CREDIT

While it will be readily admitted, seeing that the solvency of the Bank depends on the maintenance of an adequate cash balance, that the strength of the till is a matter that intimately concerns its creditors and stockholders, it may seem, to the business community generally, that the question of a greater or less Reserve, except in

so far as it affects the value of money, can present little direct interest.

As a matter of fact, however, the stability of the Bank of England concerns every banker and merchant in the Kingdom.

The explanation turns on the law of legal tender. According to law a tender of payment (of any sum above forty shillings) was formerly not valid unless made in the current gold coin of the realm or in Bank of England notes. Up to 1925, every creditor, therefore, had the right to insist on ultimate payment in gold. The Gold Standard Act of 1925 limited this right somewhat<sup>1</sup>, and in 1931 it was taken away entirely<sup>2</sup>.

In ordinary circumstances trade payments are effected by cheque, and this dormant right was all but lost sight of; nevertheless, all our buying and selling, all our borrowing and lending, was based on the principle that debts were payable in gold.

Now, the class of debts that exercises the greatest influence over the state of credit is that of bankers to their customers, and these alone (to say nothing of the indebtedness of merchants one to another) exceed by hundreds of millions sterling the whole stock of gold that the country has ever possessed. The sum due in December, 1934, by the Clearing Banks alone, under the head of Deposit and Current Accounts was nearly £2000 millions, on the basis of the published monthly averages, while the total gold holding of the Bank of England was roughly £192 millions.

<sup>1</sup> *Vide* page 210.

<sup>2</sup> *Vide* page 218.

This cannot truly be called a Reserve. The meaning of "reserve" is a fund set apart for use in an emergency—an extraordinary fund for extraordinary occasions—but the cash held by bankers is their till money, the stock in trade necessary for their everyday transactions. What they regard as a reserve for balance sheet purposes is something very different. Their cash reserve consists not of a store of cash locked up in their strong-rooms, but of their balance at the Bank.

So long as the central fund holds out, these reserves are of course just as good as cash, and are more easily managed than an accumulation of notes and coin; but the point is that they are not actually cash, and that though the banks have borrowed unheard-of sums, which they promise to repay in notes on demand, they hold comparatively few notes wherewith to pay, but depend on obtaining their supply, when wanted, from the Bank of England.

The tangible reserves kept by the London offices are adapted only to known requirements and are not meant to meet unforeseen demands; consequently, when such demands spring up, they must fall upon the Reserve.

In America, if a federal reserve bank accepts deposits, the national banking law insists that for every \$100 lodged in its hands it shall set aside \$35 in gold or lawful money; but in this country the law takes no cognizance of a banker's duty in that respect, and leaves him at liberty to keep as much, or as little, legal tender as he pleases. It forbids him to issue a single note, but is silent on the subject of deposits, the uncontrolled liability on current and deposit account amounting, in

the case of the clearing banks—as has been said—to some £2000 millions.

Practically the whole of this vast sum is virtually payable on demand, but on the assumption that only a very small proportion will be asked for at any one time, bankers have locked up about 90 per cent of it in bills of exchange, securities, loans, etc., and only the Bank of England pretends to keep a large reserve of legal tender money.

The £52 millions of notes lying (September, 1935) in its vaults are therefore the ultimate and sole cash reserve of the whole country, and, in the strictly legal sense, if the Bank lost that reserve, neither the banks which depend upon it, nor the customers which depend on the banks, would be able to keep their engagements.

On it, in theory, reposes the entire fabric of English credit. This may actually be true of credit in the sense of credit-money, but there is a very close relation between credit-money and personal credit and it would perhaps be fairer to say that the fabric of English credit reposes on the integrity and mutual trustfulness of the business community and the solidarity of the modern banking system regarded, as it well may be, as a single entity devoted to the preservation of the means of exchange, whatever form it may take.

#### DISINTERESTED ATTITUDE OF BANK

One of the most remarkable features of our banking system is the fact that the Bank of England, while allowing that its business differs from that of other banks, and that it would be injudicious to let the Reserve sink below what the

directors consider a safe point, holds nevertheless that the danger limit depends solely on the character and extent of its own liabilities (quite apart from those of the bankers who have claims upon it), and has neither expressed the intention of keeping up a reserve of specie for the whole country nor acknowledged a sense of duty on that score. But, though unwilling actually to avow responsibility, the Bank, at the same time, is unable to disavow it, and the promptitude with which it has always defended the Reserve from foreign assault, even at times when by so doing it was putting itself out of the market, suggests that it tacitly accepts the situation.

It has been suggested that the clearing bankers, instead of giving the Bank of England the benefit of their surplus funds, might form a mutual association, keep their own joint cash reserve, and share among themselves the profit now accruing to the Bank. But they seem to view such suggestions with indifference. Their motive in earlier days was probably the knowledge that if events should ever again occur of a nature to imperil the Bank's safety the Government would intervene to save it; that in another crisis, the Government, if need be, would help the Bank, and, what was more to the point, that the Bank, if need be, would help them; while, if they kept their own reserves, there would be less reason why either the one or the other should come to their assistance.

The Government, they considered, and still consider, would have no choice but to help the Bank. As its balance is kept in Threadneedle Street, and a large part of its business transacted there, the

stoppage of the Bank would throw the machinery of the State into utter confusion; besides which, the Bank is the sheet anchor of our national credit, and no ministry dare face the consequences of its failure, which would be almost as calamitous to the country as those of a civil war. Past experience, too, sides with their view. Thrice since 1844 has the Bank been on the point of closing its doors, and thrice has the Government stepped in to avert the catastrophe. On a fourth occasion, in 1914, the Government gave its promise, but action took another form.

Bankers conclude, therefore, that, whatever else may happen at a future crisis, the Bank of England will weather the storm and, by presenting it with their surplus in time of ease, they expect to establish a claim to its good offices in time of stress.

However this may be, the economic advantage of a single coherent banking system allied, possibly, to a traditional dislike of any violent change—particularly one entailing an unfathomable measure of co-operation—is undoubtedly the main reason for the little interest shown by the clearing banks in this connexion.

#### PROPORTION

The figures of the Reserve must be related to the varying liabilities against which it is held, the abstract figures alone being no criterion.

A comparison of the Reserve with the total deposits shows that up to 1913 the proportion rarely fell so low as 30 per cent, which was considered the minimum, or exceeded 50 per cent, and that the average was about 43 per cent. From

1914 on, however, the position weakens materially, the average proportion for the years 1914 to 1927 being 34, 23, 26, 19, 17, 18, 14, 14, 18, 18, 18, 19, 19, 29 per cent. From 1927 the proportion has increased considerably, the figures for 1928 and 1929 being respectively 41 and 40; in February, 1930, it had risen to  $65\frac{7}{8}$  per cent, the highest point since 1896. From 1930 to 1933 the averages were 49, 44, 35 and 44 per cent. The Proportion (or Ratio), then, is the figure in which the market interests itself rather than the actual amount of the Reserve.

#### MOVEMENTS IN RESERVE

The influences that act on the Reserve divide naturally into home and foreign—into demands connected with the internal circulation of currency, and demands connected with the working of the foreign exchanges.

Home requirements affect it because, as we have seen, it is the sole resource in the country of unemployed money, so that if more currency is at any time required by the country to carry on its business it must of necessity come from the Reserve.

There are certain clearly defined influences, at periods, for example, when the demand for cash, as opposed to credit, is greater. Such periods are the holiday and festive times of the year, Easter, Whitsun, August and Christmas. At these times the notes in circulation increase appreciably, the increase running off as soon as the particular holiday period is over. The Reserve is in this way depleted. It is increased, naturally, on those

occasions on which cash is less required and the tendency is for notes to return to the Bank. Similar, but slower, movements are seen upon changes in the state of trade and employment. With improving conditions, increased employment and rising wages more currency will be called for, and it will accordingly be found, as a broad principle, that the Bank Rate in those years in which business has been good has exceeded the average.

This is what may be termed the "home" or "domestic" drain. The "foreign" influence, in the direct form of the receipt or loss of gold in normal times, is dependent upon several factors, dealt with in a later chapter, chief among them being, perhaps, relative discount rates in different monetary centres.

Mention must be made, however, of the general relationship between the Reserve and the money market. Money may be described as "tight" or "easy," as when it is hard or easy to obtain, when supply is low or good. It naturally follows that when money is "easy" there is a tendency for its price to fall, and vice versa. Although money may be "tight" or "easy," both at times of industrial depression, such as the present, and at times of prosperity, the terms are relative. Broadly, one may say that if trade is booming, money tends to become "tight," and the Reserve to fall, because, just as credit will be wanted for the needs of industry, so notes will be wanted for wages and spending. There is therefore a tendency for the Reserve to follow the state of the market. If conditions are dull and money cannot be used with

profit, the Reserve tends to show a high figure. In July, 1931, for example, conditions were too easy, by reason of the absence of sufficient outlet for money in trade, and the Reserve was very high, at 57 per cent.

Before the War there was a fairly constant relationship between the Reserve and the Bank Rate, the latter being used regularly and inevitably to counteract movements in the former. Nowadays, the relationship is not so clear. This is because other methods of attracting gold are employed, and there are times when a rise in the Bank Rate fails to have its normal effect, as, for example, on the occasion, in 1929, of the serious export to France.

#### CRISES AND BORROWING FROM BANK

Little weight attaches to the periodical rise and fall in connexion with the everyday work performed by the currency, and such ordinary demands may be left to take care of themselves, their nature and extent being too well understood to afford ground for uneasiness, or to call for corrective measures.

With extraordinary demands the case is different. When credit is good, experience shows that the country will use no more currency than is necessary for its wants, and that notes taken for temporary purposes will return as soon as the need for them is passed. When credit is bad, on the other hand, there is no knowing how much additional currency the country may suddenly ask for, or how long it may keep it. If it asks for too much there may be something approaching a

panic. Under the 1928 Act provision is made for sudden expansion, but this was not always the case,<sup>1</sup> and at times (fortunately rare) the Reserve has melted away before the measures taken to relieve it have had time to act. These occasions have always been marked by a sharp rise in the rate.

The Currency and Bank Notes Act (and, formerly, the Bank Act) assigns a limit to the note issue against securities, and prescribes that for every note issued beyond the limit gold must be held. The 1928 Act, however, provides that the Treasury may authorize an increase in the fiduciary issue, as the Bank may deem expedient, for a total period of two years, as actually happened in 1931.

When credit is good our stock proves sufficient, because, in practice, it is supplemented to an indefinite extent by the use of cheques. But "credit" means belief—the general belief that he who promises to pay is able to pay, or, in other words, that the drawer of the average cheque has enough money at his banker's to meet it—and if events occurred of a nature to weaken that belief the efficiency of instruments of credit would be impaired. Cheques would then no longer pass current to the same extent as before, and there would be a partial reversion to the more primitive system of payment by note.

The failure of some great firm, or of a market,

<sup>1</sup> Clare, Second Edition: In one all-important particular the Act (the Bank Act, 1844) is defective, however. It makes no provision for a *sudden* expansion of those requirements. A gradual expansion may be met by importing gold from other countries (the only method, since 1844, of increasing the currency), but the contingency of a sudden demand does not appear to have been foreseen when the Act was framed.

might cause merchants to become suspicious of their neighbours' solvency. Each one would ask himself who had been involved in the failure, and whether this man or that man was still safe, and until his doubts could be set at rest, determine that, as far as possible, he would avoid the risk of taking cheques, or, if he must take a cheque, that he would at least collect it at once. Bankers might accordingly find that a great number of cheques, instead of coming forward through the Clearing House as usual, were being presented across the counter.

But perhaps the most striking effect of "discredit" is the sudden scarcity of "market money" that ensues. Bankers, by virtue of their calling, are at all times prone to a certain slight degree of mistrust, but the disturbance of credit caused by a great and unforeseen failure renders them suspicious, or, at least, dubious, and they look askance upon applications for accommodation, however legitimate. Besides, until they know what is going to happen, they naturally deem it prudent to husband their resources, and the result is that they tend to restrict their usual loans and discounts. In addition, too, they demand repayment of much of the money lying "at call" with the brokers, and as the brokers can repay only by borrowing elsewhere, a rush to the Bank of England begins. This took place, for example, in 1914.

The Bank being in such circumstances virtually the only lender that remains, all who have obligations to meet apply there for money, and in most cases ask for more than they really want at the

moment, for fear of not being able to obtain it when they do want it. In such circumstances the amount of the Bank's advances is very considerable. During the five days up to the 1st August, 1914, the Bank lent over £25 millions.

A high rate appears to have scarcely any effect in checking applications, and naturally so, for a merchant who has acceptances falling due in the morning must have the money to meet them, no matter what he pays for it.

This heavy borrowing at famine prices has been a characteristic feature of every panic. But while swelling the Bank's profits it reduces the proportion and, if the movement is accompanied by an excessive demand for currency, the actual amount of the Reserve as well. Thus panic becomes the proximate cause of a crisis.

This is not a case of a "run," such as other banks are subject to. The deposits instead of decreasing actually increase, and it is because the public mistrust each other that they demand notes, not because they mistrust the Banking Department.

As the fall in the proportion of the Reserve is thus directly attributable to fresh loans and withdrawals coincident with them, it may perhaps be thought that if the Bank refused to grant applications it could keep its Reserve, and prevent a panic. But refusal to lend would not prevent the bankers from drawing on the Reserve; it would only prevent the market from repaying what they owe the banks and a deadlock would ensue. Salvation lies in the readiness of the Bank to come to the assistance of the community.

1847, 1857, 1866, 1914 and 1931<sup>1</sup>

Since the passing of the Bank Act in 1844 there have been five "crises," those of 1847, 1857, 1866, 1914, and 1931, and on each occasion the directors of the Bank received on application a Letter of Licence from the Government of the day, authorizing them to increase their issue of notes against securities. In 1857 the Bank at once availed itself of the authorization, but in 1847 and 1869 it was not found necessary to do so, the knowledge on the part of the public that the limit had been removed having the effect of quietening the feeling of panic. In 1914, the position was met by the issue of

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<sup>1</sup> Clare, Second Edition : When it becomes known in the City that the Reserve is running low, and that the Bank may soon be perforce compelled to stop lending; when merchants realize that unless more money can be found to-morrow they will be ruined; and when bankers, in an agony of dread lest their customers should take fright, are praying for closing-time; then the height of the panic is reached, and the general anxiety culminates in a few hours of mental suffering that are long afterwards remembered as the "crisis."

There is but one remedy, and that an obvious one. The Bank Act must be suspended. As it is evident that more notes are urgently wanted to replenish the Reserve, and as more notes cannot legally be created, except against a deposit of gold—which it is impossible to obtain at a few hours' notice—the strict letter of the law must be disregarded until the gold has had time to reach us. The spirit of the law is that the issue shall adapt itself to the wants of the country, and, if those wants suddenly and without warning expand, there is no sense in retaining the fixed limit.

The Directors of the Bank accordingly lay a statement of the facts before Government, and the Ministers (who, of course, have no more power than anyone else to override an Act of Parliament) undertake in response to promote a Bill of Indemnity if it should be found necessary to break the law.

It may be asked why, if this step is sure to be taken, and everyone feels convinced that it will be taken before matters come to the worst—why there is ever a crisis at all, and why people should lose their self-possession. The reason is, firstly, that merchants who are in imminent danger of stopping payment cannot possibly keep cool; and, secondly, that there is always some amount of uncertainty as to the delay that may precede the suspension of the Act. It is uncertain whether the Directors will take action in time, uncertain whether red-tapeism may not cause a hitch somewhere, uncertain whether the Reserve will hold out until relief is given, and so on, and it is this leaven of uncertainty

Treasury notes, and in 1931 by an additional issue against securities as provided for in the Act of 1928.

The crisis of 1857 was brought about by a demand for gold for Scotland, where the failure of two large banks had led to a run on others. Unfortunately, the drain fell on a Reserve that had been suffered to run down to the low figure of £2 $\frac{3}{4}$  millions, though the average of the five previous years had been kept up to £8 $\frac{1}{2}$  millions. On the night of the 11th November it had fallen to £1,462,000, and on the following night to £581,000. The directors then appealed to the Government for aid, and at midnight a letter was addressed to them by the First Lord of the Treasury and the Chancellor of the Exchequer, stating that "if they should be unable in the present emergency to meet the demands for discounts and advances upon approved securities without exceeding the limits of their circulation prescribed by the Act of 1844, the Government will be prepared to propose to Parliament, upon its meeting, a bill of indemnity for any excess so issued." Within twenty-four hours the Reserve was gone, and the law had been broken.

The effect of the letter being to remove the arbitrary limit placed by the Act on the fiduciary issue, which at that time amounted to £14,475,000, all that the Bank had to do was to transfer a parcel of Government Securities from the credit of the Banking Department to that of the Issue

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that does all the mischief. It was even asserted after the last crisis that, if the responsibility of overstepping the limit had rested with the Directors, conditionally upon their applying afterwards (instead of beforehand) for an indemnity, people's minds would have been at ease, and everything would have passed off quietly.

Department, to issue notes against the same and to pass the notes into the Reserve.

The next Return that appeared, that of Wednesday, 18th November, 1857, is interesting as being the only one that shows an actual infringement of the Act.

The suspension of the Act, it is to be observed, in no way interfered with the principle of convertibility, and the Bank remained under precisely the same obligation as before to pay its notes in gold on presentation.

The panic of 1866 was precipitated, if not caused, by the downfall of Overend Gurney and Co., a great firm of bill and discount brokers, whose name was almost as well known throughout England and, indeed, throughout Europe, as that of the Bank itself. To be "as rich as a Gurney" denoted fabulous wealth, and the announcement of the failure created universal consternation. Country bankers, fearing the effect that the news might have on the minds of their customers, telegraphed at once to their London agents for notes, or ran up themselves by the next express to fetch them. In many instances these fears were only too well justified, and the safety of numerous banks was imperilled by the large withdrawals that took place.

Again, as ill-luck would have it, the Reserve stood at an exceptionally low point. Trouble had been brewing between Austria and Italy, and there had been an export of gold to the latter country. The usual Scotch<sup>1</sup> withdrawals had also

<sup>1</sup> Clare, Second Edition: In May and November, for the customary half-yearly payments, such as rent, interest on loans and mortgages, farm servants' wages.

taken effect. On the evening of the 9th May the Reserve amounted to £5,800,000, against an average for the five previous years of over eight millions. On the 11th ("Black Friday"), the day of the failure, £2 $\frac{3}{4}$  millions were drawn out in notes, and at the close of business the directors estimated that the available stock of cash in London and all the branches was down to £3 millions, a sum which, it was believed, would be wholly swallowed up in the morning. It was therefore deemed advisable to submit the facts without further delay to the consideration of ministers.

At once a reply was returned, signed by Earl Russell and Mr. Gladstone, saying that if "the Directors of the Bank of England, proceeding upon the prudent rules of action by which their administration is usually governed, shall find that, in order to meet the wants of legitimate commerce it be requisite to extend their discounts and advances upon approved securities, so as to require issues of notes beyond the limits fixed by law, Her Majesty's Government recommend that this necessity should be met immediately upon its occurrence and in that event they will not fail to make application to Parliament for its sanction. No such discount or advance, however, should be granted at a rate of interest of less than 10 per cent."

All fear of an actual collapse was now removed, but it was long before the country recovered from the fright. Bank Rate had to be maintained at 10 per cent until the middle of August—a period of three months—and it was not until the end of the year that the circulation contracted to its normal level.

The lesson taught by the events of 1866 speedily bore fruit. Recognizing the fact that a substantial Reserve is the one great safeguard against a recurrence of panic, the Bank increased its till from £8 to £12 millions, and further raised it to an average, for the ten years ending December, 1890, of above £13 millions.

In some respects the course of events in 1914 was similar to those of previous years of crisis. For the first seven months of the year, the Reserve had fluctuated between £22 and £34 millions. On 29th July, it stood at £26,875,000, but in the Return of 5th August, it showed a reduction to £9,966,000. The extent of this reduction is appreciated only when the figures of the Returns for the last week in July and the four weeks of August, 1914, are compared.

	Notes	Other Deposits	Other Securities	Reserve
	£	£	£	£
July 29 .	29,706,000	54,419,000	47,308,000	26,875,000
Aug. 5 .	36,105,000	56,750,000	65,352,000	9,966,000
„ 12 .	35,934,000	83,326,000	70,787,000	15,530,000
„ 19 .	37,186,000	108,094,000	94,726,000	19,223,000
„ 26 .	35,571,000	123,893,000	109,905,000	26,352,000

As is usual on such occasions, the panic led to a rapid increase in the note circulation.

After a failure of credit comes the sequel, namely: stagnation of trade, and cheap money. As merchants will no longer trust each other so far as before, they give smaller credits and transact less business. Capital goes “on strike,” as it were. Consequently, fewer bills are created and, as bankers distrust bills generally and will take none

but the best, the supply of money quickly overtakes the effective demand, and rates fall away.

After the disaster of 1866, the Bank Rate dropped steadily from 10 per cent to 2 per cent, and remained at its minimum for the protracted period of sixteen months. The minor catastrophes of 1875 and 1878 were also followed by low rates, and, in fact, the lowest averages of the twenty years, 1869-88, are those of 1876 and 1879. In 1914, the commencing year of the Great War, the Bank Rate which, in the months January to July, had gradually fallen from 5 per cent to 3 per cent, was on 30th July, raised to 4 per cent; on 31st July raised further to 8 per cent, and on 1st August, still further to 10 per cent. On 6th August, it was lowered to 6 per cent, and on 8th August to 5 per cent, at which figure it remained until July, 1916. The low rate of 2 per cent which has existed from June, 1932, to the time of printing this edition followed the suspension of the gold standard in 1931, which is dealt with in a later chapter.

#### RESERVE AND INTERNATIONAL GOLD MOVEMENTS

If our internal requirements for currency purposes were the only consideration that need weigh with the Bank in determining the price of its loans, it is probable that in normal times the advertised rate could be maintained at an almost permanent figure, and that changes would occur only rarely and in exceptional circumstances.

But on the gold standard the Reserve had to fulfil a double function. In addition to being the only stock of currency that is available for home use in an emergency, it represented the most readily

accessible store of gold to be found in Europe, and was peculiarly exposed to foreign demands.

Whenever a foreign nation happened to want gold, whether to strengthen bank reserves, for coinage purposes, as backing to a note issue, or for any other purpose, usually the quickest and least troublesome way of obtaining it was to buy bills on London, remit them here for discount, and, in theory, turn the proceeds into Bank of England notes and cash the notes at the Issue Department.

Hoardings of gold were accumulated by the state banks of France, Germany, and other countries, but these banks had no mind to part with them without a struggle and, with the possible exception of the Banque de France, they usually succeeded in opposing such obstacles to an export demand as to turn it effectually aside.

Here it was different. Our reserve was open, without let or hindrance, to all the world and no item of the "money article" was more familiar than the announcement that gold to such and such a value had been taken out of the Bank for shipment to France, Belgium, Germany, and so on.

These movements were of the greatest importance, as their influence on the Reserve was direct and immediate. Every export diminished the power of the Bank to pay its debts; and if the outflow reduced, or threatened to reduce, the Reserve below safety point, the rate had to be raised in order to check the efflux and to attract gold from other quarters. To a great extent, therefore, the Bank was guided by the general tendency of these movements in the adjustment of its rate of discount; and, as other dealers anticipated its

probable action by advancing their quotations when a gold efflux was likely, and lowering them when inward shipments were arranged, the price of money might in many cases be said to depend on the ability and will of other nations to deprive us of our stock of gold.

The Bank's transactions in bullion were so large and so frequent as to constitute an important part of its business, and the gold held by the Issue Department to provide for the payment of its notes was largely made up of bars and foreign coin, which were in constant demand for export purposes.

Foreign coin was dealt in on the same principle, though the price at which it was bought and sold was a question of negotiation, fluctuating, of course, within limits prescribed by the statutory buying and selling price of gold as moderated by the advantage, if any, enjoyed by coin in relation to bullion. As English standard gold is 22 carats fine, that is to say, contains 22 parts pure gold in 24, while the standard of French, German, American, and most other gold coin was nine-tenths fine, the equivalent buying price for the latter should have been 76s. 4d. per ounce ( $\frac{22}{24} : \frac{9}{10} :: 77s. 9d. : 76s. 4d.$ ). This assumes that the foreign mints worked with absolute exactness, but allowing one-half per mille for possible short-comings in this respect, we get 76s.  $3\frac{1}{2}$ d., which was the rate the Bank usually paid. If the coin bought at this price had actually to be melted and re-minted, the purchases would have shown a loss; but there was no necessity to send it to the Mint, as it was sure, sooner or later, to be wanted again for export, and

the Bank had only to lock it up until it was asked for. The selling price was 3d. or  $3\frac{1}{2}$ d. per ounce higher, equal to a profit of about  $\frac{1}{3}$  per cent. If a run was made on any particular coin, such as Napoleons, or American Eagles, the Bank could stay the outflow for a time by putting another penny on the price. Thus, supposing that it just covered expenses to take Napoleons from the Bank when the French exchange stood at  $124.17\frac{1}{2}$ , and the price at 76s.  $6\frac{1}{2}$ d., then an advance of a penny would stop the export until the exchange receded to about  $124.04$ .

Though a change was now and then made in the selling price of coin, the rate at which the Bank bought was practically fixed. It has been pointed out, however, that if a little more could have been offered at times when it was desirable to attract gold hither, the advance in price would have produced a more certain and more direct effect than that of an advance in the Bank Rate, which is, at best, but a roundabout way of inducing imports. As it is probable that the Bank never had to melt its foreign coin, it would have caused no actual loss to pay 1d. or 2d. more per ounce, though of course it would have reduced profits. On the other hand, there was no article in the world that responded so readily to a paying demand as gold, and, frequently, a slight rise in price would have made all the difference between profit or no profit on an import.

In the spring our commercial and banking transactions with the rest of the world in normal times left a balance in our favour, which was remitted to us in gold, but in the autumn, when

we were importing and paying for our share in the world's harvest, the balance turned against us, and the gold ebbed away. A reference to the figures of the average Bank Rate would show how closely the latter sympathized with these movements. The year opened with gold at its lowest, and the rate at its highest. As the metal flowed in, the rate gave way; the peak was reached about Midsummer, and then came the reflux, which was held in check by a further raising of the rate.

This was the position up to 1914, but from that year there is no clearly defined seasonal fluctuation of the Reserve. The latter was affected by artificial factors which provide comparison with pre-War figures only with difficulty. Briefly, conditions of artificiality prevailed from the time when gold exports to America in payment for war material so depleted our Reserve as to enforce a break-away from the gold standard, until the reinstatement of the gold standard in 1925—a decade altogether. The Reserve during this period was affected by purely domestic influences only, except to the extent to which gold export was permitted by Treasury authority, a relatively negligible factor.

It may be taken for granted, then, that the statistics of the Bank's gain or loss of strength from the gold sent into or out of the country formed the best ground-work on which to base a forecast of the future course of the market; but at the same time it must not be assumed that the connexion was always so close and clear as in the instance given. Due allowance had also to be made for other influences, such as the general

condition of the markets, the state of trade, the political outlook, etc., all of which were considerations that the directors, doubtless, took into account before deciding on a change of rate.

But, on the whole, the broad principle to be kept in view is this, that if the country was losing gold, the necessity of defending the Reserve compelled the Bank to raise its rate; while, on the other hand, the necessity of earning a dividend for its stockholders induced it to lower it again as soon as practicable, in order the better to compete with its rivals in the loan market.

Now that this country is off the gold standard, there is no English statutory price for gold (except for the special provision in Section 11 of the Currency and Bank Notes Act of 1928), and the metal is dealt in simply as a commodity. Its price, however, is related to the statutory prices in Paris and New York.

## CHAPTER VIII

### THE FOREIGN EXCHANGES

AN inquiry into the diverse influences that tend to the enhancement or to the depression of the loan value of capital would be wanting in completeness unless it included some attempt to investigate the cause of those movements of gold to and fro, which proved to be the most potent factor in the determination of its price, or, at any rate, of its price as indicated by the advertised discount rate of the Bank of England. When speaking of gold movements, we mean such movements as were caused, under the normal operation of gold standards in the principal monetary centres, by currency transactions and such gold as was allowed to have free influence on the internal credit position of the country; for it must be understood that gold imports may be sterilized or offset by central bank action, as will hereafter be shown. In other words, we refer, for the present, to movements of gold arising as a result of international trade and finance. To this end we now turn to the subject of Foreign Exchanges, under which general but indefinite designation are classed all those transactions which have for their object the transmission of capital from one country to another.

In its elementary form international trade consists simply of an exchange of commodities. To facilitate settlement, however, each country expresses the value of its exports in gold or silver—

the common denominators of exchange—and liquidates its foreign dealings by means of credit remittances.

Just as the payments to be made and received in the course of our home trade are balanced against each other by an interchange of cheques in the clearing house, so the payments that have to pass between different countries in settlement of foreign transactions are settled through the process of an interchange of credit remittances in the various money markets, or international clearing houses. Those who have exported goods to other countries go there, in effect, to sell their drafts, and thus obtain payment, and those who have imported goods from other countries go there, in effect, to buy remittances, and thus make payment. Until 1921, business in foreign bills of exchange was transacted in the Royal Exchange, dealers meeting there twice a week. An importer to this country, wishing to settle his indebtedness, might do so by remitting foreign bills bought on 'Change though, generally speaking, such bills were purchased for investment by those having funds available for temporary placement at a profit. With the course of time, however, such a method of settlement became incompatible with the requirements of an ever-increasing volume of business. Nor was it likely in earlier days that a bill could be purchased for exactly the amount required. The process of evolution changed not only the "locale" of the market but, in a sense, its nature also. The business of providing foreign remittances is now in the hands of the banks and, in so far as the settlement takes the form of the remittance of a bill of

exchange, the bill is frequently a cheque or "sight" draft, not a "time" bill. As is shown later, however, settlement is now chiefly effected by means of telegraphic transfers, which are in effect cheques drawn by telegram.

#### PAR OF EXCHANGE

Now if on a given day the demand for any kind of credit instrument on, let us say, Germany, was just equal to the supply, then in a perfectly free market 100 units of cash would buy a credit instrument for 100 units, and exchange would be at par.

The expression "Par of Exchange" means an equipoise of the exchanges, and indicates a condition of affairs in which the demand for and supply of credit instruments balance each other. Whenever they so balanced, exchange would be visibly at par; and conversely, whenever the exchange between any two countries stood at par, we should know for certain that, at that moment, their claims (in the form of active demands) on each other were equal. This suggests the existence of an international currency; but, as different countries assert their independence by employing different systems, the exchange does not in practice take so simple a form. Nevertheless, it is still true that if the supply of credit instruments on, say, Germany fits the demand, the exchange (which in this instance is expressed as the number of Reichsmark that are given for £1 sterling) must be at par.

However, we have no means of ascertaining whether and when demand and supply do so balance.

## MINT PAR

As a substitute for this ideal par, cambists have adopted what is known as the Mint Par of Exchange. This is obtained by establishing a comparison between the currencies of the countries concerned, based on the weight and fineness of precious metal contained in their respective standard coins. The relationship, for instance, existing between the English sovereign and the French franc depends on the mint regulations of the two countries, which ordain that—

(a) 1 sovereign shall contain 7·322382 grammes fine gold;

(b) 1 gold franc = ·05895 gramme fine gold,

$$\text{so that } \text{£}1 = \frac{7\cdot322382}{\cdot05895} \text{ fcs.}$$

$$= 124\cdot2134 \text{ fcs.,}$$

meaning that the same quantity of pure gold is contained in one sovereign fresh from the Mint as in 124·21 francs (basing their value on that of the golden Napoleon). The mint par between England and France is therefore

124·21 francs to the £1.

A mint par can only be established between countries that employ the same standard of value. It cannot be fixed between a country with a gold standard and one with a silver standard, because there is no fixed ratio between gold and silver. The value in England of a Shanghai tael, or of a Hongkong dollar, is determined by the price of silver in the London market; and the value of a sovereign in China, by the fixed price for gold exchange in the open market.

The mint par, again, is not affected by deficiencies of weight or fineness in the standard coin, or by the charges made for coinage, etc. It is fairly certain that 1550 average Napoleons would not lift the scale at ten kilogrammes or 1869 sovereigns at 480 ounces, but the difference does not affect the mint par, which, being purely arbitrary, is concerned only with the statutory weight and fineness, and is therefore unalterable.

#### VARIATION FROM MINT PAR

When our claims on another country about equal theirs on us, the former pay for the latter, and exchange should be at par.

But it can only very rarely happen that there exists anything like an equivalence of claims. Almost invariably there must be more on one country than the other and the operation of the law of supply and demand causes a variation in the price, i.e. affects the exchange, and produces the constant oscillations of the rate.

If, on a given day, the balance of indebtedness between England and France should be against England; that is to say, if we attempt to pay more to France than France to us, there will be the same effect as in the case of any commodity; the demand being greater than the supply, the price will rise. The intrinsic value of 100 sovereigns is 12421·34 francs; but buyers will have to pay more than £100 for a remittance of 12421·34 francs, and, if France had the same currency that we have, they would have to pay more than £100 here for £100 there. In other words, bills, telegraphic transfers (or whatever the type of

instrument or remittance) on France would be at a premium.

To beginners, the question of a premium on the exchange is often a stumbling-block. They readily understand that a bill may be worth less than its face value, but how it can ever be worth more, they fail to see. And yet the principle is quite familiar in everyday life, though it presents itself in a different aspect. Suppose, for instance, one wishes to send a sovereign to his young brother at school, how will he manage it? Probably either by buying a Postal Order, for which he will have to pay 2d., or by sending the coin itself, or a note, and paying 3d. registration fee. Such being the case, what is the charge of 2d. but a premium on the exchange? Because it would cost 3d. to send the coin, he prefers to give 20s. 2d. for a bill of 20s.; and, on the same principle, a merchant who has to remit £1000 to Paris will pay more than £1000 for a bill, rather than go to the expense of sending gold. Of course, if it cost 10s. per cent to transmit gold to Paris, he will not pay more than 10s. per cent premium on the bill. Nor would one give more than 3d. for the Postal Order. In the one case as in the other the premium cannot rise beyond the cost of remitting coin.

Assuming, then, that the balance be against us, remittances on the other country concerned will be in request here, and will go to a premium. In the days of the Royal Exchange market, this would have meant a shortage in supply of bills, but because the quantity of paper tendered for sale on 'Change fell short of the demand, it by no means followed that some of the intending buyers

had to return empty-handed, or that the exchange at once leapt to the gold-moving point. Bills, like most other things, were always to be had at a price, and, if the amount on offer was inadequate, the broker who had buying orders to execute would apply to one of the foreign bankers, who were always ready to draw on their Continental correspondents to any amount that was required. There is rarely any question of a shortage in the supply of exchange, for all banks are prepared to "manufacture" remittances in the shape of drafts on their correspondents in the centre to which the remittance is to be made. The cost of such drafts is dependent in the first place on the ratio of demand to supply, but the rate of interest paid by foreign banks on London bankers' funds held abroad and the cost of replenishing such balances must also be taken into consideration. The banker will draw at a rate that covers expenses together with his correspondent's commission (if any) and some remuneration for himself. The actual extent of the variation from mint par will depend on the equation of two forces; the strength of demand on one hand, and, on the other, the value of funds in the foreign centre drawn on, in relation to their value in other centres, i.e. the relative interest rates.

Although the indebtedness of the individual is discharged by the remittance of a banker's draft, that of the country as a whole will remain as it was until the banker covers his correspondent. Either gold, or securities, or bills on other countries will serve this purpose, but in all ordinary circumstances the "T.T." (telegraphic transfer) forms the cheapest and most convenient mode of covering.

These are purchased from other, London and foreign, bankers who have funds available in the currencies required. Formerly, when bills were the principal medium, covering was often an "arbitrage" transaction. If one had drawn on Germany, for instance, he might remit bills on Amsterdam or Vienna; if on France, bills on other, adjacent, countries, and so on. This explains the tendency in ordinary circumstances (in the absence of exchange restrictions and between countries on the same standard) of the exchanges to rise or fall in groups, and shows why an important advance in the price of bills on France was generally (in the absence of special influences) accompanied or followed by a secondary advance in the prices of those on, say, Belgium, Luxembourg and Italy.

Adverse balances were, and are, therefore, discharged continually by the transfer to the creditor country of a portion of the balance due to us by other nations.

But such a balance might persist for weeks together, and every day bring a demand for foreign currency which can be met only by recourse to the banks, who continue issuing drafts, and buying up other currencies in different forms for cover. Of course, the longer this goes on the scarcer and dearer will these other currencies, by reason of the increased demand, become, and in proportion as the banker pays more for them so he will have to charge more for his drafts. In the end—if the adverse balance is large enough, or lasts long enough—other means of remittance may become so expensive that it will pay him better to cover his drafts by buying gold from the Bank of England

(provided the gold standard is in operation) at the Bank's selling price (tariff price), and shipping it to his correspondent, who will sell it to the Bank of France or to the Reichsbank, as the case may be, at their buying rate (tariff price), and credit him for the proceeds. The price of currency is now said to have reached "Specie" or "Gold" point, and can go no higher (save in very exceptional cases, such as the outbreak of war).

#### GOLD POINTS

"Specie" or "Gold" Point, which demands particular attention, is the rate of exchange produced by buying gold in one country and selling it in another. If this operation could be carried out without expense, gold point would be identical with the mint par, which is the value of a given quantity of gold expressed in different currencies. But export and import involve charges. The metal must be packed, insured, and shipped, brokerage and commission may have to be paid, and, in addition, there will be a loss of interest while the bullion is in transit. Deduct these charges from the mint par, and you have the rate at which gold goes out; add them, and you have the rate at which gold comes in. For instance, gold of the value of £1000 was worth 124213·4 francs; but if we assume the inclusive cost of transmission to have been  $\frac{1}{2}$  per cent, then the outlay necessary to produce 124213·4 francs was £1000 +  $\frac{1}{2}$  per cent, or £1005. This was equivalent to an exchange of 123·59, so that, if remittances on France rose in value to such an extent that £1000 would only purchase fcs. 12359, exchange would have touched the outgoing gold point.

It is obvious that the price of remittances could not ordinarily rise beyond this point, for, rather than pay more, merchants would ship bullion themselves; and gold, it must be remembered, could always be had at one fixed price of £3 17s. 10½d. per oz. English Standard.

Unlike the mint par of exchange, gold point cannot be fixed with exactness. All depends on the charges that have to be paid. Gold will generally (though, owing to the presence of other factors, not inevitably) be shipped when the exchange reaches that level at which it becomes profitable to export the metal. This theoretical explanation of the movements of gold may have suggested to the mind of the reader that it has been the practice of merchants and bankers themselves to pack up small parcels of gold for remittance when drafts are too expensive to purchase. This is not so. There are in all the important centres dealers who specialize in bullion transactions and before a rate of exchange varied sufficiently to tempt others to undertake such business outside their regular routine these specialists would operate on a wholesale scale, and it was their operations which would correct, or tend to correct, the rate. They would, for example, ship gold from London to Paris for sale there, draw on their agents in Paris for the payment received in Paris and so add to the supply of bills for sale in London.

#### FOREIGN EXCHANGE QUOTATIONS

At one time all business in foreign bills in this country centred on the Royal Exchange, where

buyers and sellers met twice a week, on Tuesdays and Thursdays.

'Change was over about three, and immediately afterwards the leading brokers issued a Course of Exchange, or price-list of bills, of which the following is a type—

## COURSE OF EXCHANGE,

London, 8th March, 1888.

On	Usance	Prices	
Paris . .	Cheque	25.28 $\frac{3}{4}$ —25.33 $\frac{3}{4}$	= Francs and centimes for £1
France . .	3 mos.	25.45 — 25.50	= Francs and centimes for £1
Belgium . .	3 mos.	25.46 $\frac{1}{4}$ —25.51 $\frac{1}{4}$	= Francs and centimes for £1
Germany . .	Short	20.36 — 20.40	= Reichmarks and pfenngs for £1
Germany . .	3 mos.	20.49 — 20 53	= Reichmarks and pfenngs for £1
Holland . .	Short	12 1 $\frac{1}{8}$ — 12.1 $\frac{3}{8}$	= Florins and stivers for £1
Holland . .	3 mos.	12.2 $\frac{5}{8}$ —12.3 $\frac{1}{8}$	= Florins and stivers for £1
Italy . . .	..	26.10 — 26 15	= Lire and centesimi for £1
Switzerland	..	25.52 $\frac{1}{2}$ —25.57 $\frac{1}{2}$	= Francs and centimes for £1
Petersburg	..	18 $\frac{3}{4}$ —18 $\frac{7}{8}$	= Pence for 1 rouble
Vienna . .	..	12.85 — 12.90	= Florins and Kreuzers for £1
Trieste . .	..		
Madrid, etc.	..	46 — 46 $\frac{1}{8}$	= Pence for 1 peso
Lisbon and Oporto . .	..	52 $\frac{7}{8}$ —52 $\frac{3}{4}$	= Pence for 1 milreis
Copenhagen	..	18.33 — 18.37	= Kroners and öre for £1
Stockholm . .	..	18.35 — 18.39	= Kroners and öre for £1
New York . .	Short	49 $\frac{1}{16}$ — 49 $\frac{1}{16}$	= Pence for 1 dollar

The London rates of exchange divided into two groups. In the one was stated the amount of foreign money that exchanged for one pound sterling; in the other, the amount of sterling that exchanged for one unit of the foreign currency. Most of the extra-European exchanges, for instance, New York, Calcutta, China, Rio de Janeiro, Buenos Aires, Mexico, etc., fell into the latter division, being quoted in shillings and pence, but all the Continental rates, with the exception of Russia, Spain, and Portugal, were rendered in foreign money.

The table published at the present time is of an entirely different nature. It differs from the old "On 'Change" table not only in its construction as a table but in the significance of its constituent factors. The following is taken from *The Times* of 11th September, 1935—

Following is a list of foreign exchange rates issued under arrangements made by the London banks; it shows the range within which business was transacted yesterday. Bank rates are indicated by the figures given in parentheses following the place names—

Place	Method of Quoting	Par of Exch'ge prev. to Sept. 20, 1931	Sept. 10	Sept. 9
New York	(1½) \$ to £	4.86 $\frac{2}{3}$	4.93 $\frac{1}{4}$ -94 $\frac{1}{2}$	4.92 $\frac{1}{2}$ -4.94
Montreal	\$ to £	4.86 $\frac{2}{3}$	4.94 $\frac{1}{4}$ -95 $\frac{1}{2}$	4.93-4.95
Paris	(3) Fr. to £	124.21	74 $\frac{1}{16}$ -75 $\frac{1}{16}$	74 $\frac{1}{16}$ -74 $\frac{1}{16}$
Brussels	(2) Bel. to £	35.00	29.27-29.34	29.25-29.33
Milan	(5) Lire to £	92.46	60 $\frac{3}{8}$ -60 $\frac{3}{8}$ (f)	60 $\frac{1}{4}$ -60 $\frac{5}{8}$
Switzerland	(2½) Fr. to £	25.22	15.16-15.21	15.14-15.20
Athens	(7) Dr. to £	375.00	515 $\frac{1}{2}$	515 $\frac{1}{2}$
Helsingfors	(4) M. to £	193.23	226 $\frac{3}{8}$ -227 $\frac{3}{8}$	226 $\frac{3}{8}$ -227 $\frac{3}{8}$
Madrid	(5½) Pts. to £	25.22	36-36 $\frac{1}{2}$	36-36 $\frac{1}{2}$
Lisbon	(5) Escu. to £	110.00	109 $\frac{7}{8}$ -110 $\frac{3}{8}$	109 $\frac{7}{8}$ -110 $\frac{3}{8}$
Amsterdam	(5) Fl. to £	12.11	7 30-7.33	7.28-7.32
Berlin	(4) M. to £	20.43	12.25-12 30(a)	12.22-12.27
Vienna	(4) Sch. to £	34.59	25 $\frac{1}{4}$ -27 $\frac{1}{4}$	25 $\frac{1}{4}$ -27 $\frac{1}{4}$
Budapest	(4) Pen. to £	27.82	16 $\frac{3}{8}$ * $\frac{1}{2}$	16 $\frac{1}{2}$ * $\frac{1}{2}$
Prague	(3½) Kc. to £	164.25	119-119 $\frac{1}{2}$	119-119 $\frac{1}{2}$
Danzig	(6) Gul. to £	25.00	26-26 $\frac{1}{2}$	26-26 $\frac{1}{2}$
Warsaw	(5) Zloty to £	43.38	26-26 $\frac{1}{2}$	26-26 $\frac{1}{2}$
Riga	(6) Lats to £	25.22	14 $\frac{1}{2}$ -15 $\frac{1}{2}$	14 $\frac{1}{2}$ -15 $\frac{1}{2}$
Bucharest	(4½) Lei to £	813.60	624 $\frac{1}{2}$	624 $\frac{1}{2}$
Constantinople	Pst. to £	110.00	613 $\frac{1}{2}$ (h)	613 $\frac{1}{2}$
Belgrade	(5) Din. to £	276.32	212-222	212-222
Kovno	(6) Lit. to £	48.66	29-30	29-30
Sofia	(6) Lev. to £	673.66	385-415	385-415
Tallinn	(5) E.Kr. to £	18.16	17 $\frac{3}{4}$ -18 $\frac{3}{4}$	17 $\frac{3}{4}$ -18 $\frac{3}{4}$
Oslo	(3½) Kr. to £	18.16	19.85-19.95	19.85-19.95
Stockholm	(2½) Kr. to £	18.16	19.35-19.45	19.35-19.45
Copenhagen	(3½) Kr. to £	18.16	22.35-22.45	22.35-22.45
Alexandria	Pst. to £	97.50	97 $\frac{3}{8}$ -97 $\frac{3}{8}$	97 $\frac{3}{8}$ -97 $\frac{5}{8}$
Bombay	(3½) Per Rup.	1s. 6d.	1/6 $\frac{1}{2}$ -1/6 $\frac{1}{2}$	1/6 $\frac{1}{2}$ -1/6 $\frac{1}{2}$
Calcutta	(3½) Per Rup.	1s. 6d.	1/6 $\frac{1}{2}$ -1/6 $\frac{1}{2}$	1/6 $\frac{1}{2}$ -1/6 $\frac{1}{2}$
Madras	(3½) Per Rup.	1s. 6d.	1/6 $\frac{1}{2}$ -1/6 $\frac{1}{2}$	1/6 $\frac{1}{2}$ -1/6 $\frac{1}{2}$

Place	Method of Quoting	Par of Exch'ge prev to Sept 20, 1931	Sept. 10	Sept. 9
Hong Kong	% Per Dol.	—	1/11 7/8-2/0 7/16	1/11 7/8-2/0 7/16
Kobe	(3.65) Per Yen	24.58d.	1/2 1/16-1/2 1/16	1/2 1/16-1/2 1/16
Shanghai	Per Dol.	—	1/5 3/4-1/6 3/8	1/5 3/4-1/6 3/8
Singapore	Per Dol.	2s. 4d.	2/4-2/4 1/16	2/4-2/4 1/16
Batavia	(4) Fl. to £	12.11	7.26-7.30	7.24 1/2-7.29
Rio de Janeiro	Per Mil.	5.90d.	2 1/2-2 5/8d. (d)	2 1/2-2 5/8d.
Buenos Aires	Paper Pes. to £	11.45	18.40-18.50(b)	18.40-18.50
Valparaiso†	Pesos to £	40.00	118(e)	119
Montevideo	Per Peso	4s. 3d.	19 1/2-20d (c)	19 1/2-20d.
Lima †	(6 1/2) Soles to £	17.38	20.75	20.75
Mexico	Pesos to £	9.76	17 1/2-18 1/2	17 1/2-18 1/2
Manila	Per Peso	24.66d.	2/0 1/4-2/0 3/8	2/0 1/4-2/0 3/8

\* Official rate. † 90 days. ‡ Sellers.

(a) Registered marks are quoted at a discount of 44-49 per cent.

(b) The official rate is 15p., sellers, and the average remittance rate for importers 17.04p.

(c) The official rate is 39 1/2d., sellers.

(d) The official rate is 4 1/4d., sellers.

(e) Latest "export" rate.

(f) Rate for conversion of lire into sterling for payments of the Bank of England in respect of debts due to persons in Italy for goods and freight, 60.57 lire.

(h) Rate for conversion of Turkish currency into sterling for payments to the Bank of England in respect of debts due to persons in Turkey for Turkish goods, 621pst. to £.

EMPIRE EXCHANGE RATES\*

BUYING RATES

—	Demand		30 days' Sight		60 days' Sight		90 days' Sight	
	£	s. d.	£	s. d.	£	s. d.	£	s. d.
Australia	126	7 6	126	17 6	127	7 6	127	17 6
New Zealand†	125	10 0	126	0 0	126	10 0	127	0 0
New Zealand‡	125	7 6	125	17 6	126	7 6	126	17 6

SELLING RATES

	T.T.'s		Demand	
	£	s. d.	£	s. d.
Australia	125	0 0	125	1 3
New Zealand	124	0 0	124	1 3

Closing Rates

## SELLING RATES

—	T.T.'s			Demand		
	£	s.	d.	£	s.	d.
S.A. Union Territory (T.T.'s) . . . . .	100	17	6	100	2	6
S.A. Union Territory (sight drafts) . . . . .	101	7	6	100	2	6
Rhodesia (T.T.'s) . . . . .	100	5	0	99	15	0
Rhodesia (sight drafts) . . . . .	100	17	6	99	15	0

\* Per 100 London pounds.

† Ordinary mail rates. ‡ Direct air mail rates, plus postage.

Generally speaking, newspaper quotations, with the sole exceptions of Valparaiso and Lima, are for telegraphic transfer, the exceptions referred to being for 90 days. In addition, a cheque rate is sometimes given for New York and Montreal. It needs only a cursory comparison of the present day table with the old Course of Exchange to appreciate the growth of business between London and South America and the East. Nowadays, most of the Central and South American exchanges are given; those not included in the above table are of insufficient importance to warrant classing with the major ones. It will also be seen that the practice of quoting in foreign currency to the £ sterling has been extended.

One or two points regarding the modern table require explanation; first, the double quotations for each centre.

As *The Times* itself explains, these represent the range for the day. (Other papers have other methods of quoting, which they do not always explain, and obscure footnotes—to the bewilderment of the student—are not uncommon.) However, the table given here in illustration is a model of clarity and can hardly be misunderstood.<sup>1</sup>

<sup>1</sup> It will be noted that the complaint, made in Clare's Second Edition, that the table did not show the discount rates ruling in foreign centres has been partly met; the figures given are mostly central bank rates.

Registered marks are those in which there is not a free market, hence the discount. Official rates are those arbitrarily fixed by the Government of the country concerned. These "fixed" rates are seldom entirely effective (in the absence of control by Government manipulation of the market) and there will generally be found an unofficial rate at which much of the business in the particular currency is done. *De facto* parity is an expression sometimes met with and refers to the rate at which an exchange is kept by artificial manipulation, by the Government responsible for the currency in question. "Nominal" quotations, of course, imply that business in the relative currency is negligible and that the figure is no real guide to the rate at which transactions could actually be done.

A glance at the table will reveal that the Australian and New Zealand and South African exchanges which used to be indicated as a premium or discount in relation to the £ sterling are now quoted in the form of colonial currency for £100 sterling.

In some cases a table of forward exchanges is seen, a feature never present in the old tables. This is dealt with in some detail later.

On the Continent generally the rule obtains of stating all rates in the home currency, like ordinary prices. This is the natural and more simple method; but the London system, although somewhat perplexing on first acquaintance, possesses the advantage of enabling easy comparison to be made between the rates current here and abroad. Paris, for example, quotes London in

francs and centimes, and, as we quote Paris in the same way, it is seen at a glance whether and to what extent the rates differ. On the other hand, if it were the custom here to quote the Continent in sterling, and if, while Paris gave the price of cheques on London as, say, 124.27, we priced Paris cheques at 1.9½d. per franc, it is obvious that the identity of the two quotations could not be established without calculation. It has accordingly become the usage to state the exchange here as it is stated abroad; and as Paris and Zurich quote London in francs, London quotes them in francs; Brussels in belgas; Lisbon quotes and is quoted in escudos, and so on.

No difficulty need be experienced in dealing with a rate expressed in foreign money, if only the bearing of the rise and fall be clearly kept in view. In this case a rise of the rate is equivalent to a fall in price, and a rise in price to a fall of the rate. The following report: "Continued weakness was displayed by Swiss francs and pesetas . . . on the other hand, belgas improved to 29.83," means that the Belgian rate fell, while the Swiss and Spanish rates rose. If you have Belgian currency to sell you try to obtain as low a rate as possible, and, if you are buying, to buy as high as you can. Heavy sales cause the exchange to advance; heavy purchases cause it to recede.

When a rate in foreign money rises above par, the currency is at a discount, and when it falls below, at a premium; but these terms are in practice avoided, and we say instead that the exchange has moved for or against us, or, simply, that it is higher or lower.

The expressions "favourable" and "unfavourable" are also constantly met with. A favourable exchange is one that tends towards the incoming gold point, and is so styled because an inflow of gold produces an increased Reserve, and cheaper money. An unfavourable exchange, on the other hand, points to an export of gold, and dearer money. It will be useful to bear in mind that all the Continental exchanges are favourable when above par, and unfavourable when below, or, in other words, that *high rates are for us, and low rates against us*. Yet these expressions must be used guardedly, for a low rate (in foreign currency) is favourable to the exporter from this country, but unfavourable to the importer into this country; again, a low rate, in pence to the foreign unit, means an advantage to the British importer, but a disadvantage to the British exporter. The terms must therefore be regarded from the standpoint of the individual or class concerned in the particular transaction.

The meetings in the Royal Exchange ceased in February, 1921, when the "On 'Change" table disappeared. Foreign exchange business is now, to a far greater extent than it used to be, in the hands of the banks, who are in continuous touch with the dealers forming the exchange "market."

#### FORWARD EXCHANGE

An important development of the existing market in foreign exchange compared with that of pre-War years has been the creation of a market in "forward" exchange. It has already been explained that the prices of bills could not rise above what

were known as the "specie" or "gold export" points, for the reason that anyone desiring to settle indebtedness to a foreign creditor would choose the cheapest method, and that if the expense of shipping gold were less than the cost of telegraphic transfers, bills, coupons or securities, gold would be sent. This applied necessarily to exchange with only such countries as were on a gold standard. The War interrupted intercourse with enemy countries entirely and with the majority also of the others, whether allied or neutral, by reason of the extreme physical difficulty of transacting business. The cost of the transport of gold and other valuables became prohibitive; the bill, long or short, lost ground as a means of settlement because of the departure of most nations from the gold standard, and of the depreciation of their currencies owing to inflation. It was found necessary to work either on a "cash" basis by means of the telegraphic transfer or else to cover one's self against depreciation in the foreign currency by a forward transaction.

Let it be supposed that an English merchant sells to a Spanish buyer, when the peseta is falling to such an extent that to be paid in pesetas entails serious risk of loss. Unless the Spanish buyer agrees to pay in sterling, the Englishman cannot know within an appreciable margin what amount of sterling his pesetas will realize in, say, three months' time. This means that he cannot fix his price with any certainty. The Spanish buyer would not agree to pay in sterling, also, because of the uncertainty of his own currency; he too buys on a definite basis, on which his price to the

retailer depends. He is willing to pay in pesetas. There is a deadlock which has to be overcome, but how? Neither is willing to take the risk which must be borne by someone else; but by whom? The problem has been solved by resorting to a middleman, or rather, to more than one middleman, the banker and the foreign exchange broker. Let it be supposed also that the Spaniard demands three months' credit as a condition of his doing business. He is willing to give a three months' bill in pesetas, the right to pesetas in three months' time, but the Englishman is dubious as to the course of the peseta in the meantime. It may be that he is under contract with the Spaniard to supply material or commodities, for which he has to purchase the raw material. He knows that he will receive so much in pesetas at a definite future time but he does not know how the course of the peseta may run between now and then. If he can persuade his banker to buy from him the right to the pesetas, but on the basis of the present price of the peseta, he would be willing to sacrifice a little to avoid carrying the risk. He contracts accordingly with his banker to buy the pesetas from him at the time when he, the merchant, will be in a position to deliver, and the price is fixed on the basis of the existing price of the peseta.

His raw materials may also have been purchased from a country whose currency is fluctuating, e.g. from Germany. He knows that in three months' he will be liable to pay his German supplier so many marks, but, in order to be able to fix his price to the Spanish purchaser of the manufactured article, he must know what his

manufacturing costs, which include the costs of the material and of the marks, will amount to. He therefore contracts with his banker to sell to him at an agreed price the marks he will require, at the time he will require them, and he will be willing to pay something for being relieved of the risk of exchange fluctuations in this currency also.

This does not involve the banker in such speculative business as may, at the first glance, appear, for he aims at balancing his forward sales against his forward purchases in each currency.

#### SHORT AND LONG RATES

In explaining the theory of the exchanges it is conducive to simplicity to disregard at the outset the element of time, and to assume that an ordinary transaction takes the shape of a draft at sight drawn in one country upon someone in another country, or, what amounts to the same thing, to assume that cheques are in all cases dealt in.

A glance at the exchange table, which reflects the business that actually takes place will, however, dispel this idea. The great majority of the quotations apply to cable or telegraphic transfers<sup>1</sup>, the only exceptions being Valparaiso and Lima, for which the 90-day rate is given. Nevertheless, this is not to say that cheques on other countries are

<sup>1</sup> Formerly, when foreign bill business was transacted in the Royal Exchange, the predominant quotation was that for three months' bills, as the following extract from "Clare," Second Edition, shows: "As a matter of fact, the great majority of the quotations apply to bills of three months' currency, and the only Continental 'cheque-rate' that we quote is Paris, though Germany and Holland are also given 'short' (sight to eight days). The sight exchanges often referred to in the Money Article are not London rates, but the quotations current abroad."

not to be had here. A banker will, if desired, draw "at sight" on Palermo, or Prague, or Cadiz, or any other town of importance, with a slight adjustment of the quoted rates.

In practice, then, we read very little in London of the sight or mail transfer rate to which such prominence is given in theory, and the average exchange transaction consists of an immediate payment on this side in order to receive the equivalent abroad the same day. It is generally held that the T.T. (telegraphic transfer) rate governs the sight or cheque rate. The difference between the two must, however, rest on the interest lost or gained, as the case may be, according to which method is employed, and on the risk involved in dealing with actual drafts. The banker who draws at sight on New York has anything up to a week's use of the money which he receives for his cheque, and the rate must be higher (\$ to £) in consequence. Theoretically, the rate for telegraphic transfer is dependent on the cost to the banker of providing or replenishing balances in the centre on which he is operating. Obviously there must be a close correspondence in practice, but a multiplicity of varying transactions offset each other, and it may not be necessary to remit cover for long periods.

It will now clear the ground if we show, in the first place, how the "long" rate is arrived at, and what relationship exists between the price of a bill at three months, and the price of a cheque. Suppose that a merchant has made purchases in France and, the time having arrived for payment, has the choice between remitting a cheque or a

three months' bill; if the cheque would cost him 75 francs to the £1, what ought he to pay for the bill? Obviously the difference in price will mainly depend on the rate of interest ruling in France—not on the English rate—for his correspondent will either credit him for his remittance in three months' time, charging interest meanwhile at French bank rate, or, as is more likely, discount the bill with his banker, and credit the remitter at once with the proceeds. If bank rate is 4 per cent in France, the charge on a three months' bill will be 1 per cent cheaper than the cheque, or at 75·75. The price the merchant pays must also cover the expense of the foreign bill stamp ( $\frac{1}{2}$  per mille), which brings the rate up to 75·787.

Theoretically there is another consideration. The merchant will be under liability on his endorsement until the bill is actually paid, and the longer it runs the greater will be the risk. In three months' time the drawer and acceptor may have failed, or war may have broken out. For this risk he must also be compensated by some allowance in price, which is of the nature of an insurance premium, and will be greater or less according to the standing of the other parties to the bill, and to the general state of credit. If he reckons his chance of loss on that score at  $\frac{1}{4}$  per mille, the result will be that he will consider 75·805 for a three months' bill as the equivalent price to 75 for a cheque.

In fact, however, there is nowadays no such risk. If one buys a cheque, it is his banker's cheque in favour of his correspondent; if he remits by bill, the instrument will probably be drawn

on him by his correspondent, so that no liability as endorser will arise.

The long rate, therefore, is, generally speaking, based upon the short, or sight, rate, rising and falling with it, the amount of its deviation depending on the rate of discount ruling in the country upon which the bill is drawn, and on the state of credit. In other words, broadly speaking, demand versus supply produces the short rate, and demand versus supply, plus interest at the foreign rate, produces the long rate.

It follows that the long exchange can and does move independently of the short.

Mention has been made of the state of credit as a factor in the long rate. To a certain extent this consideration must always influence the buyer of a bill payable at some more or less distant date, but inasmuch as he can send a good bill to the centre on which it is drawn, have it discounted, and the proceeds remitted at the sight rate, the deviation in rates from this cause can never be great.

## CHAPTER IX

### THE FOREIGN EXCHANGES (CONTD.)

THE foreign exchanges, it has been well said, are the barometer of the money market. This, it must be pointed out, was said a very long time ago and relates to conditions which from the viewpoint of 1935 appear almost ideal.

#### BILL RATES AND THE PRICE OF MONEY

Between the price of London bills, as expressed in the current rate of discount, and the price of foreign bills, as expressed in the current rates of exchange, there exists at times a close sympathy,—a fact of which we are frequently reminded in the money article, where, as in the following instances—

Uncertainty in many foreign centres regarding Bank Rate prospects again caused nervousness in the foreign exchange market.

Until Thursday's reduction in Bank Rate, sterling displayed strength against nearly all currencies, but after the change all rates reacted.

reference to the position of the one constantly serves to explain a rise or fall of the other.

Before discussing the causes and import of this connexion it will be well to make sure that we understand what is meant by saying that the exchanges have risen or fallen. This refers to the figures of the quotation, not to the value of the foreign currency in terms of sterling. It will be remembered that as most quotations are made in foreign units to £1 sterling, when the foreign cur-

rency appreciates in value, the figures necessarily fall, and vice versa. It will also be remembered that the influences affecting the long rate may cause a variation independently of the sight rate. These variations must be disregarded in considering what we may call a real rise or fall in the exchange. But as the rate now quoted is for T.T., this point is of academic interest only.

The relationship existing in normal times between the fluctuations of the exchanges and those of the price of money is of the nature of cause and effect, and the link that brings them into connexion—the agency that transmutes a rise or fall in the price of foreign bills into a like movement of discount rates—is gold, the ebb and flow of which, while regulating the action of the Bank of England and, through the Bank, that of the market, is itself regulated by the demand for and supply of means of remittance. As might be expected, it is when gold point is within measurable distance that this connexion is most apparent, but at all times some semblance of agreement is traceable between the respective price waves, and it may be laid down as a general rule that discount tends to harden on a decline of the exchanges, and to weaken on an advance. Rising exchanges (those quoted as currency to the £) have thus come to be associated with the idea of cheaper money, while falling exchanges are regarded with disfavour as being the forerunner of a possible bullion drain and of its inevitable accompaniment—dear money. (It must be understood that we write of conditions which at the present time are in abeyance.)

The principles that underlie a rise or fall form

in these circumstances the next subject that suggests itself for inquiry. It is necessary, however, to state at the outset that as the international dealings of which the exchanges represent the settlement are too varied and too complex almost to be known as a whole to anyone, it is difficult to assign every fluctuation to its specific cause; and that, though a knowledge of the principles that determine such fluctuations is of great value as a guide, it is capable only of general application and cannot be relied upon to solve the meaning of each particular rise or fall.

Accepted, of course, that they serve as a means of remittance, for what purpose, let us first ask, are bills purchased, and why are there more buyers in the market at one time than at another? The demand for foreign bills is a demand for means of remittance to foreign countries. Other vehicles for the transfer of capital are also procurable, but none so suitable. Gold, or silver, or securities, might serve the same purpose but their use is impeded by the cost of carriage and insurance as well as by other drawbacks, and common sense tells us that the least troublesome and least expensive mode of sending money abroad is to buy and remit a bill of exchange, nowadays, a banker's cheque.

Such being the reason why bills are sought after, it follows that the greater the stream of outward flowing capital, i.e. the greater the volume of indebtedness to be discharged at any particular moment of time, the stronger will be the demand for bills, and the higher their price. On the other hand, if the inflow of capital exceeds the outflow,

the price of London bills will be high abroad, and the price of foreign bills low in London. The position of the exchange is therefore a sign of the relative strength of two opposing demands, and it is necessarily in favour of the country that is receiving on balance. Thus, if the exchange on Germany is against us—or below par—i.e. in favour of Germany—that fact is a fairly sure indication that we are remitting more to Germany than Germany to us; if in our favour, or above par, it tends to demonstrate the contrary. It is necessary here, however, to point out that political influences may be strong enough to affect the position. In fact, the exchange between the two countries may be entirely divorced from the question of their relative indebtedness. Political influence, in the form of lack of confidence in a country's affairs, will readily show itself in anxiety to translate its currency into that of the country which holds it or some other, more stable. Apart from this, moreover, speculation in the currencies of countries adversely or favourably affected by political considerations will sway exchanges to an appreciable degree, quite irrespective of the ratio of indebtedness between the two.

Why people should wish to make remittances to other countries admits of course of various explanations, but the most natural reason is that of settling a debt; and it is accordingly usual to assign the place of honour as a regulator of the exchanges to international indebtedness. This, it need hardly be said, arises principally out of trade. The bulk of the bills drawn by one nation on another are created in connexion with business

transactions, and if we could analyse the contents of a banker's portfolio we should be sure to find that most of his foreign bills represented consignments of goods from one country to another.

That the trade demand for bills exercises great influence over their price there can be no question, but it is an influence of which there exists no certain criterion. The Board of Trade, it is true, publishes the declared values of our national imports and exports, and, as we must undoubtedly pay for the one and be paid for the other, this information might be expected to be valuable as a starting point. It is, however, of no help, and to infer, because the returns of a given month showed an increase in our imports from Germany, or a falling-off in exports, that the German exchange was about to turn against us would, to a practical man, seem an absurdity.

In the first place, there is too much diversity in the terms upon which mercantile transactions are based. Secondly, vast sums are drawn on London for goods which never touch our shores at all. Bills on London are in universal demand, as the names and standing of the great London accepting bankers are universally known, and a bill on London will as a rule, command a proportionately higher price than one drawn on a Continental banker. Therefore, if an importer in Germany orders coffee from Rio, or cotton from New Orleans, he will, frequently, and because it pays him better to do so (or because the exporter demands it), open a credit, in favour of the shipper, with a London banker. The consequence will be that, though the produce appears in neither our imports

nor our exports, London will pay the exporting country for it and Germany will pay London, so that the Brazilian or American exchanges will, to that extent, be influenced against us and the German for us.

Then again, prior to the War, the interest due to us on the hundreds of millions that we lent to other countries had to be taken into account as a set off in part payment for the commodities they sent us; and we had, and still have, moreover, a heavy bill against them for services rendered in carrying their wares across the seas. But since the War, and as a result of its extravagant expenditure, our holdings of foreign securities have considerably diminished, a great proportion having been utilized to meet current indebtedness to America for material supplied for war purposes.

Lastly, poor countries are constantly borrowing from their richer neighbours. Year after year English capital used to find its way to every quarter of the globe, for investment in railways, mines, public works, armaments, etc., and every issue of new capital or repayment of old, and every payment of interest helped to sway the exchanges.

On the whole, therefore, we are forced to the conclusion that, owing to the many elements of uncertainty, and to the lack of information on essential points, the balance of actual indebtedness between this and other countries must remain an unknown quantity. In fact, it changes momentarily and, therefore, any calculation would be out of date as soon as it was made.

## INVESTMENT DEMAND

Though the relative strength of the demands made upon London by other countries for payment for produce and securities and those by London on other countries for the price of our manufactured goods, for interest and services, is the natural and original cause of variations in the course of the respective exchanges, there are cases in which the influence of relative indebtedness is dwarfed and even neutralized by other circumstances, which, so far as European countries are concerned, frequently play the leading part in regulating rates. It is, in fact, almost possible to classify the exchanges on the basis of the influences by which they are mainly governed; and, if an attempt were made to carry out this arrangement, they would fall into two groups, the distinguishing feature between which is known as the "investment" demand. More detailed reference to this is made later in this chapter. The group containing those countries which purchase the London bill as an investment may be said to be comprised, in order of importance, roughly, of France, Holland, Belgium, Germany, the United States, and, less markedly, Italy and Spain. Other countries participate in the demand only intermittently..

It will be seen that the principal European bourses—those of the countries with which we have the most extensive relations, and with which we are most in touch—form a group by themselves, and are characterized by the fact that their variations are dependent not so much on relative indebtedness as on the relative value of money in

the respective centres. This, being a new factor in the problem, will require some preliminary explanation.

In all countries where banking and credit are highly developed, one of the functions of a banker is to take charge of his customers' spare money until they can find a profitable use for it; and the first principle of his business or, rather, of this branch of it, is to keep the bulk of such money in a readily available form. In this country in particular, but to a rather less extent on the Continent, convertibility into cash, without difficulty, without loss and without delay, is regarded as the essential qualification of a suitable outlet for a banker's funds, and to lock up, in mortgages, ground rents, and other long-term investments, money that might have to be repaid at short warning, would be to imperil his safety and to invite disaster.

In the whole range of interest-bearing securities there is but one class, however, that can be held to possess this qualification in all points, and that is bills of exchange, which, if carefully selected, are as safe as any other investment, and are endowed, moreover, with the excellent property of turning themselves into cash automatically, and at par. A banker who has plenty of good bills to depend upon can, except in times of world upheaval, such as August, 1914, speedily replenish his cash reserve by simply letting his portfolio run down without renewal. Accordingly, they are an essential factor in banker's investments. This is true not only of bankers in these Islands, but of those on the Continent as well, though with this difference, that, whereas the British banker confines himself solely

to British paper, his neighbour on the other side of the Channel stocks his bill case with an assortment of foreign, in addition to home, acceptances.

Foreign bills as an investment have always been strangely neglected by the English joint-stock banks. Whether it be that the technicalities that have to be mastered in connexion with the business are the deterrent, or whether it be that insular prejudice regards them as unsafe, it is hard to say; but there is certainly good reason to doubt whether any of the clearing banks in Great Britain, or the Scottish and Irish, keep a single Continental acceptance in their portfolios.

In many foreign countries the case is very different. Not only in the capitals, but in all the principal towns, bankers buy and hold bills on other countries, and, other things being equal, naturally lay out most money in those which, for the time being, produce the highest return. The consequences are of the utmost importance, for if interest in this country rises above the Continental level, bankers in France, Germany, Belgium, Holland, etc., will reduce their holding of home and other bills, by selling them, or allowing them to run off, and replace them by London paper, producing a demand that may amount in the aggregate to many millions, and which almost invariably carries the exchange with it. In a like manner, if interest here falls below that level the exchange will recede as rapidly as it rose, because bankers abroad will get rid of their London bills in order to buy something more remunerative.

It will perhaps help to render this investment demand more intelligible if, at this point we make

ourselves acquainted with the exact manner in which interest is earned on a foreign bill, and also notice how the movements of the exchange affect the yield. Taking the quotations of the Paris-London exchange on, say, a 1st March—when Bank Rate in London stood at 3 per cent and in Paris at  $2\frac{1}{2}$  per cent and the market rates at  $2\frac{1}{2}$  per cent and 2 per cent respectively—at 123·086 long and 123·86 sight, a Parisian banker laid out fcs. 100,000 in a three months' bill on London for

Fcs. 100,000 @ 123·086 = £812·44, due 1st June and had sold on the 31st May at sight rate, which happens to have been again 123·86, as before. For fcs. 100,000 he would receive back

$$£812·44 @ 123·86 = \text{fcs. } 100,628·80$$

which is equal (leaving stamps, etc., out of consideration), to a little over  $2\frac{1}{2}$  per cent per annum, and is the exact return that was in prospect when the operation was initiated.

Now suppose the purchase to have taken place on, say,

5th Jan.	London bank-rate	3%	Long exchange	123·521
	London market-rate	2%	Sight exchange	124·337

fcs. 100,000 @ 123·521 = £809·58 due 5th April and the sale at the beginning of April, sight exchange being 123·863,

$$£809·58 @ 123·863 = \text{fcs. } 100,277·00$$

In this case the exchange rose so that, although 81·60 centimes per pound were received for interest, there was a loss of 47·40 centimes on the rate, making a net yield of 34·20 centimes for each pound invested, or nearly 1·1 per cent per annum.

Finally, consider the following purchase—

28th June .	London bank-rate	2½%	Long exchange	123·537
	London market-rate	2⅔%	Sight exchange	124·275

fcs. 100,000 @ 123·537 = £809·47 due 28th September, which, sold on 27th September, sight exchange being 124·438—

$$£809·47 @ 124·438 = \text{fcs. } 100,728·82$$

Here a fall of the exchange from 124·275 to 124·438 added 16·30 centimes to the 73·80 receivable for interest, giving a total return of 90·10 centimes per £1 which is over 2·9 per cent per annum.

These instances are enough to explain that, in order to earn interest by way of an investment in foreign bills, three months' paper is bought at the long or cheap price, and sold when due at the short or dearer price (if sold before maturity, the price is proportionate), the margin between the two rates giving the return on each pound invested. They make it clear, too, that until the re-sale has been effected, the outcome of the investment is never certain; for, though the difference between short and long at the time of the purchase is the presumptive yield, the actual yield will of course be the difference between the long rate at the time of purchase, and the short rate at the time of the sale. There is thus a savour of speculation about the business, which may partly account for the disesteem in which foreign bills are held by English bankers.

The Continental buying of London paper for the portfolio, though it may be said to begin as soon as the interest obtainable thereon offers a

profit over home rates, does not show itself in its full strength until the discount ruling here for the best bank bills exceeds the market price of corresponding paper ("haute banque") abroad. The great banks of Paris, Berlin, etc., want first-class paper, and are willing to pay the price. Hence the real investment demand—the demand for sums large enough to sway the course of the exchange—is governed by the London market rate for the best bank paper, and, in proportion as this rises above the corresponding rate abroad, so buying increases and the exchange advances. Finally, if the attraction of capital is sustained by the continuance of a high discount rate, exchange may even be forced up to gold point, and gold will then begin to flow in. This implies an immediate alteration in the supply of bills and a downward tendency in the London interest rates, both of which will tend to turn the exchange back towards normal.

In detail, the rise of the exchange in such circumstances is occasioned as much by sales of Continental drafts as by the purchase of London on the foreign bourses, for, as the supply abroad of choice bank bills on this country is limited, the buyers in Paris, etc., take the natural course of satisfying their requirements in the best stocked market, and, to that end, instruct their London agents to buy for them from the discount brokers here, and to draw for the amount of their purchases. The offer of these drafts for sale here has the same effect on the exchange as would be produced by the demand for an equal amount of London bills in Paris; that is to say, while London is growing dearer in Paris, Paris is growing cheaper in

London, the movements on each side being almost simultaneous and identical. It is hardly necessary to say that the London price of Paris never sensibly differs from the Paris price of London, and that—the two sides being kept in constant touch by telephone and telegraph—it is immaterial which leads, as the other will at once follow suit. If this were not so, an easy profit could be made by taking advantage of the difference.

Thus, supposing Paris quoted London at 75·23, and London, Paris at 75·20, an operator would instantly sell London in Paris (by telegraphing or telephoning his correspondent to draw upon him) and Paris in London, the result of the transaction being that for his own draft of say fcs. 75,200 he would receive £1000 here, and be charged fcs. 75,200 in Paris, and for his agent's draft of say £1000 would pay £1000 here, and be credited with fcs. 75,230 in Paris, thus finishing with fcs. 30 to the good. As, in such a case, the sales of London in Paris would tend to depress the quotation there, while the sales of Paris in London would tend to raise it here, it is clear that the difference would be speedily levelled by the action of these so-called "arbitrage" operations.

#### INTEREST RATES AND THE EXCHANGES

In illustration of the fact that high interest attracts capital from abroad, and as evidence of the influence thereby brought to bear on the course of the exchange, reference may be had to a quotation from *The Times* in February, 1931, which treats of two exchanges in this connexion. It is as follows—

## INFLUX OF AMERICAN FUNDS

The policy of the Bank of England in checking the fall in the pound sterling by reducing the redundancy of bank credit has already borne fruit. Besides making purchases of sterling bills, American banks have offered large sums for fixed deposits with London banks, and still more would be forthcoming if the open market discount rate were advanced a little further. This influx of American money has brought about a material improvement in the dollar value of sterling, and yesterday the New York exchange was the best feature among the foreign exchanges. A fortnight ago the rate was only  $\$4.85\frac{9}{32}$ ; yesterday it touched  $\$4.85\frac{3}{8}$ . The movement of funds from America to London is the more interesting since American bankers have lately called in funds from certain countries where they had been earning a better return than can be obtained in London. Apparently they prefer the lower rates that can be earned in London because the risk is less. Of course, if London called in funds as readily as some other countries the economic troubles of the world would be gravely accentuated. The new creditor countries have yet to learn that to call in foreign credits is a serious matter, especially in times like the present. Such action should only be resorted to in case of real emergency. The Paris exchange was also firmer yesterday, closing at  $123.91\frac{1}{2}$  fcs. against  $123.89$  fcs. on Monday. At the present figure gold withdrawals from the Bank are not profitable. This exchange, however, is very erratic in its movements, and no confidence can yet be felt regarding the cessation of the gold flow to Paris.

The fact that high interest attracts foreign capital is, of course, true only in given conditions. In others, high rates may prove incapable of bringing funds from abroad.

It is here useful to draw attention to another factor, one which has been much in evidence in recent years and which did not exist before the War. That factor is the existence in one centre of abnormal amounts of the balances of another. This has been a not infrequent phenomenon of the post-War period, but an outstanding example was that of the French balances transferred to

London not as a result of higher interest rates, but as a safeguard against the fall of the franc. In explanation of this it is necessary to digress for a moment.

The War brought with it abnormal production and expenditure—largely unprofitable, inasmuch as the material produced was destined for rapid destruction. The credit systems of the belligerent nations were unable to withstand the strain and, in consequence, resort was made to inconvertible paper in order to meet the huge demand for currency; the wealth of the country was “watered.” The result was that currency was created to carry goods and services which were, in the main, immediately destroyed, and, inevitably, the quantity theory of money began to function. Prices rose and the value of gold fell. Internal price levels being reflected in the external values of the currencies, the foreign exchanges swung away from mint pars; gold points went by the board, as did the gold standard and, when the War was over, the belligerent countries found themselves possessed of currencies having an exchange value far below that of 1914. Great Britain extricated herself in 1925 by a return at par to the gold standard; other countries had to “stabilize” at a point approximate to that to which the currency had fallen, in order to avoid the extreme hardship which a rigid deflation to pre-War figures would have entailed. Germany was compelled to make a fresh start with a new unit. Foreign nationals had, in the meantime, become frightened of their own currencies and had endeavoured to save themselves—by transferring balances to more stable centres, largely London

and New York—from the serious loss with which they were threatened. This naturally led to a weakening in the exchange value of the currency, which weakening became so serious that, for a time, restrictions were placed by the governments concerned on the export of the currency.

When the currencies were stabilized, the balances were repatriated, in spite of the fact that London rates were higher than those on the Continent, because they were needed in their own countries. A gold efflux ensued, reaching, in 1929, serious proportions and finally forcing the Bank of England rate to  $6\frac{1}{2}$  per cent, the highest figure for nine years. This ultimately stemmed the drain, though it brought no fresh gold to this country. It is interesting to note that in the following weeks the movements of the Bank Rate and gold were as shown—

		%	Millions			%	Millions
July	24	. $5\frac{1}{2}$	. £5 out	Oct.	9	. $6\frac{1}{2}$	. £1.6 in
"	31	. $5\frac{1}{2}$	. 8 out	"	16	. $6\frac{1}{2}$	. 0.9 in
Aug.	7	. $5\frac{1}{2}$	. 1.7 out	"	23	. $6\frac{1}{2}$	. 0.07 in
"	14	. $5\frac{1}{2}$	. 0.7 out	"	30	. $6\frac{1}{2}$	. 0.8 out
"	21	. $5\frac{1}{2}$	. 2.6 out	Nov.	6	. 6	. 0.2 in
"	28	. $5\frac{1}{2}$	. 0.6 out	"	13	. 6	. 0.6 in
Sept.	4	. $5\frac{1}{2}$	. 0.1 out	"	20	. 6	. 0.1 in
"	11	. $5\frac{1}{2}$	. 0.2 out	"	27	. $5\frac{1}{2}$	. 2.5 in
"	18	. $5\frac{1}{2}$	. 0.5 out	Dec.	4	. $5\frac{1}{2}$	. 0.9 in
"	25	. $5\frac{1}{2}$	. 3.6 out	"	11	. $5\frac{1}{2}$	. 3.2 in
Oct.	2	. $6\frac{1}{2}$	. 2.8 out	"	18	. 5	. 3.4 in

The gold "in" does not necessarily mean imported as a direct result of exchanges due to the raising of the Bank Rate, but that the Bank was able to acquire gold in the market.

Admittedly the circumstances were exceptional, but they serve to illustrate that gold movements are by no means the result of comparative interest rates only.

To invite the temporary loan of foreign floating capital by bidding high for its use is of little avail, unless its owners can feel assured of employing their money with safety as well as with profit, and to ensure the success of the operation it is no less essential to offer absolute security than to offer remunerative interest. It is, in fact, only because British credit ranks as it does that an advance in discount rates operates so effectually on the exchange, and though it requires a stretch of imagination to suppose that the best class of London bills could in any circumstances fall into discredit, it is, nevertheless, quite within the range of possibility that a shock to confidence, such as a great failure is liable to occasion, might, by rendering foreign capitalists chary of trusting us with their spare funds, rob a high Bank Rate of all magnetic virtue.<sup>1</sup> The Bank, as we know, depends for the replenishment of a falling Reserve on its ability to attract gold from abroad, but high rates have failed to influence the exchanges before when general credit was bad, and they might fail again.

Quite apart, too, from the question of credit, it is to be observed that the extent to which the exchanges may be affected by a given margin between discount rates is not reducible to rules, but varies in each case according to the attendant circumstances. There exists no necessary relation, no definite ratio, between the two sets of fluctuations. If the London market quotation gains, say, 1 per cent on that ruling in Paris, the exchange is fairly sure to exhibit some sign of the consequent

<sup>1</sup> Cf. the position in August, 1931.

investment demand; but what the actual rise will be no one can foretell, for other influences are always at work, which may either hasten or retard the upward movement. The investment buying itself is also not of uniform strength, but will be greater or less according to the condition of the foreign markets, and to the opportunities that offer for the advantageous use of spare money at home.

#### GOLD MOVEMENTS

To sum up our investigation into the influences that control the course of the chief exchanges, we find that, excluding the political factor and the possible effect of shocks affecting confidence, the amount of the deviation of the Exchanges from par is a measure of the strength, either united or counteractive, of two distinct forces—relative indebtedness and the relative value of money; and that the latter, unlike the former, is the outcome of conditions that are known and susceptible of artificial regulation.

Why an advance of the official minimum should be regarded as a means to the attraction of gold is now apparent. It is argued that if Bank Rate goes up the market will follow, or can be made to follow; that if the market rate for three months' bills rises above the corresponding charge in Paris and Berlin, etc., Continental capitalists will probably invest much of their floating funds in London paper; and that, if the supply of remittances on this country falls short of the effective demand, some part of the balance due to us may have to be sent in gold. It is assumed, in short, that the Bank

of England, by acting on the relative value of money, will be able to turn the exchanges in our favour, and, ultimately, to force them up to gold point.

In the working out of this process little difficulty is experienced until the final stage is reached. So long as credit is good here, high interest almost invariably leads to a rise of the exchanges, but it is noticeable that, when on the very verge of gold point, the upward movement almost as invariably receives a check. This is explainable to some extent by the existence, in addition to bills of exchange and the precious metals, of a third means of remittance, consisting of the so-called "international" securities. Stock exchange securities are ordinarily bought and sold only on the stock exchanges of the country of issue, but there are a few issues of bonds and other securities which enjoy a wider market, being quoted and dealt in on foreign bourses as well as on the London Stock Exchange. These can be bought in one country, and sold in another, at practically equivalent prices, and are hence available in case of need as a medium for the transmission of capital; but as the operation involves the expense of insurance and brokerages, as well as loss of the margin between buying and selling prices, it can only be resorted to with advantage when bills are exceptionally dear, and, in the matter of expense, there is probably little to choose between a shipment of bullion and a shipment of securities. When, however, an advance of the exchange is suddenly arrested just below gold point, it may mean that the "arbitrage" of bonds is beginning to yield a profit.

Another reason is that a high exchange invites speculation for the fall. When cheques on a foreign centre are quoted at a rate approaching one of the gold points, there is plenty of room for a movement away from the gold point but very little for further movement towards it, and speculative interest may spring up, based on the prospect of a return in the direction of par before the maturity of current bills. This in itself would have a corrective effect on the rate.

In spite, however, of all counteractive agencies, experience proves that, in the long run and in ordinary conditions, a high Bank Rate rarely fails to draw gold hither from one point or another. There may be protracted delay, but it is almost sure to come at last.

Now, as an increase of the Reserve must, sooner or later, be followed by a reduction of the official minimum, it is natural that the bill brokers and discount houses should give attention to the possibility of an inflow, and that, when gold point is close at hand, the further movements of the exchange should be reflected in the fluctuations of the market rate. If the exchange continues to gain, we find that discount weakens, because dealers, in their anxiety to secure as many bills as possible before the anticipated fall, begin to outbid each other; if it relapses, discount hardens, because it is feared that the Bank may be forced to give the screw another turn. So intimate, sometimes, is this connexion that it is difficult to distinguish between effect and counter-effect, or to say whether the exchange controls the discount rate, or the rate the exchange.

Immediately it becomes known that gold has actually arrived,<sup>1</sup> the market quotation gives way—the fall being greater or less in proportion to the quantity of money seeking employment, and to the magnitude of the receipts—and the exchanges follow; for as London bills now yield a lower return than before, the investment demand ceases, and the price declines for want of support. The fall is hastened by sales on the part of those who, having bought on the basis of the higher discount charge, take advantage of the relapse to realize at a profit. Thus, to take an example from the conditions that once obtained and may obtain again some day, if discount here is at 4 per cent, and Berlin quotes London 20·50 cheque and 20·30 for three months' (leaving stamps, etc., out of consideration), it is evident that a drop to 3 per cent must reduce the margin between short and long by five points to 20·50–20·35, so that those who had previously bought long at 20·30 could in theory gain about  $\frac{1}{4}$  per cent either by re-selling at 20·35, or by the more usual course of remitting the bill to London for discount and drawing against it. The competition of sellers would, however, force them to accept a lower price—say, 20·47 $\frac{1}{2}$ –20·32 $\frac{1}{2}$ ; and if discount, while going down here, were going up in Berlin they might perhaps be willing to relinquish the whole profit, making the rate 20·45–20·30; while, finally, if money were now worth more at home than here they might even sell at a loss.

<sup>1</sup> In practice, on the completion of arrangements for a gold shipment, the bullion arbitrageur sells the foreign currency which the shipments will produce, because if he waited till the arrival of the metal, the exchange might go against him and deprive him of his profit.

The following fall of the German rate will illustrate the foregoing explanation—

Date	Gold Movements during Week	Bank Rate	London Market Rate	Berlin Market Rate	London Cheque in Berlin	3 mos. London in Berlin
Oct. 3rd	£339,000 out	Raised to 5%	4½%	3½%	20 48½	20.25½
„ 10th	764,000 in	5%	3½%	3½%	20.45½	20.26
„ 17th	393,000 in	5%	3½%	3½%	20 42½	20.24
„ 24th	22,000 in	5%	3 %	3½%	20.36½	20.22½

As the effect of an advance of Bank Rate to 5 per cent the stock of bullion soon registered a large gain, and the market, believing pressure to be over, competed so eagerly for bills, that within three weeks the rate had broken away to 3 per cent, although the official minimum remained unchanged. The German exchange, it will be seen, followed the downward course of the market, but it is noticeable that whereas a fall in discount from 4½ per cent to 3½ per cent, when London was above Berlin, only brought the exchange down three points, a fall from 3½ per cent to 3 per cent, when London was below Berlin, brought it down six points.

Although the property of influencing discount quotations has, for the sake of brevity, been ascribed to the “exchanges” in general, it is to be observed that only those rates affect the market, the rise or fall of which is attended by the possibility of an eventual gold movement, and that this condition is fulfilled by very few. Gold, it is evident, can be had only from countries that have it to give, and are willing to give it. The principle is necessarily, at the present time,

entirely inoperative as regards this country, but may still apply to the countries remaining on the gold standard.

In former days the exchanges that brought gold to the Bank of England were practically reducible to three, namely: those of France, Germany and the United States. These were all wealthy nations, all holders of large stocks of metal, and were all able to bear a withdrawal of one or two millions without, as a rule, seriously feeling the loss. France we may add, is to be understood as including Belgium and Switzerland, the rates of which, though often more in our favour than the Paris quotation, never differed relatively by more than the cost of sending specie across the frontier. The Dutch and Scandinavian exchanges are also omitted, because they were prevented from attaining gold point by the arbitrage operations of Berlin bankers, and were, therefore, to a great extent subordinate to the German rate. Supplies also reached us (and still reach us) from Australia and South Africa, but these imports stand on a different footing. Being gold-producing countries, Australia and South Africa ship the produce of their mines as an article of merchandise, and in payment for goods received, just as they send copper or fruit.

Turning to the other side of the question, that of exports, we again find that France, Germany, and America took the lead. Before the War the rest of the world bought and borrowed so largely from us that there was rarely any question of the exchanges being against London. In exceptional circumstances, such as the issue of a new loan,

they might on occasions swing round to gold point, but their normal condition was favourable. How, then, one might ask, were the numerous withdrawals from the Bank of England for various destinations to be accounted for? The explanation is simple. Many withdrawals were not exchange operations at all, but were shipments "to order." This or that foreign government happening, let us suppose, to be in want of gold for some purpose or another—for example, for political reasons—instructed its banker to buy a certain quantity as cheaply as possible, and to debit it with the cost; and as London was the most accessible of the gold markets, the banker sent the order to his agent here, who executed it by taking bars from the Bank.

The Bank's losses of gold, therefore, could not all be put down to the working of the exchanges; but, on the other hand, neither could all its gains. It is said, for example, that money used to be cheapened, for the purpose of floating a new loan favourably, by the arbitrary import of bullion.

Notwithstanding the possibility of these casual interferences, the ebb and flow of gold was determined in the main by the action of the exchanges.

#### THE EXCHANGE EQUALISATION FUND

But if the countries exercising a regular exchange of gold were few, most of the Western World maintained a more or less effective adherence to the gold standard in one or other of its forms. In 1935, France is the only one of the former important centres still maintaining its free working. The position of the United States, which is on a

gold bullion standard is, however, not far behind. Holland, Switzerland, and a couple of smaller states, still maintain a precarious hold on the standard. Great Britain and the remaining "gold" countries have suspended it.

An aftermath of the War was a condition of disequilibrium between the world's productive and consumptive capacities, which brought about an abnormal fall in the prices of commodities, particularly agricultural commodities. The purchasing power of agricultural countries was so reduced that they were no longer able to buy manufactured goods which, consequently, also fell in price, though not so steeply. Country after country became involved in trade depression, and resorted to all kinds of measures—tariffs, quotas, barter, trade agreements, exchange control, etc.—in the struggle to maintain some sort of equilibrium in their trade; measures which were self-protective in intention, but so restrictive that they appear only to have deepened the depression.

There, in a brief outline, is the struggle which has been going on all over the world and which will go on until international confidence and co-operation are restored; and much must be done before that can become possible. Meanwhile, exchange control has become more prominent.

In the preceding pages, it has been shown that gold is the automatic regulator. When that fails, something else must be put in its place or international trade will rapidly go from bad to worse. Official "pegging," as has been shown, is not always effective and equilibrium of mutual indebtedness by itself is not enough, even if that can

be achieved, as the arbitrary movements of capital and the operations of speculators "fishing in troubled waters" are powerful enough to cause uncomfortably wide movements in uncontrolled rates. And it is eminently desirable that merchants, bankers and every sort of international dealer should know, at least approximately, what their foreign commitments will be worth in their own currency to-morrow and the day after, to say nothing of the need for safeguarding the community generally against uneconomic movements in prices and the price level.

In this country the control of the exchanges is exercised by means of the Exchange Equalisation Fund administered by the Bank of England.

The operations of the Control are necessarily seen, or at least felt, on the market from time to time (as are those of the French and the United States authorities) but the transactions and the accounts of the Fund are an exceedingly well-kept secret. Virtually, all that is known to the public is that in 1932 powers were taken by the Chancellor of the Exchequer to borrow by means of Treasury Bills up to £150 millions (in addition to a sum of £25 millions which already existed as a dollar exchange reserve) for the equalization of the exchanges; that the amount was increased, by the authority of Parliament, by a further £200 millions in 1933, and that the Fund is used to finance operations in foreign exchange, gold and securities.

When it is necessary to correct a rise in, say, the franc-sterling rate, it appears that Treasury Bills are taken out of the unissued reserves of the Fund and discounted in the Money Market. The sterling

thus raised is sold against francs, which therefore become dearer, i.e. there is a fall in the rate.

In time, a reverse operation may be desirable, when francs acquired as above are sold and the sterling used, in effect, for the liquidation of the Treasury Bills, which go back into the reserve. It must be repeated that the transactions of the Fund are a close secret, and the foregoing is nothing more than a partial outline of what is assumed to be its method of working.

The purpose of the Fund is not the manipulation of the exchanges for the advantage of this country at the expense of others, but the levelling out as far as possible of minor variations and the steady-ing of broad movements—and the spoiling of the market for speculators. In this it has been singularly effective. It is, however, only an expedient, and the "City" looks forward to the day when stabilization by the leading countries of the world will render possible their return to gold.

#### TREASURY BILLS

Reference has been made in the foregoing pages to bills of exchange, particularly bills having their origin in the sale and purchase of commodities and payable at some date (usually three months) after the date of the drawing or after "sight" by the drawee.

Great numbers of such bills were drawn on London banks and accepting houses and on merchants and traders of all classes and that was the class of bill that formerly filled the portfolios of the English banks—the "fine bank bill" predominating.

Among other changes that the passing of time

has brought, however, is a very large decline in the finance of trade by means of bills. This is partly accounted for by reduced overseas trade, and to some extent reflects the increase in "cash" as opposed to "credit" transactions which one would expect to find in disturbed times. In these circumstances the banks would have found it quite impossible to maintain their traditional proportion of bills amongst their assets but for a fortunate increase in the issue of British Government Treasury Bills more or less commensurate with the decrease in commercial bills. The fact that the increased supply of Treasury Bills has so conveniently adapted itself to the gap may, of course, be entirely fortuitous but, for what it is worth, the suggestion is made that the capacity of the market to absorb supplies at the low money rates which it is the Government's present policy to maintain, may have had something to do with it.

Treasury Bills, it is said,<sup>1</sup> were first suggested by Walter Bagehot in 1877. The English Treasury, he pointed out, had the finest credit in the world and should learn to make use of it. A bill nearly resembling a commercial bill of exchange would probably be favourably received and command good terms. His prediction was correct, and although the conditions of issue have varied slightly from time to time, Treasury Bills have been a feature of Government borrowing ever since. Before the War the amount issued was not important, but they were so convenient and so very acceptable to the market in the absence of commercial paper that they early played a

<sup>1</sup> Thomson's *Dictionary of Banking*.

large part in war-time finance. In 1920 the total outstanding reached the enormous figure of £1200 millions. Since then the amount has decreased, though irregularly, and on 7th September, 1935, stood at £884 millions, of which £525 millions were of the ordinary issue by tender, and the remaining £359 millions special issues.

The bills are now issued in denominations of £5000 and £10,000, normally in response to a weekly tender (which must be for multiples of £50,000) by the banks and the market. As they are all three months' bills (or rather promissory notes) the average amount of the "tender" issue falling due each week is about £40 millions and tenders for about the same amount to replace them are invited.

In the circumstances, the Treasury Bill, from being a relatively unimportant factor in the market, became one which virtually controlled the bill rates generally.

It had the quality of unquestionable security, and it followed, therefore, that where the Treasury Bill could be obtained (and there was of necessity no dearth), no one (except the Continent, whose central banks' discount regulations often prohibit their taking "one-name" bills) would prefer to take commercial, or even bank, bills at a higher price. This meant that there could be no market in trade bills, except on a price basis dictated by the price of Treasury Bills, or else for foreign investment. From the point of view of Government borrowing, the Treasury Bill has the advantage of being a short-dated security, enabling the Government to obtain the benefit of cheaper

money. There is the disadvantage at the present time (though this is not a disadvantage inherent in the Treasury Bill) that the National Debt is of such magnitude that the Government is almost forced to borrow by means of the Bill whether it likes it or not, and whatever the price of money. Fortunately, money rates at the present time have fallen to record low levels.

## CHAPTER X

### THE OPEN MARKET FOR MONEY IN LONDON

OF all the articles bought and sold in the London markets it would be difficult to name any one the price of which is subject to greater and more sudden changes, or is liable to be influenced by circumstances more numerous and complicated, than is that of loanable capital or market money.

From day to day, and sometimes almost from hour to hour, market rate may vary; and its movements are remarkable not only in point of frequency, but also for their width of range. To-day, for instance, the current charge for discounting a three months' bank bill of £1000 may be £5, and a month hence may have fallen 40 per cent to £3, or have risen 100 per cent to £10; in other words, 2 per cent, 1·2 per cent and 4 per cent respectively.

This price, like that of other commodities, is dependent in the main on the equation of supply to demand or, to be more exact, on the ratio between the amount of floating capital that lenders have available for immediate employment, and the amount that borrowers, who have satisfactory security to offer, are in immediate need of (i.e. the effective demand). But to render this definition intelligible it is necessary that we should first know, on the side of supply, what loanable capital consists of, how it is generally employed, and in what manner it becomes available for immediate use.

The general loan fund of the country is held by the banks, and is made up of customers' deposits, on which low interest is paid, and of current account balances, on only a part of which interest is paid. If it were their own money that bankers lent out, the low rates that borrowers are accustomed to would be altogether out of the question. But the money so used is what has been lodged with the banker by his customers, and for a great part of it—probably one-half—he pays nothing. Consequently the banker can afford, if "deposits" are large in proportion to capital, to lend very cheaply, and yet be able to secure a satisfactory profit. Some banks indeed—the clearing banks—hold customers' money to as much as twenty or thirty times the amount of their paid-up capital, and could thus pay a fair dividend if that money returned them no more than 1 per cent net.

From the published accounts of the joint-stock and private banks of England and Wales (exclusive of the Bank of England) it appears that at the end of 1933 the total deposits amounted to something in the neighbourhood of £2000 millions.

All this borrowed capital, with the exception of the varying proportion (usually about 10 per cent) reserved to meet withdrawals, has to be made use of somehow; and from its very nature—being repayable on demand, or at short notice—must necessarily be laid out in securities that are realizable without difficulty or loss.

Next to his notes and coin and balance of cash in the Bank of England, which we have written of as his first line of defence, the banker lends some 5 per cent to 8 per cent of his deposits to the bill

brokers and discount houses and to members of the Stock Exchange. The security must be unimpeachable and the loans are repayable at call or short notice, usually seven or fourteen days. These we have called the second line of defence. The third line of defence consists of first-class bills of exchange, which he buys (discounts) to the amount of some 15 per cent of his liabilities. From the fact that they are self-convertible, turning into cash automatically and at par, they constitute a very valuable asset, and a strong portfolio is considered so indispensable to the safety of banking business that in every case a due proportion of bills forms a leading feature of the banker's securities.

After bills, the next best outlet is to be found in gilt-edged Stock Exchange securities, which account for about 30 per cent of the assets of the clearing banks; with ordinary advances to customers as the final item amounting to some 35 per cent to 40 per cent.

#### SHORT LOAN FUND—SUPPLY

The exact amount of money which constitutes the total sum lent, and available for lending, by the banks to the market, which is called the short loan fund, is difficult to estimate. Taking the figures of the ten clearing banks for March, 1930, it will be found that the average for the month totals £184 millions in the case of Bills Discounted, and £135 millions in the case of Money at Call and Short Notice. To these figures must be added those of the other banks, non-clearing, foreign and colonial. In 1930, Mr. H. W. Greengrass, in his

*Discount Market in London*, estimated the total at the colossal figure of nearly £900 millions.

Supply is not limited, however, to the steady inflow of "old" money seeking re-investment. A pressure of "new" money frequently makes itself felt. The country in ordinary times earns more than it spends, and the accretion of savings, unless carried off by an expansion of trade, aided by home and foreign loans, etc., flows into the banks, and from the banks into the market, until some approved opening can be found for it. In that case supply becomes redundant, and rates are forced down to a low level; but company promoters bestir themselves to improve the opportunity, and there are, or were, always foreign states ready, whenever money was plentiful, to invite our assistance in the exploitation of their undeveloped resources, until, by one means or another, and sooner or later, the surplus is absorbed into permanent investments and the equipoise of supply and demand is re-established.

The enormous figures above referred to do not, of course, obtrude themselves upon the daily notice of the practical banker or broker. Short loans, once established, tend to continue with comparatively small variations from day to day; similarly the bill portfolio of each bank has a continuous existence, only the maturities of each day having to be replaced—with some addition or reduction according to the circumstances of the moment.

#### DEMAND

As regards the general demand for loanable capital, it consists, as was said, of the immediate

requirements of those who have acceptable security to offer. For the present we confine our attention to the needs of the discount market, which can be translated as the quantity of *good* bills that borrowers are desirous of converting into cash. Those borrowers (or, to be more precise, sellers) are the merchants and manufacturers of the country, and the extent of their requirements varies with, and is dependent upon, the state of trade; for as the settlement of business transactions (especially those with foreign countries) is partly effected by means of bills, it follows that the greater the volume of trade the greater will be the number of bills drawn, and the greater also the quantity tendered for discount.

Because of the intervention of the bill broker, it is scarcely correct to speak of a money market demand by the merchants and manufacturers of the country. The transactions of the latter, in so far as they are conducted with bill brokers and not with their own bankers, result in an appreciable proportion of the supply of the bill brokers' trading commodity. The real demand is by the brokers and is only indirectly dependent upon the supply of bills arising from the commerce of the country. It by no means follows that a bill drawn by a manufacturer or merchant sets up a "short loan" demand by a broker; nor does it follow that a broker's demand is dependent on the supply of bills from such producers.

The broker's stock-in-trade, in other words, comprises not only such bills as come forward in this manner, but also, and to a predominant degree at the present time, Treasury Bills; and one must

not lose sight of the fact that Treasury Bills have intruded in the "market" to an extent unheard-of before the War, seriously disturbing the market's equilibrium. The subject is dealt with more fully in the chapter on the War and post-War influences on the market and the exchanges.

To revert, creation of more paper is not the only effect of better business. It also implies that the number of bills brought to market will bear a higher proportion than hitherto to the total in existence. Seeing that, when orders are coming in freely, traders are always anxious to turn over their capital as fast as possible, and to discount every remittance as soon as received, in order to employ the money in fresh purchases, and that, on the other hand, they try, when there is "nothing doing," to avoid the accumulation of an idle cash balance by discounting no more than is necessary to meet previous engagements (unless they are working on an overdraft, in which case it may be more profitable to discount in order to reduce the debit balance), it is evident that improvement of trade signifies a relative as well as an actual increase of demand.

More trade, therefore, means more bills, larger calls on supply, and higher rates; less trade means fewer bills, a falling-off in demand, and lower rates. But, at the risk of over-emphasis, it must be pointed out that at the present time, this is subject to the predominating influence of Treasury Bills.

Again, the Stock Exchange, though not commonly counted a part of the Money Market, must, from the part it plays in the demand upon the

Short Loan Fund, be considered in this connexion. Much of the money lent by the banks at call and short notice is employed by stockbrokers and jobbers in financing the very considerable volume of business transacted on the London Stock Exchange. The demand here is, perhaps, more variable, increasing and decreasing very markedly with the alternating phases of feverish activity and comparative tranquillity.

The demand for money, leaving aside the weekly offer of Treasury Bills, is thus the summary and product of all the complex influences that affect the current condition or the future prospects of the world's markets, and, as such, is incessantly fluctuating, carrying with it the money and discount rates. It is almost entirely to the variations in the demand for loanable capital that the constant changes of rate are due. Supply may, by comparison, be regarded as an almost constant quantity. From its nature, demand can only be treated in the abstract. No figures are available that will enable us to gauge more than very approximately the quantity of bills that is likely to come forward next week or next month. If the Board of Trade Returns, the Clearing House Returns, the Railway Returns, etc., all tell the same story of an increase, we can be fairly sure that trade is improving, and that next week or next month the demand will have grown; but what the growth will be, or just when it will begin to be felt, is what we cannot know for certain. And besides, the conditions under which business is carried on are gradually changing. There is reason to believe that each year more and more

transactions are conducted on a cash or sight basis, and that the number of "time" bills now created bears a diminishing ratio to the volume of commerce. Instead of settlement by bill, a growing preference appears to be shown for settlement by cheque, cable transfer, or "sight" draft drawn under a credit—means of payment that avoids the uncertainties of a fluctuating discount rate, save the *ad valorem* cost of bill stamp, and reduce the risk of loss to a minimum. Scarcity of bills (partly comparative, owing to the growth of the loan fund) is indeed a long-standing grievance with lenders, and is substantiated by the high price that bankers now have to pay for them under the stress of competition.

The approximate distribution of bank assets has already been mentioned, but it will be helpful to take a glance at some actual figures.

The following items are taken from the published average figures of the combined Clearing Banks for August, 1935. The ratios of the assets to liabilities on current and deposit accounts are given in the right-hand column.

<i>Liabilities</i> (000 omitted)	<i>Assets</i>	<i>Ratio</i>
£	£	
Current and Deposit Accounts . . . . . 2,013,231	Coin, Notes and Cash at the Bank of England . . . . . 213,300	10.5
	Money at Call and Short Notice . . . . . 148,549	7.4
	Bills Discounted . . . . . 286,868	14.2
	Investments . . . . . 615,217	30.5
	Advances to Cus- tomers, etc. . . . . 764,511	37.9

As interest is allowed on only a part of the Deposits, it has been stated that it is not necessary

that a rise of 1 per cent in the deposit rate which the banker has to pay should be followed by a rise of 1 per cent in his quotations for interest he has to receive. However, the point has been overlooked here that his fixed investments (Stock Exchange securities) are of a permanent nature and, once having been bought, provide a rate of interest which is also fixed and does not change with variations in the Bank Rate. Over a long period, yields may gradually be increased or reduced as the effect of conversion schemes and re-investments, but that is another matter. Advances again, to ordinary customers sometimes vary with the Bank Rate, but often do not. Money at Call and Short Notice, Bills Discounted and some proportion of Advances are thus the only items that are definitely affected by changes in Bank Rate, and they form a proportion of the whole which may, and probably does, bear some very rough correspondence to the proportion of the interest-bearing deposits to the total deposits. However this may be, in practice it has become the rule to quote both deposit rates and the major part of the short loan rates at definite figures below or above Bank Rate, varying with it. Discount rates, as has been shown, are not thus fixed, being subject to market conditions, but as bills are in the main bought first by the bill brokers with money borrowed from the banks, their price to the banks must bear a somewhat close relationship to the cost of that borrowed money. Thus, a rise of, say,  $\frac{1}{2}$  per cent in Bank Rate, carrying with it a rise in the deposit rate of  $\frac{1}{2}$  per cent must cause a rise of  $\frac{1}{2}$  per cent in short

loan and, probably, discount rates or involve the banker in either an alteration in his profit basis or a descent into impracticable quotations in minute fractions.

It may be mentioned here that the cheapness of call and short notice money lent by the banks to the market, as compared with the return on Investments and Advances to customers, results from the fact that it is the banks' most liquid asset next to cash, and if they could not lend it on perfect security, subject to immediate recall or very short notice, they would not risk employing it at all and then it would earn nothing. On the other side, the bill brokers' capacity to pay is limited by the return on the commodity in which they deal. Further, though the point is hardly germane to the subject of the money market, the dearness of money advanced to ordinary borrowers as compared with money lent to the market does not imply injustice to the former. A very small proportion of the banks' return on their assets taken together represents profits for the shareholders, the majority going to meet the cost of the services they render to their customers.

#### VARIATION IN RATES

Next to the interaction of supply and demand, the chief influence that governs market rate is the rise and fall of the official minimum. As we already know, there is a necessary connexion between the two, and when the Bank Rate goes up, the market follows and, further, if there should exist good ground for anticipating an upward movement, the outside rate will take the lead.

Why the market grows firmer when gold goes out, for instance, is not so much because the removal of a million makes any appreciable difference in supply, but rather because the possible consequence of a reduction in the Reserve has the effect of making lenders more cautious, and borrowers more eager to borrow before the rise takes place.

As a matter of course, a fall of the official minimum is usually attended by a fall of market rate; but, as regards the advance, it is necessary to distinguish between a movement due to real, and one due to artificial, causes. Bank Rate may be raised in consequence of an increased demand, which is a real cause, or it may be raised quite irrespective of the actual value of money, simply to check a drain of gold, and protect the Reserve. In the former case the Bank and the market rise in unison, because the same cause acts on both; but in the latter the Bank alone is really concerned, and though other dealers may endeavour, on the strength of the official announcement, to exact a higher charge, supply may prove too much for them, and they are forced to moderate their pretensions. On such occasions there is frequently a very wide disparity between the two quotations, and if it were not for the dependence of deposit rate on the Bank the difference would be even wider. Where, again, the demand for bills is keen and money is cheap, the discount rate may fall away until there is an appreciable disparity between it and Bank Rate. In that event a fall in the latter may be anticipated and its arrival frequently has little influence on the market quotation.

## THE RISK FACTOR IN RATES

There is one other factor that enters into the composition of discount rates, and that is credit, or the standing of the parties to the particular bill. In every loan operation the lender, before fixing a rate, has to decide for himself whether there is reasonable certainty of repayment at the stipulated time, and of repayment in full. If quite satisfied on both points, he charges only for the use of the money and for his trouble, but, if there is any room for doubt in the matter, he also charges for his risk, and thus makes the borrower pay an insurance premium in addition.

At the same time, it is a principle of good banking that no rate is high enough for a doubtful bill. This variable element is, therefore, usually absent from the quotations for "bank" or "fine trade" bills, only making its appearance in times of disturbance, when the general disinclination to lend on any security whatsoever causes an all-round advance, but its effects are distinctly visible in the great diversities of charge that are always co-existent; for loanable capital has as many different values as there are degrees of credit, from the 60 per cent charged by the moneylender to the 1 per cent charged by the banks to the bill brokers in the last few years.

Less and less, however, does the risk element enter into banking charges as between one borrower and another. The "liquidity" of different classes of loan, and the trouble of handling and watching the different classes of security, have the greater effect.

## THE BILL BROKER

No detailed reference has yet been made to the very important part performed in the economy of the discount market by the middleman, through whom, in practice, nearly the whole of the better class of business is transacted.

At first sight, the need of an intermediary may not be apparent; and, from the fact that every banker discounts for customers as part of his regular business, it would be natural to infer that the stock of bills shown in his balance sheet had been acquired at first hand. Generally speaking, however, it is not so. A considerable amount of paper may and does go direct to the banker, especially in the provinces, but the bulk of the superior sort, of the bank and best trade bills, passes through the hands of the London "bill brokers" (or bill merchants, as it would be more correct to designate the majority of them) and discount houses, which include nine joint-stock companies with large capital and a dozen private firms.

The broker's business is to buy from merchants and, in the case of Treasury Bills, from the Government, and to re-sell to bankers; and, as his turnover is usually on a considerable scale, a very small difference in the rate is sufficient to remunerate him.

The explanation of the practice of banks in buying from brokers rather than from the actual suppliers (the first holders in this country) is that it is simply a question of division of labour. Bill discounting is really a trade by itself, and a trade that requires extensive knowledge of a

very special kind. The discounters must have the financial and moral standing of hundreds of commercial houses at his fingers' ends. He has to find out, if possible, who X is, and what his history is; whether he speculates, or accepts too much; whether he was involved in any recent failure, or has lost by the fall in copper or silver or whatever commodity he trades in; and, according to the mental estimate which the banker or broker thus forms of the state of X's affairs, he is guided as to the amount of X's acceptances that it is safe to hold. In a word, he must know men and their means, in order that he may be able to tell a good bill from a bad one. And further, unless his mental estimate is kept posted up to date it soon becomes useless, so that he must always be looking for fresh information. Knowledge of this sort, it is evident, can be acquired only by long experience and the exercise of great judgment; and the broker, to whom it is of vital importance, gives his whole mind to it. Formerly, it appears, a banker was content to rely on the brokers' judgment and considered a fractional difference in the rate a reasonable price to pay for the guarantee of the brokers in respect of all the bills they sold him. Now, however, the banks not only maintain their own information departments to assist them in their appraisal of the bills they buy direct, but seldom take other than Treasury Bills and bank acceptances from the market. Nevertheless, it must be remembered that "bank acceptances" is a wide term and covers more than acceptances of the best banks only, and the banks are still glad to have the backing

of the brokers to their bills. There is another reason for the banker's employment of the middleman. The former likes to buy his bills according to the state of his portfolio and his available funds, and he likes to specify the dates, or approximate dates, upon which his purchases shall mature. The broker buys as he can, and it is part of his business to select and group his bills into parcels acceptable to the banker.

From this it will be seen why the "bill broker" is a bill merchant rather than a broker. The term "brokers" would be more accurately applied to a small number of firms who sometimes act as intermediaries between banks and the market, and who sell without recourse. These, however, are known as "runners" or "running brokers."

The holder of bills which it is desired to turn into immediate cash also derives benefit from the existence of the broker, as the latter, under the stimulus of competition, gives him a better rate than he could obtain from his own banker; and as the merchants of Manchester, Liverpool, etc., as well as those in London, offer the pick of their remittances in the London market, the result is that all the best paper in the country comes to that market.

The broker may be considered as a dealer in floating money, for his function is to take such of the banks' cash as is not immediately required, but which it is not desired to tie up for long, and, by his organization, to give it a certain fixity and thus to convert it to the use of industry and the State. Loans to the brokers are in many cases literally ephemeral, but out of such transitory balances

they are enabled to make advances for three months or more by the discount of bills.

What happens in practice, very briefly, is this. The bank Treasurer (whether that be his official title or not) is faced each morning at the opening of business with an ever-recurrent problem which centres round the preservation of his cash ratio. Starting from his overnight position, he has money coming in, money going out, bills maturing, investments to pay for and so forth. In addition, experience will tell him how his deposits are likely to move during the day and whether money generally will tend to be short, comfortable or plentiful. By the end of the day, he must have so operated that the various assets, cash in particular, will continue, as far as may be, to bear their proper proportions to his liabilities.

Amongst his assets, as we have seen, are Loans at Call and Short Notice, and Bills Discounted, and it is these items which are the subject of his daily intercourse with the market. The majority of the loans are on a day-to-day basis, and most of the remainder are fixed for short periods with a proportion falling due each day. Thus, the banker can count on a considerable sum from the market, if he needs it. But generally he will agree to continue these loans. There is usually, however, a variable addition to the total of this regular money. Neither the banker nor the broker can make up his books with mathematical exactitude. The former, therefore, arranges matters so that his regular loans and his cash are at safe working levels, which implies a margin of "surplus" money which acts as a buffer, moving about with the

ebb and flow of the clearing and sometimes, as has been seen, out of the market altogether. The brokers are often glad to draw on this surplus, when and where it is available, in order to balance their accounts, and as they usually borrow such money late in the day, when both banker and broker can see how the day's work is tending, until the next morning only, it is called "night money." Night money is repaid without the formality of being called, and owing to its uncertain availability is known to the market as "bad" money. The epithet is also applied to the uncertain loans of the smaller banks who are not regular lenders.

The Treasurer, then, having night money to come in, bills maturing and various contingencies to allow for, lays his plans and awaits the routine visits of the bill brokers. A few words with each suffice to arrange the continuation of the loans, or the calling-in of some part of them, and the purchase of bills to replenish the portfolio. Later in the day the brokers' clerks call in to give effect to the business that has been agreed upon.

The broker, for his part, employs his own capital and the money entrusted to him by the banks, as we have seen, in the purchase of bills. These are deposited with the banks as security for their loans until sooner or later they are re-sold.<sup>1</sup> The broker thus always carries a large floating stock of bills, profiting by the difference between the cost of his money and the yield on the bills and making a further minute profit on their price

<sup>1</sup> The practice of requiring security for money lent to the bill brokers is said to date from the failure of the Overends, who held millions against their mere acknowledgment.

when he sells. Perhaps one should say that he hopes to profit in these ways. Circumstances sometimes prevent his doing so; in recent years particularly, brokers have had to work at a loss for long periods owing to entirely abnormal conditions and more than one old-established firm has given up the struggle.

It is of course evident that, under ordinary circumstances, the incomings of the brokers as a body on any particular day must about balance the outgoings, as the amount "called" by those bankers who are "short," makes those to whom it is transferred "over," and is lent out again by the latter. But when money is taken clean out of the market, as, for instance, when bankers are preparing for dividend and coupon payments, etc., they find it necessary to strengthen their balances, and the money "called" for that purpose has to remain locked up for a day or two. The brokers, the conditions of whose business preclude the carrying of large reserves of cash, are then compelled to seek assistance at the Bank of England, which, if the applications are heavy, sometimes takes advantage of the situation by raising the charge for loans to perhaps 1 per cent over Bank Rate, so that the broker then stands in the peculiar position of having to borrow at perhaps 5 per cent with one hand, while at the same time taking in bills from his customers at  $3\frac{1}{2}$  per cent or 4 per cent with the other, for it must be remembered that whatever the broker may be paying for money, he cannot possibly refuse to discount for regular customers, and he is always expected to quote below Bank Rate. It may be mentioned in

passing, that in 1858, as a direct consequence of the panic of the previous year, the Bank refused to help the brokers by re-discounting for them, but its willingness to assist is now almost taken for granted, though it is very strict in regard to the class of bills it will take.<sup>1</sup>

An increase of the Other Securities, showing that recourse has been had to the Bank, sometimes affords a good clue to the course of the market, as it proves that the outside supply of money has run short.

In addition to day-to-day money, discount houses and broking firms hold large deposits at short notice; and, like the banks, base their deposit rate on the Bank Rate, borrowing in fact at a slightly higher rate than that allowed by the clearing banks on deposits. Unlike the banks, however, they do not get any part of their money for nothing; and, as they make their profit out of the difference between the rate at which they borrow and the rate at which they lend—that is to say, out of the difference between deposit rate and market rate—they have to submit to a reduction of profit, if not to actual loss, whenever the disparity between market rate and Bank Rate is wider than usual. An accusation that has been levelled at the bill brokers as a body is that of “beating down” rates and thus rendering the Bank Rate inoperative. There may be some truth in this though it is obvious from the foregoing that the interest of the chief houses, which hold large deposits, lies in just the opposite direction.

<sup>1</sup> Even in August, 1914, the Bank intimated that it would not be prepared to grant accommodation to bill brokers; but the decision was rescinded the same morning as it was made.

But it is difficult to see how it could be otherwise, for they not only compete with each other, but are in the anomalous position of competing for bills with the very people to whom they hope to sell them at a profit—the banks.<sup>1</sup>

#### LOANS TO STOCK EXCHANGE

However suitable bills and money-market loans may be as an investment for loanable capital, the outlet thereby provided is totally inadequate to carry off more than a fraction of the millions for which employment has to be found; and the banker, being forced to look elsewhere for means to mobilize the greater part of his customer's money, resorts, in the first place, to other loans and advances, which, in point of magnitude, constitute his principal asset. The second largest of his assets consists of investments in first-class stock exchange securities and of them nothing more need be written.

The other loans and advances referred to are divisible into two classes—

(a) trade and personal advances, by way of loan and overdraft;

(b) loans to members of the London Stock Exchange.

The first mentioned, although of considerable bulk, may be dismissed in a few words. Being transactions of a special nature, each application is dealt with on its merits, and the rate charged by the banker for the accommodation varies

<sup>1</sup> "Clare," Second Edition: The real culprits, it is far more likely, are the banks themselves, who, rather than keep money idle, offer it at constantly decreasing prices.

according to the circumstances of the case, but is usually based upon Bank Rate.

As regards the second class, a portion of the surplus funds is disposed of in loans from day to day or fortnight to fortnight on the London Stock Exchange. The attraction presented by this mode of employment lies in the fact that, while involving comparatively little risk or trouble, it yields a relatively high return, anything from  $\frac{1}{2}$  per cent below Bank Rate to, say,  $\frac{3}{4}$  per cent above being charged. Jobbers in the gilt-edged, or "Consol" market, who borrow on a day-to-day basis, have the advantage of the best rates; the general run of stockbrokers, working from one account day to the next, pay at the higher level.

From the banker's point of view a loan to a member of the House is a very simple and easily managed affair. On account day, the broker ascertains how much he wants to carry him over and calls on his banker to learn how much the latter is prepared to lend. The securities are deposited, giving a margin dependent upon the nature and type of the securities, and the credit is received. Securities are usually valued at the so-called "making-up" price, which is officially fixed for each stock at every settlement. The loans run from one settling or account day to the next, and a renewal is treated in every respect as a fresh transaction, the securities being revalued at the new making-up price, and additional cover given if the value has fallen below the limit. The Consol jobbers take their loans in much the same way as the bill brokers.

Contrary to a not uncommon belief, bank loans

to the Stock Exchange are not made to facilitate speculation. They are made primarily for the financing of the ordinary business of the market, in just the same way as other markets are financed. It is not always possible to balance buying and selling orders exactly, and it is not always possible to complete the whole business of transferring an investment from seller to buyer on a given day. There is necessarily, therefore, always an enormous amount of stocks and shares in the hands of the market, in reserve, as it were, or in transit from seller to buyer. All of this has to be paid for by someone, primarily the brokers and jobbers, who borrow for that purpose.

This is not to deny the existence of a very large amount of speculation which the banks, however much they discourage it, cannot prevent, under the accepted conditions, by any means short of withdrawing their support entirely. They are, however, not obliged to lend and this gives them a measure of control over the more extreme speculative element. Beyond this, they rely on the stringent rules of the Exchange and the good sense of the members. Of speculators who employ their own money only nothing need be said.

In a certain sense, every buyer of stock is a speculator for the rise, inasmuch as no one buys a stock that he thinks will fall, but the term is usually applied only to those who cannot go on holding what they have bought unless they can continue to borrow; in other words, those who buy what they cannot pay for.

If the speculative buyer, or "bull," does not intend to pay for and take delivery of his purchase

on settling day, he asks his broker to "carry over" the bargain until the next account. The broker is not bound to do so, however. He has the right to insist on payment if he pleases, or in default to re-sell the stock and charge his client with the difference; but the right is rarely exercised (unless he is prepared to lose his customer), and, if instructed to "carry over," he does so as a matter of course.<sup>1</sup> This means that he must pay for the stock himself on delivery, and, if necessary, raise the money by pledging the same or other securities with his banker. The more conservative firms on the Stock Exchange, however, discourage carrying over, or even refuse entirely to do any business on those lines.

The charge (technically known as the "contango") made to the speculator by the broker (or jobber) for carrying over is dependent on several considerations; for, though ruled to a great extent by the value of money—interest being its elemental factor—it also varies according to the volume of speculation open for the rise, according to the more or less risky character of the security sought to be "continued," and according to the supposed ability of the speculator to meet an eventual loss. As it must be taken, too, to include the broker's remuneration for pledging his credit, as well as for the use of the 10 per cent margin that he provides, and for his time and trouble, it is naturally always more than the banker receives.

Besides speculation for the rise, there is another purpose for which money is borrowed by the

<sup>1</sup> The £1 per cent stamp duty on transfers has greatly reduced contango business. Operators on the market are more inclined to cut their loss.

Stock Exchange. Whenever it can be had cheaply, large sums are laid out in dividend-paying securities, with a view to realizing the margin between the interest they yield and the rate charged for the loan. Thus, if a dealer can borrow at say  $2\frac{1}{2}$  per cent, it may pay him to buy a 4 per cent stock at par, and to pledge it on a 10 per cent margin, the operation working out as follows—

On £1100 stock he receives at the rate of	.	.	£44 per annum
and on £1000 borrowed thereagainst pays	.	.	25 per annum
			£19 per annum
Showing a profit at the rate of	.	.	£19 per annum

on each £1100 of net outlay. This example does not take into consideration the income tax factor, but it serves to illustrate the point in question; nor does it make allowance for the fact that the full interest on a stock may not be accounted for in the price. Until the rate begins to rise, this is very satisfactory, but immediately it approaches 4 per cent, he must either face a loss or sell out; and it is on the realization that the actual result depends, for, if the stock should have declined in value since he bought, the prospective profit may be curtailed or may even disappear altogether. Bankers are said to discourage loans simply for the purpose of “running” stocks in this manner, and would almost certainly refuse them unless the borrowers were of very good standing.

Why the price of money should exert influence over the stock markets, as everyone knows it does, is now easily perceived. Securities rise when money is cheap, not only because the low return obtainable on capital employed in the outer market induces purchases for investment, but also

because those yielding a fixed rate of interest are largely bought on borrowed funds in order to secure the margin of profit, as just explained; and also because light contangos are in themselves an incentive to speculation for the rise. When money grows dear, on the other hand, prices give way from the opposite causes: that is to say, because capital can then be employed so advantageously in other directions that investment buying falls off, and because those who previously bought on borrowed money—whether for the sake of the interest difference or as a “bull” speculation—are forced into realization by the onerous charges. In securities of the class favoured by speculators it consequently happens that important fluctuations are sometimes assigned to causes that appear singularly far-fetched and irrelevant (a fall in securities which are dealt in in several leading money markets may perhaps be ascribed to a decline of the Paris cheque rate, or an advance of the Dutch bank rate), but that are quite intelligible if the principle of this relationship is borne in mind, and if it is remembered that the missing link in the connexion is the effect that operators expect to see produced in the value of loanable capital.

## CHAPTER XI

### 1914 AND AFTER

#### THE WAR AND ITS EFFECTS ON THE MONEY MARKET AND THE EXCHANGES

THIS chapter is not to be construed as an attempt to cover the post-War monetary history of Europe—it would not bear the burden; nor is it intended as a summary of those cataclysmic events which have each formed the subject of libraries of their own. It is, on the contrary, merely a guide to the events above referred to, an indication as to the possible evolution from a straightforward and peaceful monetary existence to the jungle of monetary nightmares, such as inflation, demonetization, exchange collapse, etc.; such explanation as is necessary to prepare the student of this Primer for the wealth of search and research awaiting him—as is necessary moreover to maintain the balance between the rudiments of the subject and its practical application in normal and abnormal times.

The money and exchange history of the period 1914 to date has been punctuated by statutes and radical changes in custom. The most important of such statutes and other documents are here given in full.

It has been mentioned in earlier chapters that the War has been responsible for drastic changes in the money and foreign exchange markets. The Treasury Bill has, temporarily, at least, outgrown the trade bill as the dominant factor in the

discount market ; exchanges have given way, under pressure of an overwhelming flood of paper money, until they have ceased to exist ; the gold standard has almost everywhere gone by the board ; the English are no longer an overwhelmingly creditor nation ; and a new vocabulary has become necessary for the description of the new phases through which the money economy of several nations passed—we now speak of “inflation” and “deflation,” “stabilization” and “demonetization” as if we had known them all our lives ; we discuss the “shortage” of gold as we previously thought of decreasing coal supplies. Competitive money markets and new units of currency have appeared. International indebtedness has given place to reparations, which, in turn, have resulted in an international bank with pretensions far above the functions of a mere reparations clearing house. Above all (but a point with which this book is little concerned), prices have risen enormously and fallen again, and wages likewise ; and world conditions have, in the years which have passed since the War ended, sunk into a profound depression out of which, one may be permitted to hope, they have begun to rise again.

England began its financial history of the War, in August, 1914, with the threatened suspension of the Bank Act. The crisis was overcome by means of a moratorium and the issue of an emergency currency. Without any warning worthy of mention, our relations with the greater part of Europe were cut off ; goods could not be delivered or obtained ; bills could not be collected or paid ; and this not only so far as combatant countries were

concerned, but as regards neutrals also, because of the risk of making shipment. Because also of the same risk gold points no longer had any significance, and the exchanges, even between neutrals, became so unsettled as seriously to hinder international trade. It needs no imagination to picture the intense uncertainty which prevailed, nor the serious risk of collapse which threatened those firms and businesses dependent upon foreign connexions. This position was met by the Government in several ways. Firstly, a moratorium of one month was granted to the accepting houses; secondly, loans were made by the Government to acceptors, and, in addition, the Bank of England was enabled to depart from its previous attitude of rigid refusal to accept for discount bills accepted by the London offices of foreign banks, commonly known as "foreign agencies."

The situation in the closing days of July, 1914, is well illustrated in the letter, dated the 1st August, 1914, from the Bank of England to the Chancellor of the Exchequer. The letter is given below in full, as portraying the feelings and misgivings of the directors of the Bank.

We consider it to be our duty to lay before the Government the facts relating to the extraordinary demands for assistance which have been made upon the Bank of England in consequence of the threatened outbreak of hostilities between two or more of the Great Powers of Europe.

We have advanced to the Bankers, Bill Brokers and Merchants in London during the last five days upwards of Twenty-seven Millions Sterling, upon the security of Government Stocks, Bills of Exchange, etc., an unprecedented sum to lend, and which, therefore, we supposed would be sufficient to meet all their requirements; although the proportion of this sum which may have been sent to the country must materially affect the question.

We commenced this morning with a reserve of £17,420,000 which has been drawn upon so largely that we cannot calculate upon having so much as £11,000,000 this evening, making a fair allowance for what may be remaining at the Branches.

We have not up to the present refused any legitimate application for assistance, but having regard to the depletion of the reserve, we fear that unless we obtain authority to issue Notes against Securities in excess of the amount permitted by law it will shortly become necessary to curtail the facilities which under present conditions we regarded as essential to offer to the trade and commerce of the country.

In response to this letter, the Bank was informed that, if necessity called for such action, it should "extend its discounts and advances upon approved securities" and that the Prime Minister and Chancellor of the Exchequer would not "fail to make application to Parliament for its sanction," the Bank to deduct a fair charge for risk, expense and trouble, and the profits, after this had been done, to accrue to the public.

The widening of the Bank of England category of discountable bills was the next important step. From an official point of view, the matter is put in the enclosure to a letter addressed by the Chancellor of the Exchequer to the Bank of England on 12th August, 1914, as follows—

... We are now able to announce that the Chancellor of the Exchequer has completed arrangements with the Bank of England for terminating the present deadlock in the money market and, for enabling the trade and commerce of the country to resume its normal course. The greatest difficulty arose from the stoppage of remittances to London both from the provinces and from other countries not only in Europe but in all parts of the world. This caused a breakdown in the foreign exchanges and deterred bankers from discounting bills in the normal way. To overcome this difficulty as well as that of providing traders in this country with all the banking facilities they need, the Government have now agreed to guarantee the Bank of England from any loss it may incur in

discounting bills of exchange either home or foreign, bank or trade, accepted prior to 4th August, 1914. Accordingly we are authorized to make the following announcement:

The Bank of England are prepared on the application of the holder of any approved bill of exchange accepted before the 4th day of August, 1914, to discount at any time before its due date at Bank Rate without recourse to such holder, and upon its maturity the Bank of England will in order to assist the resumption of normal business operations give the acceptor the opportunity until further notice of postponing payment, interest being payable in the meantime at 2 per cent over Bank Rate varying. Arrangements will be made to carry this scheme into effect so as to preserve all existing obligations.

The Bank of England will be prepared for this purpose to approve such bills of exchange as are customarily discounted by them and also good trade bills and the acceptances of such foreign and colonial firms and bank agencies as are established in Great Britain.

The enclosure was published the next day and tended greatly to the restoration of confidence.

#### CURRENCY AND TREASURY NOTES

The magnitude of the scale on which the War was conducted soon carried production of war materials to a stage hitherto undreamed of, but such production brought no lasting benefit, for the reason that materials and food were manufactured and grown purely to be destroyed or consumed in war service. The necessity for producing on a huge scale and in the shortest possible time meant throwing to the winds all ideas of economic manufacture or of economic purchase, which meant production and purchase without regard to cost. Those who had anything to sell which was required for the promotion of the War demanded their price, which was usually forthcoming without argument. Those goods in particular, and food,

which had to be obtained from abroad were acquired at famine prices, for the sellers realized that the buyers were in a cleft stick; moreover, shipping became an unprecedented costly business, the cost of transport increasing with the decrease in the tonnage due to war destruction and with the increase in the danger.

Again, those of the population who were engaged in munitions manufacture were in a position to command wages on a scale out of all proportion to what would ordinarily have been regarded as the value of their services. This condition arose as a result of the combination of several factors. In the first place must be considered the extreme necessity of providing a continuous and ever-increasing flow of munitions; secondly, the labour obtainable for such production was limited by the enrolment of men for the fighting services and by the fact of there being a transition period during which had to be taught a new class of workers—a class which had hitherto had no connexion with that type of industry. The effect of these two factors, combined with the existence of a Government determined to provide for the fighting services all that was required for a successful and, if possible, rapid termination of the War, led, as has been indicated, to a class of wage-earner who began the movement for higher wages throughout the country.

Finally, the situation was made worse by a psychological change in the attitude of the nation in general. Those whose business kept them in this country, having much more to spend than ever before, acted in what can only, in the circum-

stances, be regarded as a natural manner; they spent more, and obtained luxuries where before they had been able to purchase necessities only. Those whose fortunes took them into more dangerous areas decided to avail themselves of every opportunity to make the most of life, in case it did not last. They, too, therefore, spent liberally on the all too few occasions which were granted them. In fact, the whole nation became prepared to pay almost any price for anything, and shopkeepers and, to a less extent, manufacturers also, benefited accordingly—but relatively, not absolutely, because the combination of circumstances served to raise prices generally, so that every profit was less real than it seemed.

This augmentation in the total production of goods in the country, this ability to command higher wages and this willingness to spend to a previously unknown degree soon resulted in a serious shortage in currency and again the Government stepped in, becoming, for the first time in the history of this country, a note-issuing body. The need had been foreseen, for, as a preliminary to the suspension of the Bank Act, the Bank Rate was on 1st August raised to 10 per cent, to which figure it had been raised from 8 per cent, the rate of the previous day. The 10 per cent rate ruled for five days only, there then being reductions to 6 per cent on the 6th August, and to 5 per cent on the 8th, no further change taking place until the 13th July, 1916.

The issue by the Government took the form of notes (*a*) in which Bank of England balances could be cashed or (*b*) which could be borrowed by the

banks up to an amount not exceeding 20 per cent of their deposit and current account liabilities, bearing interest at Bank Rate. By August 26th, 1914, the sum taken in this way amounted to over £21 millions; this rose to £38 millions by the end of the year and the figures thereafter were—

End of 1915	.	£103 millions	End of 1922	.	£301 millions
„ 1916	.	150 „	„ 1923	.	299 „
„ 1917	.	213 „	„ 1924	.	296 „
„ 1918	.	323 „	„ 1925	.	297 „
„ 1919	.	356 „	„ 1926	.	296 „
„ 1920	.	368 „	„ 1927	.	300 „
„ 1921	.	326 „	(Nov. 21) 1928	.	287 „

Not only, however, was recourse had to Treasury note issues because of the additional volume of currency required, but because also of the need for the conservation of gold, which was in time entirely replaced by paper.

It was obvious that sooner or later the Treasury issue would have to be dealt with toward a permanent basis and the matter was delegated by the Government to what is known as the “Cunliffe” Committee, whose first interim report was made in August, 1918. The following is the summary of its conclusions—

#### SUMMARY OF CONCLUSIONS

Before the War the country possessed a complete and effective gold standard. The provisions of the Bank Act, 1844, operated automatically to correct unfavourable exchanges and to check undue expansions of credit.

During the War the conditions necessary to the maintenance of that standard have ceased to exist. The main cause has been the growth of credit due to Government borrowing from the Bank of England and other banks for war needs. The unlimited issue of Currency Notes has been both an inevitable consequence and a necessary condition of this growth of credit.

In our opinion it is imperative that after the War the conditions necessary to the maintenance of an effective gold standard should be restored without delay. Unless the machinery which long experience has shown to be the only effective remedy for an adverse balance of trade and an undue growth of credit is once more brought into play, there will be grave danger of a progressive credit expansion which will result in a foreign drain of gold menacing the convertibility of our note issue and so jeopardizing the international trade position of the country.

The pre-requisites for the restoration of an effective gold standard are—

- (a) The cessation of Government borrowing as soon as possible after the War. We recommend that at the earliest possible moment an adequate sinking fund should be provided out of revenue so that there may be a regular annual reduction of capital liabilities, more especially those which constitute the floating debt.
- (b) The recognized machinery, namely, the raising and making effective of the Bank of England discount rate, which before the War operated to check a foreign drain of gold and the speculative expansion of credit in this country, must be kept in working order. This necessity cannot, and should not, be evaded by any attempt to continue differential rates for home and foreign money after the War.
- (c) The issue of fiduciary notes should, as soon as practicable, once more be limited by law, and the present arrangements under which deposits at the Bank of England may be exchanged for legal tender currency without affecting the reserve of the Banking Department should be terminated at the earliest possible moment. Subject to transitional arrangements as regards Currency Notes and to any special arrangements in regard to Scotland and Ireland which we may have to propose when we come to deal with the questions affecting those parts of the United Kingdom, we recommend that the Note Issue (except as regards existing private issues) should be entirely in the hands of the Bank of England. The Notes should be payable in London only and should be legal tender throughout the United Kingdom.

As regards the control of the Note Issue, we make the following observations—

- (1) While the obligation to pay both Bank of England Notes and Currency Notes in gold on demand should be maintained, it is not necessary or desirable that there should be any early resumption of the internal circulation of gold coin.
- (2) While the import of gold should be free from all restrictions, it is convenient that the Bank of England should have cognizance of all gold exports, and we recommend that the export of gold coin or bullion should be subject to the condition that such coin and bullion has been obtained from the Bank for the purpose. The Bank should be under obligation to supply gold for export in exchange for its notes.
- (3) In view of the withdrawal of gold from circulation we recommend that the gold reserves of the country should be held by one central institution and that all banks should transfer any gold now held by them to the Bank of England.

Having carefully considered the various proposals which have been placed before us as regards the basis of the fiduciary note issue, we recommend that the principle of the Bank Charter Act, 1844, should be maintained, namely, that there should be a fixed fiduciary issue beyond which notes should only be issued in exchange for gold. The separation of the Issue and Banking Departments of the Bank of England should be maintained, and the Weekly Return should continue to be published in its present form.

We recommend, however, that provision for an emergency be made by the continuance in force, subject to the stringent safeguards recommended in the body of the Report, of Section 3 of the Currency and Bank Notes Act, 1914, under which the Bank of England may, with the consent of the Treasury, temporarily issue notes in excess of the legal limit.

We advocate the publication by the banks of a monthly statement in a prescribed form.

We have come to the conclusion that it is not practicable to fix any precise figure for the fiduciary Note Issue immediately after the War.

We think it desirable, therefore, to fix the amount which should be aimed at as the central gold reserve, leaving the fiduciary issue to be settled ultimately at such amount as can be kept in circulation without causing the central gold reserve

to fall below the amount so fixed. We recommend that the normal minimum of the central gold reserve to be aimed at should be, in the first instance, £150 millions. Until this amount has been reached and maintained concurrently with a satisfactory foreign exchange position for at least a year, the policy of cautiously reducing the uncovered Note Issue should be followed. When reductions have been effected, the actual maximum fiduciary circulation in any year should become the legal maximum for the following year, subject only to the emergency arrangements previously recommended. When the exchanges are working normally on the basis of a minimum reserve of £150,000,000, the position should again be reviewed in the light of the dimensions of the fiduciary issue as it then exists.

We do not recommend the transfer of the existing Currency Note Issue to the Bank of England until the future dimensions of the Fiduciary Issue have been ascertained. During the transitional period the issue should remain a Government issue, but new notes should be issued, not against Government securities, but against Bank of England Notes, and, furthermore, when opportunity arises for providing cover for existing uncovered notes, Bank of England Notes should be used for this purpose also. Demands for new currency would then fall in the normal way on the Banking Department of the Bank of England.

When the fiduciary portion of the issue has been reduced to an amount which experience shows to be consistent with the maintenance of a central gold reserve of £150 millions, the outstanding Currency Notes should be retired and replaced by Bank of England Notes of low denomination in accordance with the detailed procedure which we describe.

The final report was presented in December, 1919, and is given below—

## CURRENCY AND FOREIGN EXCHANGES

2. *Foreign Exchanges.*—We stated in the introduction to our Interim Report our opinion that a sound system of currency would in itself secure equilibrium in the Foreign Exchanges. We have reviewed the criticisms which have been made upon this part of our Report, but we see no reason to modify our opinion. We have found nothing in the experiences of the War to falsify the lessons of previous experience

that the adoption of a currency not convertible at will into gold or other exportable coin is likely in practice to lead to over-issue and so to destroy the measure of exchangeable value and cause a general rise in all prices and an adverse movement in the foreign exchanges.

3. The nominal convertibility of the currency note which has been sustained by the prohibition of the export of gold is of little value. The weakness of the exchanges is in a measure due to trade conditions, but an important cause of the depreciation in sterling in New York and other financial centres is, in our opinion, to be found in the expanded state of credit in this country. The existing expansion is not merely the legacy of the stress of war finance and Government borrowings, which even now have not ceased, but also, in part the result of maintaining rates for money in London below those ruling in other important financial centres. The difficulties of the Foreign Exchanges' position are aggravated by the grant of long term loans and credits, whether directly or under guarantee or otherwise by the Government or by private lenders, to enable foreign States or their nationals to pay for exports from this country. Few of these loans and credits will be liquidated at an early date. The large payments which we have to make to America, North and South, for necessary imports of foodstuffs and raw materials from those countries make it essential that we, in our turn, should secure payment in cash for as large a proportion as possible of our exports visible and invisible. We recommend therefore that preference should be given to exports to countries which are able to make payment in the ordinary course of trade.

Increased production, cessation of Government borrowings and decreased expenditure both by the Government and by each individual member of the nation are the first essentials to recovery. These must be associated with the restoration of the pre-War methods of controlling the currency and credit system of the country for the purpose of re-establishing at an early date a free market for gold in London.

4. *Bank of England*.—The principles of the Bank Charter Act of 1844 were fully considered by us in our Interim Report. We have examined with care the opinions there expressed in the light of certain criticisms which have been made with regard to them. We see, however, no reason to alter our conclusions. We have again considered the principles governing the banking systems of the principal foreign countries

and we are satisfied that they are not so well adapted to the needs of this country as those contained in the Act of 1844. Certain important alterations which experience suggested to be desirable have been made in the constitution and management of the Bank during the War, and we do not now think it necessary to make any further recommendation.

5. *Government Borrowings on Ways and Means Advances from the Bank of England.*—We desire to draw attention to the extensive use made during the War of the system of Ways and Means Advances from the Bank of England. We referred to this matter in paragraph 16 of our Interim Report and explained its effect in causing credit and currency expansion. The powers given to the Government by Parliament to borrow from the Bank of England in the form of an overdraft on the credit of Ways and Means were, as the name implies, intended to enable the Government to anticipate receipts from Revenue or permanent borrowings for a brief period only. Indeed, Parliament by expressly providing that all such advances should be repaid in the quarter following that in which they were obtained showed that it had no intention of bestowing upon the Government the power of securing an overdraft of indefinite duration and amount. Under the exigencies of war finance the Government found it necessary to re-borrow in each quarter on the credit of Ways and Means the amount needed to enable them to comply with the statutory requirement that the previous quarter's Ways and Means Advances should be repaid, with the result that the total outstanding advances remained for a long time at a high figure. We are glad to see that efforts are now being made to reduce this overdraft to more moderate dimensions.

We, therefore, hope, now that conditions are less abnormal, that the Government will confine its use of Ways and Means and Advances from the Bank of England to providing for purely temporary necessities. Such advances afford a legitimate method of tiding over a few weeks' shortage, but are entirely unsuitable for borrowings over a longer period.

6. *Foreign Banks.*—Several of our witnesses have called attention to the conditions under which it is open to foreign banks to establish themselves in this country. We suggest that this is a matter which should receive the early attention of His Majesty's Government.

7. *Scottish and Irish Banks.*—We have now taken evidence in regard to the application of the recommendations in our Interim Report to Scotland and Ireland. The status of legal

tender was given to the notes of the Scottish and Irish Banks of Issue as an emergency measure to tide over the period at the outbreak of war when a serious shortage of currency was threatened, a condition of affairs which no longer obtains. Some of the witnesses on behalf of the Scottish and Irish Banks showed a marked desire to retain the privilege of legal tender status for their notes. In our opinion the grant of legal tender status could not be given permanently to the notes of Scottish and Irish Banks except under statutory conditions similar to those embodied in the Bank Act of 1844. The evidence before us indicates that rather than be subjected to such conditions the banks would prefer the restoration of the pre-War status. We accordingly recommend that the pre-War status be restored. We further recommend that when the position which we contemplate in our Interim Report is ultimately reached the cover held by the Scottish and Irish Banks for their excess issue shall take the form of any legal tender at that time in existence.

8. *Currency Note Issue*.—We have considered whether steps should not be taken at an early date to impose limitations upon the fiduciary portion of the currency note issue with a view to the restoration of the normal arrangements under which demands for new currency operate to reduce the reserve in the Banking Department of the Bank of England. In view of the fact that demobilization is approaching completion and that as we hope fresh Government borrowing will shortly cease, we consider that effect should now be given to the recommendation made in our Interim Report that the actual maximum fiduciary circulation in any year should become the legal maximum for the following year, subject only to the emergency arrangements which we proposed in paragraph 33 of our Interim Report. The policy of placing Bank of England notes in the Currency Note Reserve as cover for the fiduciary portion of the issue as opportunity arises should, of course, be continued. We recommend further that the Treasury Minute made under Section 2 of the Currency and Bank Notes Act, 1914, providing for the issue of currency notes to Joint Stock Banks, which is in fact inoperative, should now be withdrawn.

In particular, it was advocated that the recommendation of the interim report, that the actual maximum fiduciary circulation in any year

should become the legal maximum for the following year, should be put into effect. This (which had for its object the gradual reduction of the degree of inflation and of making it less difficult, when the time should come, to return to pre-War conditions) was done until the passing of the Currency and Bank Notes Act, 1928, which provided for the amalgamation of the currency note issue with that of the Bank of England and for a fixed fiduciary issue. The text of the Act is as follows—

**THE CURRENCY AND BANK NOTES ACT, 1928**

(18 and 19 Geo. 5. Ch. 13)

An Act to amend the law relating to the issue of bank notes A.D. 1928 by the Bank of England and by banks in Scotland and Northern Ireland, and to provide for the transfer to the Bank of England of the currency notes issue and of the assets appropriated for the redemption thereof, and to make certain provisions with respect to gold reserves and otherwise in connexion with the matters aforesaid and to prevent the defacement of bank notes. *(2nd July, 1928.)*

1.—(1) Notwithstanding anything in any Act—

- (a) the Bank may issue bank notes for one pound and for ten shillings;
- (b) any such bank notes may be issued at any place out of London without being made payable at that place, and wherever issued shall be payable only at the head office of the Bank;
- (c) any such bank notes may be put into circulation in Scotland and Northern Ireland, and shall be current and legal tender in Scotland and Northern Ireland as in England.

Amendment with respect to powers of Bank of England to issue bank notes.

(2) Section six of the Bank of England Act, 1833 (which provides that Bank notes shall be legal tender), shall have effect as if for the words "shall be a legal tender to the amount expressed in such note or notes and shall be taken to be valid as a tender to such amount for all sums above five pounds on all occasions on which any tender of money may be legally made" there were substituted the words "shall be legal tender for the payment of any amount."

3 & 4 Will. 4. c. 98.

15 & 16  
Geo. 5. c. 29.

(3) The following provisions shall have effect so long as subsection (1) of section one of the Gold Standard Act, 1925, remains in force—

- (a) notwithstanding anything in the proviso to section six of the Bank of England Act, 1833, bank notes for one pound or ten shillings shall be deemed a legal tender of payment by the Bank or any branch of the Bank, including payment of bank notes:
- (b) the holders of bank notes for five pounds and upwards shall be entitled, on a demand made at any time during office hours at the head office of the Bank or, in the case of notes payable at a branch of the Bank, either at the head office or at that branch, to require in exchange for the said bank notes for five pounds and upwards bank notes for one pound or ten shillings.

(4) The Bank shall have power, on giving not less than three months' notice in the London, Edinburgh and Belfast *Gazettes*, to call in the bank notes for one pound or ten shillings of any series on exchanging them for bank notes of the same value of a new series.

1 & 2 Will. 4.  
c. 37.

(5) Notwithstanding anything in section eight of the Truck Act, 1831, the payment of wages in bank notes of one pound or ten shillings shall be valid, whether the workman does or does not consent thereto.

Amount of  
Bank of  
England  
note issue.

2.—(1) Subject to the provisions of this Act the Bank shall issue bank notes up to the amount representing the gold coin and gold bullion for the time being in the issue department, and shall in addition issue bank notes to the amount of two hundred and sixty million pounds in excess of the amount first mentioned in this section, and the issue of notes which the Bank are by or under this Act required or authorized to make in excess of the said first mentioned amount is in this Act referred to as "the fiduciary note issue."

(2) The Treasury may at any time on being requested by the Bank, direct that the amount of the fiduciary note issue shall for such period as may be determined by the Treasury, after consultation with the Bank, be reduced by such amount as may be so determined.

Securities for  
note issue to  
be held in  
issue depart-  
ment.

3.—(1) In addition to the gold coin and bullion for the time being in the issue department, the Bank shall from time to time appropriate to and hold in the issue department

securities of an amount in value sufficient to cover the fiduciary note issue for the time being.

(2) The securities to be held as aforesaid may include silver coin to an amount not exceeding five and one-half million pounds.

(3) The Bank shall from time to time give to the Treasury such information as the Treasury may require with respect to the securities held in the issue department, but shall not be required to include any of the said securities in the account to be taken pursuant to section five of the Bank of England Act, 1819. 59 Geo. 3. c. 76.

4.—(1) As from the appointed day all currency notes issued under the Currency and Bank Notes Act, 1914, certified by the Treasury to be outstanding on that date (including currency notes covered by certificates issued to any persons under section two of the Currency and Bank Notes (Amendment) Act, 1914, but not including currency notes called in but not cancelled) shall, for the purpose of the enactments relating to bank notes and the issue thereof (including this Act) be deemed to be bank notes, and the Bank shall be liable in respect thereof accordingly. Transfer of currency notes issue to Bank of England 4 & 5 Geo. 5. c. 14 4 & 5 Geo. 5 c. 72.

(2) The currency notes to which subsection (1) of this section applies are in this Act referred to as "the transferred currency notes."

(3) At any time after the appointed day, the Bank shall have power, on giving not less than three months' notice in the London, Edinburgh and Belfast *Gazettes*, to call in the transferred currency notes on exchanging them for bank notes of the same value.

(4) Any currency notes called in but not cancelled before the appointed day may be exchanged for bank notes of the same value.

5.—(1) On the appointed day, in consideration of the Bank undertaking liability in respect of the transferred currency notes, all the assets of the Currency Note Redemption Account other than Government securities shall be transferred to the issue department, and there shall also be transferred to the issue department out of the said assets Government securities of such an amount in value as will together with the other assets to be transferred as aforesaid represent in the aggregate the amount of the transferred currency notes. Transfer to Bank of certain part of assets of Currency Note Redemption Account.

For the purpose of this subsection the value of any marketable Government securities shall be taken to be their market price as on the appointed day less the accrued interest, if any, included in that price.

(2) Any bank notes transferred to the Bank under this section shall be cancelled.

(3) Such of the said Government securities as are not transferred to the Bank under the foregoing provisions of this section shall be realized and the amount realized shall be paid into the Exchequer at such time and in such manner as the Treasury direct.

6.—(1) The Bank shall, at such times and in such manner as may be agreed between the Treasury and the Bank, pay to the Treasury an amount equal to the profits arising in respect of each year in the issue department, including the amount of any bank notes written off under section six of the Bank Act, 1892, as amended by this Act, but less the amount of any bank notes so written off which have been presented for payment during the year and the amount of any currency notes called in but not cancelled before the appointed day which have been so presented.

(2) For the purposes of this section the amount of the profits arising in any year in the issue department shall, subject as aforesaid, be ascertained in such manner as may be agreed between the Bank and Treasury.

(3) For the purposes of the Income Tax Acts, any income of, or attributable to, the issue department shall be deemed to be income of the Exchequer, and any expenses of, or attributable to, the issue department shall be deemed not to be expenses of the Bank.

(4) The Bank shall cease to be liable to make any payment in consideration of their exemption from stamp duty on bank notes.

7.—Section six of the Bank Act, 1892 (which authorizes the writing off of bank notes which are not presented for payment within forty years of the date of issue), shall have effect as if, in the case of notes of one pound or ten shillings, twenty years were substituted for forty years, and as if, in the case of any such notes being transferred currency notes, they had been issued on the appointed day and, in the case of any such notes not being transferred currency notes, they had been issued on the last day on which notes of the particular series of which they formed part were issued by the Bank.

8.—(1) If the Bank at any time represent to the Treasury that it is expedient that the amount of the fiduciary note issue shall be increased to some specified amount above two hundred and sixty million pounds, the Treasury may authorize the Bank to issue bank notes to such an increased amount,

Profits of  
note issue to  
be paid to  
Treasury.  
55 & 56 Vict.  
c. 48.

Amendment  
of s. 6 of 55  
& 56 Vict.  
c. 48

Power to  
increase  
amount of  
fiduciary  
note issue.

not exceeding the amount specified as aforesaid, and for such period, not exceeding six months, as the Treasury think proper.

(2) Any authority so given may be renewed or varied from time to time on the like representation and in like manner :

Provided that, notwithstanding the foregoing provision, no such authority shall be renewed so as to remain in force (whether with or without variation) after the expiration of a period of two years from the date on which it was originally given, unless Parliament otherwise determines.

(3) Any minute of the Treasury authorizing an increase of the fiduciary note issue under this section shall be laid forthwith before both Houses of Parliament.

9.—(1) For the purpose of any enactment which in the case of a bank in Scotland or Northern Ireland limits by reference to the amount of gold and silver coin held by any such bank the amount of the notes which that bank may have in circulation, bank notes held by that bank or by the Bank on account of that bank, shall be treated as being gold coin held by that bank.

Amendment as to issue of notes by banks in Scotland and Northern Ireland.

(2) A bank in Scotland or Northern Ireland may hold the coin and bank notes by reference to which the amount of the bank notes which it is entitled to have in circulation is limited at such of its offices in Scotland or Northern Ireland, respectively, not exceeding two, as may from time to time be approved by the Treasury.

10.—The form prescribed by Schedule A to the Bank Charter Act, 1844, for the account to be issued weekly by the Bank under section six of that Act may be modified to such an extent as the Treasury, with the concurrence of the Bank, consider necessary, having regard to the provisions of this Act.

Amendment of s. 6 of 7 & 8 Vict. c. 32.

11.—(1) With a view to the concentration of the gold reserves and to the securing of economy in the use of gold, the following provisions of this section shall have effect so long as subsection (1) of section one of the Gold Standard Act, 1925, remains in force.

Power of Bank of England to require persons to make returns of and to sell gold.

(2) Any person in the United Kingdom owing any gold coin or bullion to an amount exceeding ten thousand pounds in value shall, on being required so to do by notice in writing from the Bank, forthwith furnish to the Bank in writing particulars of the gold coin and bullion owned by that person, and shall, if so required by the Bank, sell to the Bank the whole or any part of the said coin or bullion, other than any

part thereof which is *bona fide* held for immediate export or any which is *bona fide* required for industrial purposes, on payment therefor by the Bank, in the case of coin, of the nominal value thereof, and in the case of bullion, at the rate fixed in section four of the Bank Charter Act, 1844.

Penalty for defacing bank notes,

12.—If any person prints, or stamps, or by any like means impresses, on any bank note any words, letters or figures, he shall, in respect of each offence, be liable on summary conviction to a penalty not exceeding one pound.

Short title, interpretation and repeal.

13.—(1) This Act may be cited as the Currency and Bank Notes Act, 1928.

(2) This Act shall come into operation on the appointed day, and the appointed day shall be such day as His Majesty may by Order in Council appoint, and different days may be appointed for different purposes and for different provisions of this Act.

(3) In this Act, unless the context otherwise requires—

The expression “the Bank” means the Bank of England:  
The expression “issue department” means the issue department of the Bank:

The expression “bank note” means a note of the Bank:  
The expression “coin” means coin which is current and legal tender in the United Kingdom:

The expression “bullion” includes any coin which is not current and legal tender in the United Kingdom.

(4) The enactments set out in the Schedule to this Act are hereby repealed to the extent specified in the third column of that Schedule.

## INFLATION

Inflation may be said to be a War creation, for, at least, the War brought into prominence a condition of affairs which, though it had existed previously, had not been generally recognized and understood as it has since become. It is a condition of affairs in which the volume of currency is expanded to a degree greater than is necessary to meet the requirements of the volume of goods and services it is intended to serve. Inasmuch as the price level of a country is dependent

upon the amount of currency in circulation, or more truly, on the volume of credit, it is clear that in a condition of inflation, prices must rise. This is what happened in this and most other countries during and after the War, with, in certain cases, dire results. The extent of the inflation in this country can be gauged very roughly from the price level figures given below—

WHOLESALE PRICES  
*"The Statist" Index Number*  
 1913 = 100

1914 . . . . . 100	1919 . . . . . 242
1915 . . . . . 127	1920 . . . . . 295
1916 . . . . . 160	1921 . . . . . 182
1917 . . . . . 206	1922 . . . . . 154
1918 . . . . . 226	

The indication is approximate only, because other factors, as is shown on p. 183, tended to raise the price level.

It is a generally accepted theorem in foreign exchange that, setting aside any influences such as the interference in trade between two countries or international influences on them, the exchanges between them would reflect the relative price levels. At any rate, it needs no great effort to appreciate that any serious alteration in the price level of a country will have an effect on the exchanges between it and other countries. Elementally, a country with a relatively high price level is a good country to export to and a bad one to purchase from; and vice versa. It follows, therefore, that inflation must have an effect on the exchanges; the greater the degree of inflation, the greater the "fall" in the country's currency value, as reflected

by the exchanges. If we take  $P$  and  $P'$  as the price levels of two countries, and the exchange as  $A = B$ , then if  $P$  is trebled, the original hypothesis—

$$P : P' :: A : B$$

becomes  $3P : P' :: 3A : B$ ,

which means that the currency of the country with the inflated currency is worth only a third of what it was, and, consequently, that three times as much is now necessary to purchase the same unit of the currency of the other country. It will be realized that this statement is very rough as it takes no account of extraneous factors.

Although it does not affect the statement, it is necessary here to point out that in considering the effect of money on prices, regard has to be had to another factor, that of the rapidity of circulation. This is not a subject to be discussed here, but it may be added that the influence of inflation on the monetary condition of this and other countries during the War was increased by the fact that money circulated much more rapidly than in "normal" or pre-War times. It is not difficult to see that the effect of a given volume of money doing twice the normal amount of work is, broadly speaking, the same as that which would arise from double the volume. Introducing this factor to the equation given earlier, on the basis that the velocity of circulation in country A is twice that in country B, we find the following—

$$3P : 2P' :: 3A : 2B$$

or

$$3P \times 2B = 2P' \times 3A.$$

This and much more is what happened after 1914 to most of the countries of Europe. Some

countries responsible for inflating their currencies succeeded in staying the "rot"; it is said of others that they deliberately fostered it until their currency was entirely valueless. All were in some measure or other affected by the disease and one only, Great Britain, was able to revert to the pre-War state of affairs, so far as currency value was concerned. It was achieved by what is known as deflation—a deliberate reduction of the amount of currency in relation to the quantity of goods and services which the currency had to finance.

#### DEFLATION

Deflation is the opposite of inflation and has the opposite effect. Where an inflation of the currency means an increase in the price level, deflation means a reduction; and such reduction signifies, in terms of figures, an increase in the value abroad of the country's currency. That country becomes a good one to buy in, a bad one to sell in.

The possibilities in policies both of deflation and inflation have given rise everywhere since the War to intense argument. Not only did the War leave most countries with depreciated currencies; it left them with over-capitalized industries; with a far greater capacity for production than a peace-time regime could demand; it meant, therefore, a serious reduction in the incomes of those in receipt of fixed and unearned incomes, such as are obtained from stocks and shares; it meant a level of wages higher than post-War conditions warranted; it meant serious unemployment, unprecedented and harsh adjustment from a war to a peace basis; and, finally, a higher price level than the currency

position seemed to justify. In other words, adjustment was bad and difficult, and each difficult factor operated adversely on others in a kind of vicious circle. Needless to say, therefore, suggestions as to remedial measures were not few. The form they actually took depended largely upon the degree to which the particular country had fallen from its 1914 estate. To the one which succeeded in returning to its pre-War currency status, there remained the industrial and financial difficulties. Those who were not so fortunate (or so unfortunate, as we are sometimes persuaded to believe), had first to give attention to their currencies and, subsequently, to their industrial and financial positions. Their currencies they had first to stabilize, incidentally aiding their industry and finances.

#### STABILIZATION

Stabilization of currencies is the restoration of those currencies to a constant relationship with one another. Its effect is to confine fluctuations within narrow and defined limits, thus affording a degree of certainty in the calculation of the finance of overseas transactions of all kinds. Stabilization may be either *de facto* or *de jure*. *De facto* stabilization may be either natural, as where it is the result of the unfettered influence of economic forces on the one side as related to those on the other; or artificial, as where a currency, as indicated by the exchanges, is maintained at a given figure by governmental or central bank action—otherwise known as “pegging.” *De jure* stabilization is, of course, stabilization given the

force of law. Its enactment usually follows when experience has actually demonstrated that stabilization has been achieved and maintained over a considerable period.

“Pegging” an exchange is the artificial maintenance of the rate at a desired level and is achieved by the purchase and sale of exchange on the country or countries with which it is desired to have stable exchanges. To take, for instance, the example of America and England during the War, the rate of  $\$4.76\frac{1}{2}$  approximately was maintained in spite of the fact that economic forces were tending to force the rate down against this country. Dollars, in the shape of American securities held by English nationals, were sold to such an extent as to counteract the effect of natural economic forces, until in 1919, when restriction was removed, the exchange fell to its proper level. Again, before the War, India—through the gold exchange standard—maintained the value of the rupee by selling Council Bills and Reverse Councils, in London and India respectively. This meant the maintenance, in London, of a (gold) reserve which could be drawn upon as occasion required.

Obviously, “pegging” means an adequate reserve, which would normally be acquired as the result of the purchase, by the Government or other exchange controlling body, of bills drawn upon the other country, or other rights to the exchange of the other country, as the outcome of trade or of the voluntary or compulsory sale by holders of securities expressed in the desired currency. In the case of the American example during the War, the extent to which this artificial main-

tenance could be sustained was bound to come to an end before much longer, for a huge proportion of our rights to dollars had been exhausted and we had little to sell which the Americans desired; the system would, then, have broken down sooner or later, unless America was prepared to continue indefinitely her loans and credits to this country. But so long as the reserve can be fed, so long can the exchange be "pegged."

#### REPUDIATION

One other method was resorted to as a means of overcoming currency difficulties during the War. This was what has been called repudiation, but in fact, is only an extreme form of inflation. If the process is carried far enough the currency becomes of no worth at all. This is what happened in Germany, whose position was made more difficult by the action of foreign nationals in speculating in the mark. The extreme degree to which inflation in Germany was carried soon had not only the direct effect expected, of currency depreciation; but also the indirect one, of further depreciation, due to the fact that the value of the mark fell so rapidly that it was dangerous to hold marks. Those held or acquired one day were, the next, worth only a fraction of their value of the previous day. The mark became discredited abroad and in Germany itself. It was a case of all sellers and no buyers, until finally, German citizens refused to accept mark notes. It is no exaggeration to say that certain eccentric people used them as wall paper.

The currency had gone. Those who held marks had lost all that they represented—the notes were

so much waste paper. Germany found several expedients, among them the renten-mark, issued against charges on property. A new gold mark was created, for which the old Reichsmark was exchangeable at a fantastic figure, and was tied to gold.

#### POST-WAR INDUSTRIAL DIFFICULTIES

In the paragraph dealing with inflation, it has been said that remedial measures for the existing industrial depression after the War were not few. One of the most strongly advocated, however, was inflation itself, in carefully regulated doses. We were asked to "manage" our currency, in the sense of increasing its volume with the purpose of so increasing prices as to give a fillip to trade. Briefly, it is held that rising prices mean increasing business; that there is the incentive to increase production to take advantage of the rising prices, to turn over stocks more quickly—and it is said that this increase in business must permeate the whole industry and trade of the country, by reason of its psychological effect.

This is true up to a point, but there must come a setback which will be all the more serious because of the greater extent of the boom, and which will take the longer to overcome. Perhaps it may be said that this doctrine is advocated by a relative few, and that few, extremists. There is, however, another remedy deserving of serious consideration. It is the remedy of a stable price level, the achievement of which provides a reasonably sound basis upon which the trade and industry of the country may be revived.

Much has been done in this direction already,

but some of the exponents of the stable price level policy, considering the great importance of this particular factor to the community generally, advocate more drastic measures than have yet been found practicable. They have the support of a leading economist, and their view is propounded from time to time through one of the large banking institutions of London. The achievement of a stable price level is, they suggest, to be obtained by the alteration of the amount of currency in circulation according to a carefully compiled and revised index number of prices, so that business men may know always within a little that prices will not be liable to fluctuate against them. They will make no speculative profit, but, on the other hand, are safeguarded from unforeseen loss. The arguments for and against could be elaborated *ad libitum*, but this Primer is scarcely the place. Yet the student of the money market and the exchanges should know of the existence of these suggestions and of their possible effect.

With regard to the exchanges under a managed currency, it is clear that unless other countries follow the example of managing the currency, the exchanges must fluctuate much more widely than they do at present. It is said that the gold standard would be reduced largely to nothing, because in order to maintain the stable price level, incoming gold might not be allowed to affect the credit position as it does now. It would be sterilized. The opponents of this solution seem to forget that our currency is even now "managed" by the deliberate counteraction of gold movements by the "open market" policy of the central bank. Besides,

it is argued, under a managed system gold would be superfluous; an important argument, perhaps, in view of the possibilities of a gold shortage.

The fallacy in the argument for a managed currency would seem to lie principally in the factor of control. Much can be said for the system in theory, but would it, in practice, prove as efficacious as, in theory, it seems? The danger is in the possible failure to restrict the inflationary and deflationary movements to the strict requirements of trade and industry; in other words, in the reliance upon human, instead of automatic, control.

#### GOLD

The War was not without its effect on gold; in fact, the influence of the War in this respect has had very far-reaching results. In the first place, pre-War ideas as to gold reserves had to be revised. The pressure of increased currencies and international debts meant the throwing over of the gold standard by all the combatant (with the exception of America), and a few non-combatant, countries.

It was in August of 1916 that this country relinquished its position of a free gold market by prohibiting the export of gold. This was due to the sheer impossibility of paying in gold for the enormous indebtedness to America, which had grown up in respect of huge purchases of war materials from that country, purchases increasing in amount every day. It has to be remembered that not only was this country spending to an entirely abnormal extent—on materials destined to almost immediate destruction—but we were

not earning anything like our normal income. It will be remembered, too, that our position as a creditor nation before the War was due to the fact that for years, decades, in fact, we had conducted a great part of the world's business in the spheres of banking, insurance and carrying, which gave us an enormous surplus income, which was invested in enterprises throughout the world. This earning capacity was cut off. Not only was the country's shipping seriously depleted by the ravages of German war craft, but it was employed, not in earning an income from other countries, but in serving the British Government in bringing war material from those countries, principally America, to which we were compelled to have recourse.

The sudden reduction of much of our overseas trade meant the concurrent reduction in the means of making invisible exports. Less banking and insurance services were required, and fewer claims by this country on foreign countries were consequently acquired by us, resulting in a reduction in our national income, and in our foreign lending capacity.

#### MOBILIZATION OF DOLLAR SECURITIES

The position was met partly by the mobilization of dollar securities. Before the War, our holding of such securities was estimated at something over £1200 millions; holders were given the opportunity to make them over to the Government, either for cash or in exchange for securities of the British Government. Later, the sale to the Government was made compulsory. These securi-

ties were utilized for the settlement of indebtedness in America, either directly, or indirectly, as by borrowing against them.

Our exchange with America was thus maintained at a time when it was vital that it should not depreciate, but it meant the loss of our former income from foreign securities and the accretion of a colossal indebtedness, to be met, or otherwise dealt with, at the end of the War.

Thus was gold conserved up to a point. But yet another step was taken with this object in view. Before the War, all the banks of the country held gold reserves of their own, apart from their balances with the Bank of England. By arrangement with the Bank, these domestic reserves were transferred to the Bank with the object of concentrating the total gold stock. This was achieved early in the War, the banks receiving Treasury notes in exchange.

It will be remembered that the Interim Report of the "Cunliffe" Committee recommended that "after the war the conditions necessary to the maintenance of an effective gold standard should be restored without delay." That this was not possible until 1925 was due to two reasons. Firstly, sufficient gold had to be acquired to give the country an adequate reserve against the very much increased note circulation. Secondly, unless we were to stabilize our currency at the then existing level, it was necessary to resort to deflation in order to bring the pound sterling back to pre-War parity—in other words, to remove the discount on the paper pound. The size of our debt to America and the fact that it was unfunded

made the first of these difficult of achievement; any gold produced and shipped to this country was automatically taken to swell the coffers of the U.S. Treasury. For this purpose, licences were granted by the Treasury in London. The result of this trans-Atlantic movement of gold was a serious shortage in this and the other countries of Europe, and a serious plethora in America. The effect of inward gold movements being to increase the basis of credit and, consequently, to raise the price level, America found herself obliged to sterilize the metal. It was, therefore, simply stored and not allowed to become the basis of credit, which meant that it had no utility and, into the bargain, cost the Government of the United States something for its safe custody.

The gold standard was restored in this country in 1925, but not without much criticism at the time and since. It is still maintained that, when other countries were making no effort to restore their currencies to their pre-War level—on the contrary were thinking deliberately of stabilizing at a figure far below it, it was the height of folly for us to deflate and thus lower our price level, depress our trade and place us at a definite disadvantage, compared with other nations, in the post-War endeavour to regain trade and prosperity.

The arguments against this course have already been given. It was not that the opponents of the move were not sensible of the advantages which a return to the gold standard would bring, if there had been no other factors to take into

consideration. The need for regaining our supremacy as the leading money market of the world was obvious, for it was to our pre-eminence in this direction that our pre-War status as a creditor nation was in no small measure due. It has to be borne in mind also that we were threatened in our standing as an international money market by both New York and Paris. For a time, America seriously threatened us in this connexion because, from a purely financial and commercial point of view, she had been placed by the War in the shoes which this country wore before 1914. But she had not the technique. Paris, too, is said to have had (and still to have) designs, with the advantage of being, in a European sense, better placed geographically.

On the other hand, again, it was thought that the inevitable difficulties which would follow as a result of the required course of deflation would express themselves in such a dislocation and depression of our industries that we should find it impossible to avail ourselves of the ordinary benefits of the gold standard. Nevertheless, the step was taken, for better or worse.

#### GOLD STANDARD ACT, 1925

The text of the Act is given below. In order to smooth the difficulty which it was thought would naturally be met with in the attempt to return to the gold standard, a credit was arranged for the Bank of England in New York, to be in force for two years. But no use was made of it, for the effect, abroad, of the decision to return was so productive of confidence that the matter went

through and the change over was made as if its effect had been allowed for long before.

It will be noticed that the Act of 1925 was described as "an Act *to facilitate* the return to a gold standard," which reminds one that there was no previous Act formally abrogating the standard. In 1916 an embargo was placed on the export of gold and in 1920 an Act was passed specifically prohibiting the export of the metal, but the bank note was always technically convertible as it had been since 1821. A simple withdrawal of the prohibition would have sufficed to make the standard operative again, but there were obvious dangers in submitting a system which had not been tested since 1914 to the conditions obtaining in 1925. Three safety measures were therefore decided upon, viz., to make bank and currency notes inconvertible, to limit the sale of gold to bullion, and to give the Treasury power to borrow for the purpose of exchange operations.

The gold bullion standard thus set up was obviously a very different thing from the old standard in principle, though perhaps not in practice. It appears likely, however, that it was intended as but a stepping stone to a complete return to the old conditions.

#### THE GOLD STANDARD ACT, 1925

A.D. 1925.

An Act to facilitate the return to a gold standard and for purposes connected therewith. (13th May, 1925.)

BE it enacted by the King's most Excellent Majesty, by and with the advice and consent of the Lords Spiritual and Temporal, and Commons, in this present Parliament assembled, and by the authority of the same, as follows—

1.—(1) Unless and until His Majesty by Proclamation otherwise directs—

- (a) The Bank of England, notwithstanding anything in any Act, shall not be bound to pay any note of the Bank (in this Act referred to as "a bank note") in legal coin within the meaning of section six of the Bank of England Act, 1833, and bank notes shall not cease to be legal tender by reason that the Bank do not continue to pay bank notes in such legal coin: Issue of gold coin suspended and right to purchase gold bullion. 3 & 4 Will. 4. c. 98.
- (b) Subsection (3) of section one of the Currency and Bank Notes Act, 1914 (which provides that the holder of a currency note shall be entitled to obtain payment for the note at its face value in gold coin) shall cease to have effect: 4 & 5 Geo. 5. c. 14.
- (c) Section eight of the Coinage Act, 1870 (which entitles any person bringing gold bullion to the Mint to have it assayed, coined and delivered to him) shall, except as respects gold bullion brought to the Mint by the Bank of England, cease to have effect. 33 & 34 Vict. c. 10.

(2) So long as the preceding subsection remains in force, the Bank of England shall be bound to sell to any person who makes a demand in that behalf at the head office of the Bank during the office hours of the Bank, and pays the purchase price in any legal tender, gold bullion at the price of three pounds, seventeen shillings and tenpence halfpenny per ounce troy of gold of the standard fineness prescribed for gold coin by the Coinage Act, 1870, but only in the form of bars containing approximately four hundred ounces troy of fine gold.

2.—(1) Any money required for the purpose of exchange operations in connexion with the return to a gold standard may be raised within two years after the passing of this Act in such manner as the Treasury think fit, and for that purpose they may create and issue, either within or without the United Kingdom and either in British or in any other currency such securities bearing such rate of interest and subject to such conditions as to repayment, redemption or otherwise as they think fit, and may guarantee in such manner and on such terms and conditions as they think proper the payment of interest and principal of any loan which may be raised for such purpose as aforesaid: Power for Treasury to borrow for exchange operations.

Provided that any securities created or issued under this section shall be redeemed within two years of the date of their issue, and no guarantee shall be given under this section so as to be in force after two years from the date upon which it is given.

(2) The principal and interest of any money raised under this Act, and any sums payable by the Treasury in fulfilling any guarantee given under this Act, together with any expenses incurred by the Treasury in connexion with, or with a view to the exercise of, their powers under this section shall be charged on the Consolidated Fund of the United Kingdom or the growing produce thereof.

(3) Where by any Appropriation Act passed after the commencement of this Act power is conferred on the Treasury to borrow money up to a specified amount, any sums which may at the time of the passing of that Act have been borrowed or guaranteed by the Treasury in pursuance of this section and are then outstanding shall be treated as having been raised in exercise of the power conferred by the said Appropriation Act and the amount which may be borrowed under that Act shall be reduced accordingly.

Short Title. 3. This Act may be cited as the Gold Standard Act, 1925.

#### THE CRISIS OF 1931

Our return to gold is considered by some authorities to have been undertaken at too high a valuation for sterling, and thus, it is argued, our export trade suffered for a number of years the handicap of an over-valued currency. Whether this view is right or wrong, this country's prestige, and confidence in her financial stability, were re-established by the step taken. London became again the world's financial centre and the repository for large foreign balances, particularly those of the nationals of countries whose own currencies were considered to be none too stable.

In this way, large French balances, especially, found a home here. After 1929, the economic and financial recovery of France led to a steady repatriation of these funds, with the result that there was a continuous exodus of gold from this country to France, whose stocks of the precious metal rose to

dimensions second only to those existing in the United States. The accumulation of gold in the latter country had arisen from her conversion, as an outcome of the War, from a debtor nation to the world's largest creditor nation, coupled with the prohibition imposed by her tariff policy upon payment of the debts due to her in any other medium than gold.

These developments culminated in the concentration in France and America of two-thirds of the world's monetary stocks of gold. Instead of being allowed to fulfil their proper function as the basis of an expansion of currency, they were largely sterilized, and were thus prevented from bringing about, through a rise of prices in the country holding the extra stocks of gold, the automatic adjustment provided by the orthodox operation of the gold standard. The world witnessed, and still witnesses, the paradox of two countries very heavily over-stocked with gold, while most of the remaining countries are greatly in need of replenishment of their supplies to afford adequate cover for their credit needs.

This serious maldistribution of gold was one of the principal causes of a steep fall in commodity prices, which was most marked in the case of agricultural products. In 1928-29, America, visualizing for herself a period of perpetual prosperity ahead, indulged in an orgy of wild speculation in her stock markets. Prices of industrial shares in particular rose to fantastic heights, and the activity attracted funds from many other countries, owing to the extravagant rates of interest offered for call-money in New York. Gold was shipped

steadily from London to that centre during the latter half of 1928 and the greater part of 1929, and although the Bank Rate here was raised to as high a figure as  $6\frac{1}{2}$  per cent, the drain continued. Only when, in October and November, 1929, the bottomless character of the Wall Street boom was generally realized, and prices tumbled even more rapidly than they had risen, did the demand for funds abruptly end and London enjoy a respite.

This American debacle, though not initiating the fall in world commodity prices, undoubtedly helped the downward movement, for the "rot" which set in in the stock markets of that country spread to her commodity markets, and, indeed, left no sphere of activity there untouched. America at all times wields a great influence in world trade and in prices of commodities, and the reverberations of the events in New York echoed in all markets throughout the world. The drastic falls in commodities brought depression to many primary-producing countries, which found themselves glutted with unsaleable goods and unable to meet their interest obligations to other countries—Great Britain among them. Our revenues from this source, which at all times play an important part in our trade balance, were consequently greatly diminished.

With the deepening of world depression, British overseas trade suffered considerable contraction, an immediate result of which was a sharp increase in unemployment. Consequently, a serious shrinkage of budgetary revenue coincided with a rapid growth of expenditure. At the same time, the unemployment insurance fund was running a

heavy and expanding deficit, with no appearance of its eventual liquidation.

Early in 1931 there came the banking troubles of Austria and Germany. For some years previous, the latter country had been borrowing at high rates of interest, mainly from America, in order to meet her reparations payments and to rehabilitate her economic resources and equipment on up-to-date lines. The Wall Street boom opened up a more profitable avenue at home for American funds, and Germany had to seek resources elsewhere. For a time, Britain came to her aid, to safeguard her already heavy commitments in Germany, but the position remained very shaky and unsound. The Hoover moratorium, postponing all payments due in respect of reparations and war debts, was mooted at this time, but crisis supervened. The German banks had to close their doors, and later re-opened subject to the strictest control by the Reichsbank of all foreign exchange transactions. Much American and British capital was locked up in the German banks, and difficulties in obtaining exchange prevented the repayment of these sums. As a result, the first "Standstill" agreement was reached, whereby repayments were postponed on certain terms. This agreement has been renewed from time to time.

All these factors combined to throw a great strain upon London, and engendered a feeling of mistrust abroad of her ability to withstand the pressure. The doubts entertained were reinforced by the publication of two official documents, the Macmillan Report and the May Report. The first of these, which constituted the findings of a

Committee on Finance and Industry, drew attention to certain defects in our banking system which in normal circumstances would have excited no particular anxiety, but which now served further to weaken faith in the invulnerability of London as a financial centre. There followed the report of the Committee on National Expenditure (the May Report), which showed that our national finances were far more seriously unbalanced than had been supposed. This thoroughly alarmed foreign holders of sterling balances, whose withdrawals from London reached considerable proportions.

Credits in Paris and New York, amounting to £130 millions, and an increase of the Bank of England's fiduciary issue by £15 millions, served to buttress the tottering fabric for a time, but the inevitable crash came on 21st September, 1931. By that date, withdrawals of foreign balances had reached the substantial sum of £200 millions, and the Bank of England's gold reserve had dwindled to the dangerously low figure of £130 millions. It was evident that neither the sacrifice of our remaining store of gold nor any other measure open to us could do more than postpone the step to which we were being inexorably driven. By the Gold Standard (Amendment) Act, 1931, therefore, the Bank of England was relieved of its obligation to pay out gold bullion in exchange for its notes. The full text of the Act is quoted below. Bank Rate was raised, on the same day, from  $4\frac{1}{2}$  per cent to 6 per cent, and purchases of foreign exchange were restricted then, and for several months thereafter, to *bona fide* trade and travel requirements.

The suspension of the gold standard was one of the first acts of the National Government, which had replaced the Labour Government about a month previously—on 24th August. A supplementary Budget had been passed on 10th September, enacting certain increases in taxation, salary cuts, etc., and, generally, setting a curb on expenditure whilst raising further revenue.

The immediate effects of our departure from gold were, naturally, a depreciation in the value of sterling, which stimulated our export trade, and a discouragement to the withdrawal of foreign balances from London. Many other countries, notably those of Scandinavia, having important trade interests with this country, followed us off gold.

The dollar exchange fell to under 3·80 and the French franc to 96, with a further adjustment subsequently to lower levels. Many sterling securities were remitted from abroad for sale in London and a tariff policy was inaugurated for the assistance of British industry. In the following year the dollar fell to 3·19 at its lowest and francs to between 80 and 90, and the Exchange Equalisation Fund was set up. The situation was not merely saved but the restoration of confidence was completed by a payment of £29 millions in gold to America on account of War indebtedness in December, 1932. The Bank Rate fell to 2 per cent in June and the market rate for Treasury bills to the extraordinarily low level of  $\frac{3}{8}$  per cent in September. During 1933 the Bank acquired about £150 millions of gold. It must be admitted that the high ambition to restore Britain's ancient

prosperity by the return to gold with the £ at its old parity, nearly brought disaster, while the first complete abandonment of the gold standard in 110 years, coupled with tariffs and exchange control, have brought some little measure of prosperity. It has become clear that the true value of sterling in terms of the franc, on a price-parity basis, is nearer 80 than 124.

#### THE GOLD STANDARD (AMENDMENT) ACT, 1931

A.D. 1931.

An Act to suspend the operation of subsection (2) of section one of the Gold Standard Act, 1925, and for purposes connected therewith. *(21st September, 1931.)*

BE it enacted by the King's most Excellent Majesty, by and with the advice and consent of the Lords Spiritual and Temporal, and Commons, in this present Parliament assembled, and by the authority of the same, as follows—

Suspension  
of right to  
purchase  
gold bullion.  
15 & 16  
Geo. 5. c. 29.

1.—(1) Unless and until His Majesty by Proclamation otherwise directs, subsection (2) of section one of the Gold Standard Act, 1925, shall cease to have effect, notwithstanding that subsection (1) of the said section remains in force.

(2) The Bank of England are hereby discharged from all liabilities in respect of anything done by the Bank in contravention of the provision of the said subsection (2) at any time after the eighteenth day of September, nineteen hundred and thirty-one, and no proceedings whatsoever shall be instituted against the Bank or any other person in respect of anything so done as aforesaid.

(3) It shall be lawful for the Treasury to make, and from time to time vary, orders authorizing the taking of such measures in relation to the exchanges and otherwise as they may consider expedient for meeting difficulties arising in connexion with the suspension of the gold standard.

This subsection shall continue in force for a period of six months from the passing of this Act.

Short Title.

2. This Act may be cited as the Gold Standard (Amendment) Act, 1931.

The Treasury Order made under Section 1 of the Act was as follows—

Order made by the Treasury under Section 1 of the Gold Standard (Amendment) Act, 1931.

THE Lords Commissioners of His Majesty's Treasury in pursuance of Section 1 of Gold Standard Act, hereby order that until further notice purchases of Foreign Exchange or Transfers of Funds with the object of acquiring such exchange directly or indirectly by British subjects or persons resident in the United Kingdom shall be prohibited except for the purpose of financing normal trading requirements—contracts existing before 21st September—reasonable travelling facilities or other personal purposes.

(Signed) PHILIP SNOWDEN.

*22nd September, 1931.*

#### DISCOUNT MARKET

The effect of the War on the discount market was evidenced in two ways. The volume of commercial bills fell enormously until some time after the War; and the balance between the commercial and the Treasury bill was radically altered.

The beginning of hostilities meant the immediate cutting-off of commercial intercourse between this country and a large part of Europe. The risk attaching to transport, and the scarcity of shipping, meant a serious decrease in the trade with other parts of the world. The temporary "nationalization" of industry in this country entailed a marked reduction in the number of trade bills drawn; finally, Government borrowing was responsible for the enormous growth of the Treasury Bill, the serious competitor of the commercial bill, but at the same time the salvation of the bill broker.

The latter was, consequently, forced over to a commodity which had previously comprised only a small part of his stock-in-trade, and one which called for no great degree of technique or know-

ledge, as did the commercial bill. In other words, his business became automatic.

This, in turn, operated on the money market. A function of the central bank of a country on the gold standard is to conserve the nation's gold holding and it does so through its discount rate. It will thus be appreciated that the Bank Rate had in that sense lost its purpose, because there could be no question of the loss of gold. As for the function of the retarding of speculative movements, again, the reason for this had gone. The only speculation—if such it can be called—was indulged in by the Government and no raising of the Bank Rate would have stopped it. Further, central bank action for the control of the basis of credit was neutralized by the fact that such control had passed from the central bank to the Treasury.

Moreover, the predominance of the Treasury Bill in the market meant that market rates became subsidiary to the Treasury Bill rate; and it is evident, therefore, that the nature of the money market had altered beyond comparison. Instead of being a free market, dependent upon the supply of and demand for commercial bills, and on the demand for and supply of gold, as permitted to effect the main policy of the central bank, it became quite artificial, with the Government as the arbiter of prices, rates, commodity and effect.

In addition, the position was made still more artificial by the fact that the dollar exchange, the most potent of all, was "pegged"; that the free interplay of international price levels was obstructed; that the Continental exchanges, such as there were, were operated through London, on New

York; and that gold in New York was sterilized so as to have no effect on the price level or, therefore, on the dollar exchange. Artificiality was rife and it was always a question of safeguarding until the end of the War should make it clear what efforts would be required, and in what directions, for a return to normality within the shortest possible time and with the minimum of cost and trouble.

#### FOREIGN EXCHANGES

In August, 1914, England, France, Germany and the United States were on the gold standard. Many countries were indebted to Great Britain. During the early months of 1914, there had been a general gold exodus from this country and America to the Continent, principally France and Germany, pointing rather to war preparations. The money position in this country had been easy for the thirteen years of the twentieth century, except in 1907, the occasion of the American banking crisis, when the average Bank Rate, which had moved between 3 per cent and 4 per cent, was 5 per cent, the highest point touched being 7 per cent.

July and August, 1914, saw an almost frantic endeavour on the part of most countries to repatriate the capital they had invested abroad. In the case of Great Britain and America, the calling-in of credits forced the dollar rate up to 7. The French selling of London bills sent the franc against us. Germany seemed to have dealt with the situation before the War began; the exchange was in fact rather in our favour until it ceased to exist.

The position in America was that that country

was indebted to Europe in a very considerable sum, which after the outbreak of War was demanded by its creditors, but which, nevertheless, could not be immediately repaid owing to the fact that the normal shipments of U.S. produce could not be made. It has to be remembered that America was largely dependent on Great Britain for her transport, and that such transport was otherwise engaged; that countries to which commodities of all kinds would normally have been exported were unable to accept them. The difficulty was overcome by passing gold into Canada to be held on behalf of the British Government and of earmarking it in New York on behalf of France. Gradually, the position righted itself, helped considerably by the purchases of combatant countries in America. At the end of 1914, the dollar had fallen to a little less than 4·86; at the end of 1915, to some 13 cents below par and after the War the exchange stood at over a dollar below par, i.e. at a substantial premium in favour of America.

It was almost a year after the beginning of hostilities that steps were taken to prevent the exchange going still further in favour of America and, as has already been explained, the support given took the form of the mobilization of dollar securities in London for sale in New York. The efforts of the Treasury resulted in the "pegging" of the rate round about  $4\cdot76\frac{1}{2}$ , until early in 1919—the 21st March to be exact—when the official purchase of sterling in New York ceased and the exchange was permitted to move free from artificial control.

This meant an immediate fall to \$4.55-61, for the British Government was heavily in the debt of America still. Until the funding of this debt, the exchange (average of daily rates)

fell to \$3.80 in December, 1919,

to \$3.38 in February, 1920;

rose to \$4.17 in December, 1921,

to \$4.62 in December, 1922,

and thereafter fluctuated between \$4.26 and \$4.70 until 1925 when it returned to the neighbourhood of gold parity.

For purposes of this Primer, the countries of Europe may be taken together. We are concerned principally with France and Germany, but much the same, in another degree, may be said of Belgium and Italy.

Without going into figures, it may be said that the exchanges of both France and Germany fell away from par as a result of the inflation which took place in those countries. The internal situation was most severe in Germany, which probably accounts for the fact that the degree of inflation there was considerably greater than in France. Germany was isolated in a very real sense. By the time the end of the War came, Germany was reduced to the use of shoddy as a substitute for cotton and wool, a similar position being found in other spheres besides that of textiles. Germany was left with no raw material worthy the mention and no means of obtaining any. Food had become less deserving of the name. By reason of its isolation, Germany had to use every means of obtaining the wherewithal to continue the War; and such wherewithal became more and more difficult

to acquire and constantly more costly. The country's ordinary financial resources were rapidly exhausted, but internal purchases had still to be paid for; and thus Germany, like all the belligerents, came to inflation. The greater the need, the greater the extent to which this panacea was resorted to, until finally, the currency became valueless—refused acceptance even in Germany.

While inflation, wherever it was found, was due to, and an index to, the condition of the particular country, yet, in spite of that condition, it need not have become so virulent as it did. The situation, so far as the post-War economic state was to be concerned, was aggravated or relieved according to the method of war finance adopted. According to Schacht—*The Stabilization of the Mark*, p. 14—Dr. Knauss is stated to have calculated that in England 20 per cent of the cost of the War was financed by direct taxation; in Germany, 6 per cent only; in France, none. To quote Schacht, speaking of Germany: "The inflation, which thus originated in the War, could undoubtedly have been kept within narrower limits by heavier taxation of the population." Berlin was one of the four really important monetary centres before the War. In Sept., 1935, the Reichsbank's holding of gold was under £8 millions.

Although the case of Belgium is little different from that of France, she returned to the gold standard before France. In doing so, she stabilized at a higher rate, 175 francs to the £, but instituted a new exchange unit, the belga, which was to be equal to fcs. 5. We thus have quotations in belgas, at a par of 35.00—although the franc is still used internally. France stabilized at 124.21 in 1928.

Her post-War financial history has naturally been one of continuous effort, but her Governments, harassed as they have been by the difficult temperament of her people, have handled the successive situations very ably and, pinning their faith firmly to gold, have avoided major troubles and acquired a stock of the precious metal second only to that of the United States.

America, on the other hand, has recently suffered the greatest depression she has ever known. One does not forget the gallant lives she gave in the common cause, but on the purely material side, she alone of the belligerents was a potential gainer by the War and assumed Great Britain's former position as the world's creditor. This, and her own vast resources, might have made prosperity certain, but the two factors became antagonistic. Debts could only be paid in goods; the import of goods would damage her own producers. In 1932 Great Britain paid an instalment of her debt (£29 millions) in gold, adding a trifle to the immense store of useless metal which America had accumulated. Thereafter we had to bow to the logic of the situation. By her protective measures America prevented our paying in goods and we could not pay our vast debt in gold (largely because America already held so much of the world's supply). The more intelligent, but less vocal, section of the community over there recognized the justice of our plaint and the matter was somewhat indecisively shelved.

Meanwhile, the great speculative boom, and collapse, which are briefly referred to on p. 214 had taken place. In 1933, the President inaugurated

an intensive system of controlled inflation which appears to have set the country on its feet again. The dollar exchange rose from about 3.20, to which it had fallen in December, 1932, to 5.50 towards the end of 1933 and then settled down in the neighbourhood of the old parity of 4.86. As a part of the U.S. plan, its buying price of gold was raised to \$35 per fine ounce, and the price of the metal on the London market naturally soared far above the old statutory price—to about £7 per fine ounce.

But except where it touches this country directly, the story of American finance over the past two years is outside the scope of this book, which is unfortunate because it is exceedingly interesting.

#### LOOKING FORWARD

Subsequent to the establishment of currencies on a gold basis, the exchanges were affected by little of note until the new, wholesale departure from the standard. Mint parities, which disappeared with the currencies' divorce from gold, were again instituted. Gold points again became effective. The serious problem, it was said, was the shortage of gold and its mal-distribution.

The world, for many years—but to a less extent in some countries than in others—has suffered from inability to buy. There has been a world industrial depression and there has been depression in the mental sense as well. The seriousness of the position is increased by the fact of a gold shortage and the possibility of a more serious shortage in times to come. It is argued that a further fall

in world prices is inevitable, if we are to remain attached to gold, and that such fall must react on industry and make it still more difficult to improve the condition of affairs. It is thus only natural that remedial measures are suggested. Estimates of gold production and the appropriation of the metal have enabled economists and bankers to appreciate the position and the need for some means of meeting it.

Two methods are put forward, but it is not the purpose of this book to discuss them. They must, however, be referred to; firstly, and it has already been mentioned, to throw over the gold standard and "manage" our currency by reference to an index number so as to stabilize our price level. Gold would then become unnecessary, it is asserted. Clearly, this could not be effected, except in a country dependent on no other country, or, in other words, self-contained, unless other nations followed the same course. And even if they did, how would surplus indebtedness of one to the other be met if the international currency, gold, were to be devaluated? It would seem that the scheme presupposes not only the acquiescence of all, or, at least, the majority, of the leading nations but the existence of an international committee with supreme powers to regulate the flow of trade so that international indebtedness, so far as there may be an excess between any two countries, is not permitted to exist beyond a certain point. Secondly, it is suggested that there be created a new international currency, based, shall we say, on two metals—one to be gold, the other a metal of which there is plenty and no likelihood of a

shortage. Whether it is the conservatism of humanity or the inherent difficulty in either of the two schemes which will prevent their materialization, cannot be said, but it is hard to see that they can be accepted.

The position has been ameliorated somewhat by inter-central bank action and also, more recently, it may be, by the Bank for International Settlements. The essence of the matter lies in the avoidance of the unnecessary transfer of gold from one centre to another and the avoidance, consequently, of dislocation of the exchanges. Through the International Bank transfers may now be made by mere book entry, and it is not hard to visualize the situation where all the gold in the world is concentrated in the hands of one authority, one custodian, the Bank in question or some other international body. This again, nevertheless, presupposes the investment of that body with supernatural authority, an authority which can in no circumstances be interfered with by any member. It would be churlish perhaps to suggest that this is a Utopian condition, but it would be true to say that many people view the possibility with scepticism and refuse to allow it to assume the importance of a probability.

The Bank for International Settlements was originated with the object of dealing with reparation payments by Germany; in other words, it was to be an international clearing house of War debts between Germany and other countries. Nevertheless, those responsible for it are believed to see in it a solution to many of the currency ills which have beset the world as a result of the War.

That the Bank can function as a clearing house requires no imagination, but whether it can also be the means of sinking national currency prejudices remains to be seen.

#### THE COMMITTEE ON FINANCE AND INDUSTRY

It would not be fitting to bring this book to its conclusion without some reference to the "Macmillan" Report which was published in 1931. This monumental compilation is in itself a text-book, or rather a practical handbook, of banking, and as such it is worth the serious attention of the student of the modern English system.

The Macmillan Committee was appointed—

To inquire into banking, finance and credit, paying regard to the factors both internal and international which govern their operation, and to make recommendations calculated to enable these agencies to promote the development of trade and commerce and the employment of labour,

and a glance at the Table of Contents will show to what extent the subject-matter of "Clare" has entered into the Committee's deliberations. While an exhaustive analysis of the findings and recommendations would be out of place, a brief liaison of "Clare" with the Report may give that fillip which the practical and topical application of one's reading always provides.

The Report is divided into two Parts, the first historical and descriptive, the second giving the conclusions and recommendations. Almost every page contains something for the student of the rudiments of the money market or for the advanced inquirer, but these notes are the concern only of the former.

The first point of interest is the description of the Bank of England and the past and present positions of the note issue. Under the heading of "The Banking Department" is given a full statement of the composition of the assets of the Bank. Then follows a statistical treatise on the joint-stock banks, ending with a statement by Sir Ernest Harvey that the banks are the guide to the Bank of England as to the needs of industry for an increased volume of credit. "The barometer to which we look is the volume of money that is seeking investment in the short market." The remainder of the chapter (IV) is given up to a description of the position of the accepting houses in the money market, and the discount market in general.

Chapter VIII comprises the story of international events since 1925, the year of Great Britain's return to the gold standard. The first Part closes with a consideration of "The influence of Monetary Policy on the Price Level" and includes eight paragraphs on the functions of Bank Rate.

Incidentally, it is to be remarked that "There is only one real prohibition that is imposed upon the Bank, and that is in the Tonnage Act of 1694, which says that in order not to oppress His Majesty's subjects the Bank is to be debarred for all time from using any of its funds in dealing in merchandise or wares of any description."

It is the second Part, however, which is of more importance and, therefore, of greater interest. Choosing those conclusions and recommendations which have definite relation rather to the money

market as an organization than to the present economic situation, one meets the statement that

Our objective should be . . . first of all to raise prices a long way above the present level and then maintain them at the level thus reached with as much stability as can be managed. This means that the monetary system of this country should be a managed system and the Bank of England should be entrusted with the task of managing. This view has been advocated for many years past, but it is doubtful whether anyone anticipated that a Government commission, of such composition, at least, would, with only one dissentient, have put forward such a proposition.

Chapter II of the second Part opens with a reiteration of the recommendation that this country should adhere to the gold standard; and continues with the Committee's conception of the proper policy of Central Banks—

The aim of the Central Banks should be to maintain the stability of international prices both over long periods and over short periods . . . .

The Central Banks should confer together at frequent intervals to decide whether the general tendency of their individual policies should be towards a relaxation or a tightening of the conditions of credit . . . .

This form of joint policy should be consistent with a full measure of autonomy for each national institution. In particular, each Central Bank should remain free to attract gold.

Each Central Bank should undertake to do its best to avoid the importation of unwanted and unnecessary gold merely as a result of leaving natural forces to work themselves out unchecked . . . .

Central Banks should consider the rate of long-term investment as well as short-term investment as falling within their purview, and should take whatever steps may lie within their power, and are suited to their local circumstances, to counteract any tendency which their own nationals may show either to keep their investible resources excessively liquid or to undertake excessive long-term commitments.

The chapter concludes with an appeal for an abundance of cheap money in the respective money markets and that Central Banks should use their influence to promote confidence in the duration of low short-term rates.

The criticism of the principle of the fiduciary note issue is the next point to note. The Committee is of opinion that "the principle of the fixed fiduciary issue is wrong in that it associates the amount of the gold which the Bank of England should hold immobilized and unavailable for export with the amount of the active note circulation." It points out that, with the exclusion of gold from circulation, gold need no longer be held to meet an internal drain and that, therefore, it should be used for the one purpose for which it is held, i.e. to meet a foreign drain. The principle of the fiduciary issue prevents this and it is suggested—

(a) that the amount of the issue should be fixed at, say, £20 millions beyond the amount of the seasonal maximum, and the sum of £400 millions is mentioned;

(b) that the Bank should be prohibited from allowing its gold reserve to fall below £75 millions except with the permission of the Treasury and then temporarily only.

The next outstanding feature of the Report is the recommendation that the Issue and Banking Departments of the Bank should be amalgamated, their separation being meaningless, leading to unnecessary confusion and offering no advantage. This would entail the amalgamation of the statements of the two Departments, the consolidated

Return (taking for illustration round figures for 29th April, 1931) would appear as follows—

Proprietors' Capital . . . . .	£ 14,500,000	Government Securities	£ 274,000,000
Rest . . . . .	3,500,000	Discounts and Ad-	
Public Deposits . . . . .	17,000,000	vances . . . . .	7,000,000
Bankers' Deposits . . . . .	49,000,000	Other Securities . . . . .	39,000,000
Other Deposits . . . . .	37,000,000	Silver Coin . . . . .	4,000,000
Notes in Circulation . . . . .	350,000,000	Gold . . . . .	147,000,000
	<hr/>		<hr/>
	£471,000,000		£471,000,000,
			<hr/>

In the words of the Committee, "We also attach great importance to it as a first step towards dissociating in the world at large the question of the right level of a country's gold reserve from the question of regulating the note issue."

Paragraph No. 356 gives an interesting summary of the means by which the Bank can manage the monetary system. These have probably never been so frankly stated in print as they are in the Report, though the several methods have been known to all concerned with the practical operations of the money market.

A further point of importance in the present connexion is the relationship between the Bank and the joint-stock banks. To begin with, the Committee criticizes the monthly and half-yearly "window-dressing," being the practice designed to make a "brave show" of deposits at the Bank of England. It is urged that this practice be given up. The further recommendation is made that the joint-stock banks should reduce their holdings of notes so as to increase their balances with the Bank and lessen their power over the Bank's "reserve."

Finally, there is an earnest appeal for more and better statistics.

British bankers are a conservative body, and it was not to be expected that the Report would be followed by sudden and obvious changes. It is believed, however, that on the whole its findings have been accepted as indicating sound lines of policy and that the leaders of our great financial institutions have been, and as necessity and opportunity arise will continue to be, guided by them.

It is hoped that this short historical survey of the events of the War and post-War periods may enable the student to picture the effects of the War on money markets and exchanges, and that it may serve as a natural continuation to the somewhat modernized "Clare" which preceded them.

# INDEX

	PAGE
<b>Act of 1708</b> . . . . .	5
<b>Act of 1826</b> . . . . .	5
<b>Act of 1833</b> . . . . .	36
<b>America</b>	
banking in . . . . .	78
crisis, 1929 . . . . .	214
exchange during War . . . . .	222
exchange with . . . . .	217, 223
Federal Reserve Banks' reserve requirement . . . . .	78
gold granary of the world . . . . .	37, 213
post-War . . . . .	225
standard of fineness of gold . . . . .	95
war debts to . . . . .	217-225
<b>Arbitrage</b>	
of securities . . . . .	140
operations . . . . .	134
<b>Australia</b>	
exchange quotations . . . . .	III, 113
<b>Austria</b> . . . . .	215
<b>Bagehot, Walter</b> . . . . .	149
<b>Bank Charter Act, 1844</b>	5, 9
and excess issues . . . . .	30
and purchase and sale of gold . . . . .	9, 44
defined status of Bank . . . . .	10
effect on country bank issues . . . . .	31
indemnity for breach of . . . . .	89, 180
provisions <i>re</i> Return . . . . .	24
revolutionary legislation . . . . .	5, 7
suspension of . . . . .	39, 88, 178
<b>Bank for International Settlements</b> . . . . .	178, 228
<b>Banking</b>	
capital, object of . . . . .	50
change in nature of, from 1844 to 1914 . . . . .	32
Department, effect of gold movement on . . . . .	76
joint-stock, origin of . . . . .	1
<b>Bank of England</b>	
accounts of joint-stock banks with . . . . .	13, 55
and Act of 1708 . . . . .	5
and Act of 1826 . . . . .	5
and Act of 1833 . . . . .	40
and gold movements . . . . .	15
and purchase and sale of gold . . . . .	44
balance sheet (in ordinary sense) never published . . . . .	25
bank post bills . . . . .	54
bill discounting, category widened . . . . .	180
borrowing from . . . . .	86
bullion dealings . . . . .	95

**Bank of England—(contd.)**

capital	49
change in power over money market	11
charter granted limited liability	3
circulation, fiduciary issue	33
circulation, figures of	32
clearing banks settle their differences through	55
creditors not compelled to take notes	40
Cunliffe Committee conclusions	184, 188
date of establishment	1
deposits in relation to notes	32
deposits, increase in	15, 50
deposits repayable in gold on demand	73
discounts bills for customers at market rate	16
disinterested attitude of	79
dividend	51
dividend-earning not its object	10
exceptional relation to other banks	8
exchange control	10, 147
export of gold, Return illustrating	75
focus of monetary system of the country	10
formed to raise loan to Government	13
Government bank	8
Government debt	3, 33
Government pledged to see note paid	35
Government Securities. See <i>Government Securities</i>	
history	1
interest on deposits	11
investments	68
legal tender. See <i>Legal Tender</i> .	
legislation and status	5
lending to market in July, 1914	180
letter from the Chancellor of the Exchequer	180
letter to Chancellor of the Exchequer	179
Macaulay on	4
method of reducing unemployed market money	62
note. See <i>Note</i>	
note circulation. See <i>Note Circulation</i> .	
only lender in times of crisis	86
open-market policy	63
other banks, holds reserves of	55
other deposits. See <i>Other Deposits</i> .	
Paterson's scheme	2
political convictions of founders	2, 4
private corporation	8
public deposits. See <i>Public Deposits</i> .	
public revenue received by	52
rate of discount. See <i>Bank Rate</i> .	
receives gold from France, Germany, U.S.A.	144
relation to joint-stock banks	11, 233
relationship with money market	10
religious convictions of founders	2
repository of gold bullion	8
reserve. See <i>Reserve</i> .	
reserve, ratio to liabilities. See <i>Proportion</i> .	

<b>Bank of England—(contd.)</b>	
residual issue. See <i>Note Circulation.</i>	
rest . . . . .	49
return. See <i>Return.</i>	
Scottish withdrawals. See <i>Reserve.</i>	
stability equal to British Government . . . . .	8
State bank, not a . . . . .	8
Ways and Means advances . . . . .	53, 189
weekly return, only bank required to publish . . . . .	49
working capital . . . . .	50
<b>Bank Note.</b> See <i>Note and Note Circulation.</i>	
<b>Bank Rate</b>	
and conservation of reserve . . . . .	20
and control of note issue . . . . .	20
and crises . . . . .	21
and short loan fund . . . . .	12, 17
and speculation . . . . .	20
averages 1844-1935 . . . . .	21
definition of . . . . .	16
efficacy of . . . . .	17, 60, 141
functions of . . . . .	20
movements in . . . . .	93
reason for changes in . . . . .	20
relation to market rate . . . . .	18, 53, 60, 160
reserve, the key to . . . . .	73, 98
variation in . . . . .	161
<b>Bank Return.</b> See <i>Return.</i>	
<b>Banks</b>	
deposits with Bank of England . . . . .	13, 55
See also <i>Joint-Stock Banks.</i>	
<b>Banks of Issue</b>	
restrictive legislation . . . . .	31
<b>Bar Gold.</b> See <i>Gold.</i>	
<b>Baring's Bank</b> . . . . .	58, 71
<b>Barometer of Money Market</b>	
foreign exchanges are . . . . .	122
<b>Belgium</b>	
post-War exchange . . . . .	224
<b>Berlin</b>	
exchange . . . . .	221
export of gold, how prevented . . . . .	62
Imperial Bank of Germany . . . . .	39
Reichsbank . . . . .	39, 62
standard of fineness of gold . . . . .	95
<b>Bill</b>	
brokers . . . . .	161, 164, 219
discounting, inadequate as outlet for capital of banks . . . . .	171
discounting of . . . . .	18
foreign agencies . . . . .	179
home and Continental demand . . . . .	18, 124
investment by foreign banks . . . . .	60, 128, 129, 132
investment by joint-stock banks . . . . .	129, 154
market . . . . .	100, 108, 164, 219
market—foreign exchange quotations . . . . .	109
rates and the price of money . . . . .	122, 160, 170

	PAGE
<b>Bill—(contd.)</b>	
runners . . . . .	166
scarcity . . . . .	159
<b>British "Crisis" Regulations</b>	40
<b>Bullion</b>	
dealing . . . . .	108
transactions of Bank of England . . . . .	95
<b>Cable Transfers</b> . . . . .	119, 159
<b>Call-Money</b> . . . . .	14, 154, 159, 167
<b>Capital</b>	
"on strike" . . . . .	92
<b>"Carry-over"</b> . . . . .	174
<b>Central Banks</b>	
functions of . . . . .	12, 231
<b>Cheque</b>	
main currency of England . . . . .	77
rate . . . . .	119
<b>City of Glasgow Bank</b>	
failure . . . . .	23, 58, 71
<b>Clearing</b>	
banks, figures . . . . .	159
house, international . . . . .	100
house returns show condition of trade . . . . .	158
<b>Collie &amp; Co.</b>	
effect of failure . . . . .	58, 71
<b>Committee on Finance and Industry</b>	229
<b>Condition of Trade</b>	
may be ascertained from official returns . . . . .	158
<b>Consols</b>	
borrowing on, by Bank of England . . . . .	63
<b>Contango</b> . . . . .	174
<b>Continental Investment</b>	
demand . . . . .	18, 60, 129, 130, 132, 139
<b>"Continuing"</b> . . . . .	174
<b>Convertibility</b>	
of Bank of England note . . . . .	6, 46
<b>Course of Exchange</b> . . . . .	109
<b>Credit</b>	
a factor in exchanges . . . . .	120
disturbance of, effect on banks . . . . .	86
disturbance of, effect on trade and money . . . . .	92
explanation of . . . . .	77, 85
reserve as basis of . . . . .	76
risk factor in discount rates . . . . .	163
sequel to failure of . . . . .	92
system and Bank of England note . . . . .	40
<b>Crimean War</b> . . . . .	22
<b>Crisis</b>	
and Bank Rate . . . . .	21
and borrowing from Bank . . . . .	84, 86
and note circulation . . . . .	47
and Other Deposits . . . . .	58, 65
and Other Securities . . . . .	71
and suspension of Bank Act . . . . .	39

<b>Crisis—(contd.)</b>	
Bank only lender in times of . . . . .	86
causes of . . . . .	22
regulations, British and Continental . . . . .	39
1847, 1857, 1866, 1914, 1931 . . . . .	22, 23, 88, 212
<b>Cunliffe Committee</b>	
and Bank of England . . . . .	184, 188
and currency note issue . . . . .	190
and foreign banks . . . . .	189
and foreign exchanges . . . . .	187
and Scottish and Irish banks . . . . .	189
and Ways and Means advances . . . . .	189
final report . . . . .	187
interim report . . . . .	184, 207
<b>Currency</b>	
Bank of England note as medium . . . . .	40
managed . . . . .	203, 227, 233
reason for increase in demand for . . . . .	82, 85
<b>Currency and Bank Notes Act, 1914</b>	6
<b>Currency and Bank Notes Act, 1928</b>	
and fiduciary issue . . . . .	85
and Return . . . . .	26
provisions of . . . . .	35, 41
Section II, <i>re</i> gold . . . . .	37, 195
text . . . . .	191
<b>Currency Note</b>	
an emergency currency . . . . .	178
control by Treasury . . . . .	35
fiduciary issue . . . . .	7, 28
form of issue . . . . .	183
inconvertibility of . . . . .	7, 210
increase in total . . . . .	184
redemption of . . . . .	35
<b>Day-to-Day Money</b> . . . . .	14, 167
<b>Deflation</b> . . . . .	199
<b>Deposit Rate</b>	
and bank rate, and market rate . . . . .	19, 160
<b>Deposits</b>	
Bank of England, and capital . . . . .	50
Bank of England, and note circulation . . . . .	32
Bank of England, repayable in gold on demand . . . . .	73
joint-stock banks, and note circulations . . . . .	33
joint-stock banks, figures of . . . . .	77, 153
the important element in banking . . . . .	33
<b>Discount</b>	
market . . . . .	156, 164
on exchange . . . . .	113, 114
rates and gold movements . . . . .	139
See also <i>Bank Rate</i> and <i>Market Rate</i>	
<b>“Discount Market in London”</b> . . . . .	155
<b>Dollar Exchange</b>	
during War . . . . .	222
<b>Dollar Securities</b>	
mobilization of . . . . .	206

	PAGE
<b>Einzig, Paul</b> . . . . .	ix, 39
<b>England</b>	
and carrying trade of world . . . . .	127
currency mainly cheques . . . . .	77
insular prejudice . . . . .	130
interest on money lent to other countries . . . . .	127
investment in foreign securities . . . . .	127
legal tender . . . . .	77
standard fineness of gold . . . . .	95
system of banking . . . . .	79
<b>Europe during War</b> . . . . .	223
<b>Exchange</b>	
affects the market where gold movement possible . . . . .	143
at premium or discount . . . . .	104, 114
bringing gold to England . . . . .	144
control . . . . .	145, 210
course of . . . . .	109
favourable and unfavourable . . . . .	115
fluctuations and price of money . . . . .	123
high, invites speculation for "fall" . . . . .	141
in favour of country receiving money on balance . . . . .	125
London rates of, method of quotation . . . . .	109
mint par. See <i>Mint Par.</i>	
par of . . . . .	101
pegging of . . . . .	201
premium on . . . . .	104
price of . . . . .	104, 106
quotations, anomalies in . . . . .	112
reasons for rise or fall in . . . . .	124
specie point. See <i>Gold Point.</i>	
stabilisation of . . . . .	200
supply of . . . . .	104
time element in . . . . .	120
See also <i>Foreign Exchange.</i>	
<b>Exchange Equalisation Fund</b> . . . . .	145, 217
<b>Exchequer</b>	
account at Bank of England . . . . .	52
<b>Failures</b>	
of great firms, effect on reserves . . . . .	87, 138
See also <i>Overend Gurney &amp; Co., Collie &amp; Co.</i>	
<b>Famine Prices</b>	
borrowing at . . . . .	87
<b>Favourable Exchanges</b> . . . . .	115
<b>Federal Reserve</b>	
banks' reserve requirements . . . . .	78
<b>Fiduciary Issue</b>	
bank note . . . . .	33
to-day . . . . .	7, 13, 27, 34, 36, 85, 184, 190, 192, 232
<b>"Fight for Financial Supremacy, The,"</b> by Paul Einzig . . . . .	ix, 39
<b>Finance and Industry, Committee on</b> . . . . .	229
<b>Foreign Bankers and Remittances</b> . . . . .	105
<b>Foreign</b>	
agencies . . . . .	181
balances held in London, New York, etc. . . . .	15, 59, 135

<b>Foreign—(contd.)</b>	
balances, repatriation of . . . . .	135, 212, 215
banks, Cunliffe Committee on . . . . .	189
bills, neglected by English bankers . . . . .	130, 132
bills, how interest is earned on . . . . .	131
capital, attracted by high interest . . . . .	64, 133
capital, not attracted by high interest . . . . .	136
coin . . . . .	95
investment demand for bills . . . . .	18, 60, 128, 130, 132, 142
investment, English . . . . .	127
<b>Foreign Exchanges</b>	
and gold movements . . . . .	142
and interest rates . . . . .	134
and international trade . . . . .	100
and the War of 1914-1918 . . . . .	177, 221
between gold and silver standard countries . . . . .	102
Cunliffe Committee conclusions . . . . .	187
defined . . . . .	99
effect of a failure upon . . . . .	138
favourable and unfavourable . . . . .	115
forward exchange . . . . .	115
long and short rates . . . . .	118
mint par . . . . .	102
par of exchange . . . . .	101
premium on exchange . . . . .	104
price of bills . . . . .	107
quotations . . . . .	108
rise or fall in, principles governing . . . . .	123
summary of causes of movements in . . . . .	139
the barometer of money market . . . . .	122
<b>Forward Exchange</b>	
explanation of . . . . .	115
<b>Fox, Fowler &amp; Co.</b> . . . . .	31
<b>France</b>	
and gold withdrawals . . . . .	94
Bank of . . . . .	62
exchange on . . . . .	106, 217, 218
export of gold to, in 1929 . . . . .	84, 212
post-War . . . . .	224
standard of fineness of gold . . . . .	95
<b>Free Trade</b>	
in gold . . . . .	94
<b>Funded Debt</b>	
commenced with founding of Bank of England . . . . .	3
<b>Germany</b>	
Reichsbank and gold . . . . .	62
standstill agreement . . . . .	215
See also <i>Berlin</i> .	
<b>Glasgow Bank Collapse</b>	
effect of . . . . .	58, 71
<b>Gold</b>	
a common denominator of exchange . . . . .	100
and Currency and Bank Notes Act, 1928 . . . . .	37, 195
and price of money . . . . .	96, 99

**Gold—(contd.)**

and Reserve	74
as link between foreign exchanges and price of money	123
attraction of	84, 139, 141
Bank of England prices	7, 9, 95
bar, profit on sale of	46
bullion standard	210
coinage of	7, 9, 45, 211
coin and bullion cover for note issue	44
concentration with Bank of England	8
conservation of, during War	207
dealings of Bank	95
effect of War upon	205
England, France and U.S.A.	213
English standard	95
export of, and money rates	61
export of, and Reserve	74
export of, preventive measures	61
export, post-War	137
foreign standards of fineness	95
free market	12, 94
free minting prohibited	7, 9
holding of Bank of England in 1934	77
how taken from Bank	74, 94
import of, and capital issues	145
licences to export after War	208
maldistribution of	213
market, free, London and New York	12
minting of	7, 9, 44, 211
mint price of	9, 44, 95
movements	139
movements and Bank of England	16, 60, 139
movements and Government Securities	69
movements and Other Deposits	60
movements and price of capital	99
movements and Reserve	93, 97
movements, causes of	96
movements, effect on Banking Dept.	76
movements, effect on discount rates and exchanges	135
movements, effect on Return	74
note issue against	34, 44
point	107
point and mint par	108
post-War efflux	137
premium imposed by Bank of France	62
price of	9, 44, 95
purchase and sale of	7, 9, 44
reserves, control and custody by Bank	36
sale by Bank	7, 9, 45
shipments during War	37
shortage	178, 213, 226
sources of	144
standard	12, 146, 231
Standard Act, 1925	6, 7, 9, 12, 46, 210
Standard (Amendment) Act, 1931	216, 218

**Gold—(contd.)**

standard and the War . . . . .	178, 205
standard fineness in England, France, Germany, U.S.A. . . . .	45, 95
standard, restoration of, in England . . . . .	• 208, 212, 217
standard, suspension of . . . . .	178, 210, 217
sterilization of . . . . .	208, 213
war demand for . . . . .	37
See also <i>Bank of England</i> .	

**Government**

balances . . . . .	53, 68
borrowing . . . . .	189
borrowing, Cunliffe Committee conclusions . . . . .	64
cheap-money policy . . . . .	3, 33
debt . . . . .	35, 48
pledged to see bank note paid . . . . .	68
Securities . . . . .	69
Securities, effect of a movement in . . . . .	80
support to Bank . . . . .	

**Great War.** See *War***Greengrass, H. W.**

"Discount Market in London" . . . . .	155
---------------------------------------	-----

**Indemnity**

for breach of Bank Act . . . . .	89, 180
----------------------------------	---------

**India**

exchange with . . . . .	201
-------------------------	-----

**Inflation**

. . . . .	196
-----------	-----

**Interest**

rates and the exchanges . . . . .	134
-----------------------------------	-----

**International**

currency . . . . .	227
gold movements and Reserve . . . . .	93, 97
indebtedness, settlement of . . . . .	106, 125
money market, Paris and New York . . . . .	209
securities . . . . .	140
Settlements, Bank for . . . . .	178, 228
trade and foreign exchanges . . . . .	99

**"International Gold Movements,"** by Paul Einzig

ix, 39

**Investment Demand**

for bills . . . . .	18, 60, 128, 129, 132, 142
---------------------	----------------------------

**Ireland and Scotland**

Bank Act of 1845 deals with . . . . .	39
Cunliffe Committee on banks in . . . . .	189

**Issue.** See *Note***Issue Department**

history . . . . .	29
indifferent to gold movements . . . . .	47
whether assets hypothecated to note issue . . . . .	39

**Issuing Authority**

new . . . . .	42
---------------	----

**Joint-Stock Banking**

I

**Joint-Stock Banks**

and deposits . . . . .	19, 160
balances with Bank . . . . .	14, 54, 66, 233

**Joint-Stock Banks**—(contd.)

cash reserve . . . . .	13
deposits of, figures . . . . .	77, 153
investment of funds . . . . .	129, 154
relation to Bank of England . . . . .	11, 233
reliance upon Bank . . . . .	78
reserve of . . . . .	78, 80

**Knauss**

on the cost of the War . . . . .	224
----------------------------------	-----

**Legal Tender**

law of . . . . .	77
------------------	----

<b>Letter of Licence</b> . . . . .	88, 180
------------------------------------	---------

**Liabilities.** See *Proportion.*

**Licence**

letter of . . . . .	88, 180
---------------------	---------

**Limited Liability**

Charter of Bank of England granted . . . . .	3
--	---

**Loan**

fund of the country . . . . .	153
-------------------------------	-----

short. See *Short Loan Fund.*

temporary, to government . . . . .	53, 189
------------------------------------	---------

**London**

bills, investment demand . . . . .	18, 60, 128, 132, 142
------------------------------------	-----------------------

Gazette, weekly Bank return . . . . .	24
---------------------------------------	----

<b>Long Rate</b> . . . . .	118
----------------------------	-----

**Macaulay**

on Bank of England . . . . .	4
------------------------------	---

<b>"Macmillan" Report</b> . . . . .	215, 229
-------------------------------------	----------

<b>Mail Transfer</b> . . . . .	119
--------------------------------	-----

<b>"Making up" Price</b> . . . . .	172
------------------------------------	-----

<b>Managed Currency</b> . . . . .	203, 227, 233
-----------------------------------	---------------

**Market**

money . . . . .	154
-----------------	-----

money, scarcity when credit is bad . . . . .	86
--	----

open. See *Open Market.*

rate, and Other Deposits . . . . .	55
------------------------------------	----

rate defined . . . . .	18
------------------------	----

rate influenced by Reserve . . . . .	141
--------------------------------------	-----

rate, relation to Bank Rate . . . . .	18, 53, 61, 160
---------------------------------------	-----------------

rate, the important factor in money market . . . . .	60
--	----

See also *Money.*

<b>"May" Report</b> . . . . .	215
-------------------------------	-----

**Melting Coin**

for profit . . . . .	46, 95
----------------------	--------

**Middleman**

in the discount market . . . . .	164
----------------------------------	-----

**Mint**

par . . . . .	102
---------------	-----

par between London and Paris . . . . .	102
--	-----

par, its relation to gold point . . . . .	107
---	-----

price of gold . . . . .	9, 45, 95
-------------------------	-----------

variation from par . . . . .	103
------------------------------	-----

<b>Mobilization of Dollar Securities</b> . . . . .	206
--	-----

	PAGE
<b>Monetary Policy, Influence on Price Level</b>	227
<b>Money</b>	
demand for	157
"easy" or "tight"	83
market and the War of 1914-18	177
market, control of	61, 62
market, loans to Stock Exchange	171
on "call"	14, 167, 168
price of, and bill rates	122
price of, and exchange fluctuations	123
price of, and gold	95, 98
price of, and stock market	175
rates, risk factors in	163
See also <i>Short Loan Fund and Bill</i>	
<b>Moratorium</b>	179
<b>"Nationalization" of Industry</b>	219
<b>New Zealand</b>	
exchange quotations	111, 113
<b>Note</b>	
and short loan fund	13
fiduciary issue. See <i>Fiduciary Issue</i> .	
for £1	35, 42, 191
inconvertibility of	7, 46, 210
issue against gold an actual loss	38
issue against securities a source of profit	38
issue, control of	20
issue guaranteed by government	34
issue, limitation of profit-earning part	31
issue, return of	24
issue. See also <i>Committee on Finance and Industry</i> .	
legal tender in England and Wales	40
lost importance as currency medium	41
position in credit system	40, 210
profits of issue	36, 38, 44, 194
purpose served by	42
regulation of, in Germany	39
release of Bank from liability to stamp duty on	36
versus cheques	42
volume in relation to deposits	32
See also <i>Currency Note</i> .	
<b>Note Circulation.</b>	
artificial increase in	42
causes of increase in	42
increase in times of panic	43
in relation to population	41
of Bank of England. See <i>Bank of England</i> .	
over-issue	29
relation of pre-War to post-War figures	42
1876-1914	41
<b>Note-holder</b>	
and depositor	39
protection of	32
<b>Note issuing Banks</b>	
extinction of	31

<b>Notes</b>		
for £1 and 10s.	. . . . .	35, 42, 191
reasons for increased demand for	. . . . .	82
<b>Notes and Coin</b>	. . . . .	73
<b>“ On Change ”</b>	. . . . .	110, 115
<b>Open Market</b>		
for money in London	. . . . .	152
policy	. . . . .	63
pressure shown by increase in Other Securities	. . . . .	70
<b>Other Deposits</b>		
and gold movements	. . . . .	61
and market rate	. . . . .	55, 62
bankers' balances and Return	. . . . .	57
composition of	. . . . .	54
effect of rumour on	. . . . .	58
figures of	. . . . .	57
floating money	. . . . .	57
increase in time of crisis	. . . . .	58, 87
movements in	. . . . .	57, 71
used as lever	. . . . .	63, 67
<b>Other Securities</b>		
and Return	. . . . .	69
composition of	. . . . .	69
defined	. . . . .	69
increase in, denotes pressure in open market	. . . . .	70
movements in	. . . . .	69, 71
on outbreak of Great War	. . . . .	72
<b>Over-Issue</b>	. . . . .	29
<b>Overend Gurney &amp; Co.</b>		
failure of	. . . . .	22, 71, 90, 168
<b>Overstone, Lord</b>		
suggestion <i>re</i> Bank of England	. . . . .	30
<b>Panic.</b>	See <i>Crisis.</i>	
<b>Paper</b>		
money, inflation of	. . . . .	178, 197
money, principle asserted by Sir Robert Peel	. . . . .	30
<b>Par of Exchange</b>	. . . . .	101
<b>Paterson, William</b>	. . . . .	2
<b>Peel, Sir Robert</b>		
principles asserted by	. . . . .	30
<b>Pegging</b>		
of exchanges	. . . . .	201, 222
<b>Population</b>		
and Bank of England Note circulation	. . . . .	41
<b>Post-War</b>		
industrial difficulties	. . . . .	203
<b>Premium</b>		
imposed by Bank of France	. . . . .	62, 94
on exchange explained	. . . . .	104
quotation as	. . . . .	113
<b>Price</b>		
of gold at Bank of England	. . . . .	9, 44, 95

	PAGE
<b>Price</b> —( <i>contd.</i> )	
of gold at Mint . . . . .	9, 44, 95
of money, and gold . . . . .	94, 99
of money, and stock market . . . . .	175
<b>Price Level</b>	
and the exchanges . . . . .	198
figures . . . . .	197
influence of monetary policy on . . . . .	230
rise in, due to War . . . . .	178
stable . . . . .	204, 231
<b>Profit</b>	
on sale of bar gold . . . . .	46
<b>Proportion or Ratio</b>	
at times of crisis . . . . .	24
figures of . . . . .	81
<b>Public Deposits</b>	
composition of . . . . .	52
movement in, and effect . . . . .	53
<b>Quotations</b>	
dominion exchange . . . . .	111
exchange . . . . .	109
<b>Ratio.</b> See <i>Proportion.</i>	
<b>Reichsbank.</b> See <i>Berlin.</i>	
<b>Remittance, Means of</b> . . . . .	124, 140
<b>Reparations</b> . . . . .	178, 228
<b>Repatriation</b>	
of foreign balances . . . . .	137, 221
<b>Repudiation</b> . . . . .	202
<b>Reserve</b>	
and Bank Rate . . . . .	21, 84, 99, 161
and foreign exchanges . . . . .	115
and gold movements . . . . .	93, 97
and market rate . . . . .	141
credit dependent upon . . . . .	79
defence of, by Bank . . . . .	80
defined . . . . .	73
effect of diminution in . . . . .	94
effect on, of failures . . . . .	84, 138
gold, conservation and control of . . . . .	20
influences upon . . . . .	82, 87
is a banking reserve . . . . .	73
movements in . . . . .	82
of Bank of England (undistributed profits, or Rest) . . . . .	50
of joint-stock banks . . . . .	77, 79
only Bank of England holds its own . . . . .	55
proportion or ratio. See <i>Proportion or Ratio.</i>	
Scottish withdrawals, effect of . . . . .	89
seasonal fluctuation of . . . . .	97
serves a double function . . . . .	93
the basis of credit . . . . .	76
<b>Rest</b> . . . . .	49
<b>Return</b>	
and bankers' balances . . . . .	57

<b>Return—(contd.)</b>	
Banking Department . . . . .	26, 27, 49
effect of gold movement on . . . . .	74
explanation of change in . . . . .	26
illustration of . . . . .	24-26
Issue Department . . . . .	26
Macmillan Committee, recommendations of . . . . .	232
modification of . . . . .	36
Other Securities shown in detail . . . . .	69
<b>Risk Factor in Rates</b> . . . . .	163
<b>Royal Exchange</b>	
course of exchange . . . . .	109
the bill market . . . . .	100, 104, 108, 115, 118
<b>“ Run ”</b>	
and Other Deposits . . . . .	58
effect on Issue Department . . . . .	47
<b>Schacht</b>	
“The Stabilization of the Mark” . . . . .	ix, 224
<b>Scotland and Ireland</b>	
Bank Act of 1845 deals with . . . . .	39
Cunliffe Committee on banks in . . . . .	189
<b>Securities</b>	
arbitrage of . . . . .	140
international . . . . .	140
issue against . . . . .	13, 27, 36, 38, 85, 192
<b>Seven-day Bills</b> . . . . .	54
<b>Short Loan Fund</b>	
and Bank Rate . . . . .	14, 17
and note circulation . . . . .	15
augmentation of . . . . .	16
bankers' balances with Bank of England . . . . .	17, 55
demand . . . . .	155
supply . . . . .	154
<b>Short Rates</b> . . . . .	118
<b>Sight Rate</b>	
in relation to T.T. . . . .	119
of exchange . . . . .	119
<b>Silver</b>	
a common denominator of exchange . . . . .	100
coin held by Bank of England . . . . .	38
Exchanges . . . . .	102
See also <i>United States</i> .	
<b>South Africa'</b>	
exchange quotations . . . . .	112, 113
<b>Sovereign</b>	
supersession of . . . . .	42
<b>Specie Point.</b> See <i>Gold Point</i> .	
<b>Speculation</b>	
and Bank Rate . . . . .	20
<b>Stabilization</b>	
<i>de facto</i> . . . . .	200
<i>de jure</i> . . . . .	200
post-War . . . . .	136
“Stabilization of the Mark, The,” Schacht . . . . .	ix, 224

<b>Standard of Fineness</b>		
gold . . . . .		45, 95
<b>State Bank</b>		
Bank of England not a . . . . .		8
of the U.S.S.R. . . . .		8
<b>Sterilization of Gold</b> . . . . .		208
<b>Stock Exchange</b>		
brokers and jobbers . . . . .		172
bull, definition . . . . .		173
"carry-over" . . . . .		174
contango . . . . .		174
influence of price of money . . . . .		175
loans to . . . . .	158,	171
making-up price . . . . .		172
market and price of money . . . . .		175
prices and price of money . . . . .		176
speculation with borrowed capital . . . . .		173
<b>Suspension of Bank Act</b> . . . . .	39, 81, 85,	178
<b>Taxes</b>		
effect on Public Deposits . . . . .		52
<b>Telegraphic Transfers</b> . . . . .	101, 118, 119	
<b>Ten Shillings</b>		
notes for . . . . .		35, 191
<b>Time</b>		
element of the exchanges . . . . .		120
<b>"Times, The"</b> . . . . .	64, 110, 112, 134	
<b>Transfers</b>		
cable . . . . .		118, 159
mail . . . . .		119
sight . . . . .		119, 159
telegraphic . . . . .		118
<b>Treasury Bills</b>		
and the War . . . . .		177
history . . . . .		149
in relation to commercial bills . . . . .		219
tender . . . . .		150
the dominant factor in the discount market . . . . .		150, 177
See also <i>Government Securities</i> .		
<b>Treasury Note.</b> See <i>Currency Note</i> .		
<b>Treasury, The</b>		
a new issuing authority . . . . .		42
borrowing from Bank . . . . .	53, 68,	189
<b>Unfavourable Exchanges</b> . . . . .		115
<b>United States.</b> See <i>America</i> .		
<b>Variation in Bank Rate</b> . . . . .		161
<b>Vocabulary</b>		
monetary, and the War . . . . .		178
<b>War</b>		
and foreign security holdings . . . . .		127
and gold standard . . . . .	178,	205
and growth of forward exchange market . . . . .		115

	PAGE
<b>War—(contd )</b>	
and holding of foreign balances . . . . .	135
Bank Rate at commencement of . . . . .	93
concentration of gold reserves after . . . . .	9
conservation of gold during . . . . .	207
debts, payment to America . . . . .	217, 225
demand for gold . . . . .	37
effect on currencies . . . . .	136, 221
effect on gold . . . . .	205
effect on Treasury Bills . . . . .	156, 177, 219
effects on the Money Market and foreign exchanges . . . . .	177
expenditure . . . . .	182
finance . . . . .	6, 35
Knauss on cost of . . . . .	224
mobilization of dollar securities . . . . .	206
“nationalization” of industry . . . . .	219
post-War industrial difficulties . . . . .	203
production . . . . .	6, 181
rumours, effect of . . . . .	58
shipments of gold during . . . . .	37
stabilization . . . . .	136, 200
<b>Ways and Means</b>	
advances . . . . .	53, 68, 189
<b>Westminster Bank, Ltd.</b> . . . . .	51
<b>Wholesale Prices</b>	
Index numbers . . . . .	197
<b>Window Dressing</b>	
by banks . . . . .	58, 70, 233

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