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A MANUAL OF FOREIGN EXCHANGE

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AND "AN INTRODUCTION TO THE PRACTICE OF FOREIGN EXCHANGE"

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THE PAPER AND BINDING OF
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PREFACE TO THIRD EDITION

At the present moment, the chief nations of the world are admittedly experimenting with currency values. The technique of currency management has attained a temporarily static form, but the levels at which currencies shall exchange one for another is still in course of being discovered by a process of trial and error. The eventual international monetary system which will emerge is still in the womb of Time and, under such conditions, all that the would-be historian can do is to deal with things as they are and not as they may be.

Consequently, this edition must be regarded as transitory since it cannot be more than an attempt to deal with a period of transition. Even more than before am I conscious of its imperfections and shortcomings, but I crave the indulgence of my readers under extenuating (and very provoking) circumstances.

H. E. E.

NOTE TO THIRD EDITION REPRINT

CERTAIN chapters of this book deal with the pre-war foreign exchange market, which is, at least for the present, no longer in existence. The post-war International Monetary System is slowly taking shape, but is still in too fluid a state to be moulded into a coherent whole. Consequently, the necessary revision of certain parts of this book has been temporarily postponed, but the story of post-war developments in world monetary affairs up to July, 1947, is told in the author's companion volume, *Exchange and Trade Control in Theory and Practice* (Pitman).

H. E. E.

PREFACE

TO FIRST EDITION

THREE years ago, in reply to inquiries whether I was going to write another book, I used to answer in an emphatic negative. Since then, I have come to the conclusion that preparing a new edition of an existing book is at least as hard a task. My first book was a composite volume entitled *Practical Banking, Currency and Exchange*, and year by year, while the banking section required little, if any, alteration, the foreign exchange side required continuous amendment and extension. At last the volume reached over 600 pages but needed still further revision and extension, and my publishers consented to its division into two separate books. *Practical Banking* has been issued on its own and here is the companion to it.

The title of A MANUAL OF FOREIGN EXCHANGE has been chosen for the present volume so as to avoid any possible confusion with any other of the many works on the same subject. It consists mainly of Part II of the original composite volume, but I have done my best to eliminate errors, to supplement omissions, and to bring it as up to date as is possible when new happenings are of daily occurrence and a period of months must elapse between the writing and the publishing of such a book as this. With some invaluable help from my friend Mr. A. E. Williams, I have re-written entirely the chapter on Empire Exchanges, many other sections have been altered and extended, and paragraphs (or at least footnotes) have been added on the most recent happenings in the financial world.

I am most grateful to all those who have given me help and encouragement, particularly to those who have written to tell me that my work has been of use to them, and I must, of course, acknowledge my indebtedness to Mr. W. F. Spalding for the early knowledge gained from his numerous and comprehensive works on Banking and Foreign Exchange.

H. E. E.

LEIGH-ON-SEA.

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A MANUAL OF FOREIGN EXCHANGE

CHAPTER I

MONEY, CREDIT, AND PRICES

PRIMITIVE man was under the necessity of satisfying such of his needs as his own personal efforts could not cover, by exchanging the products of his labour for the differing products of the labour of others, as, for example, where a grower of potatoes feeling the need for a change of dietary, exchanged part of his potato crop for part of a catch of herrings with a fisherman who felt a similar want.

This exchange of commodities for commodities is known as "barter," but such a double coincidence of wants is impossible under our modern social system. Imagine a market gardener who wants a haircut making a round of barbers' shops in an endeavour to find a barber who will cut his hair in exchange for a bunch of radishes! Not only might he find difficulty in discovering a barber who was fond of radishes but the further difficulty would arise of the nice adjustment of the number of radishes which each party considered the haircut to be worth.

With the development in mankind in general of a diversity of needs requiring satisfaction, came the need for some medium in terms of which the value of all commodities could be expressed, i.e. the need for a common denominator of value. This medium was termed "money" and many different substances have been used for the purpose. Always, however, the substance has been one which was desired for its own sake, as well as for its utility in facilitating the exchange of goods and services, by the community by which it was used. Oxen among the ancient communities, tea in China, salt in India and Arabia, cowrie shells in Africa, all having in themselves a value in the eyes of the persons using them, have served as material money.

“ Money ” Defined.

We may best define money as something which is accepted generally by a community as a measure of value and a medium of exchange of goods and services. It is a measure of present value; but it should also be a measure of future value, a *store* of value, that is. It gives the owner a command over the goods or services of other members of his community, which command he should be able to exercise at his option. Anyone who has exchanged his goods or his labour for money should have obtained something which he can again exchange for the goods or services of others to an extent which satisfies him that he has received a fair return.

Qualities of a Money Material.

In order to function successfully, the substance chosen for the money of a community should possess certain attributes which may be described as—

- (1) Utility and value,
- (2) Portability,
- (3) Indestructibility,
- (4) Homogeneity,
- (5) Divisibility,
- (6) Stability of value,
- (7) Cognizability.

This means that the substance chosen must possess utility in that it is generally accepted by the community as a medium of exchange and must have value in that it is desired for its own sake, i.e. it has intrinsic worth. It must be of a form which will allow a large value to be represented by a comparatively small bulk; wheat or rice does not make good money as one would have to carry about 5 bushels of wheat to pay for a suit of clothes. It must be durable to withstand constant handling and must not be subject to deterioration, as would be the case with fish or eggs. It must be of the same value throughout and must be capable of being divided into smaller parts without a disproportionate loss of value; cattle and slaves as money would not fulfil this condition. In order to act as a store of value, it must be something of which the demand for and supply of is as constant as possible, so that fluctuations in its own value are reduced to a minimum. Finally, it must be something which can be recognized easily and

for which the substitution of something similar can be readily detected.

With the evolution of modern social life came the elimination of most of the early forms of money until the choice was narrowed down to the "precious" metals, gold and silver. The reasons for the final adoption of gold almost generally are given later in this chapter.

The Work of Money.

The substance chosen as money is called upon to perform the following functions. It must be—

(a) A MEDIUM OF EXCHANGE in that it is freely accepted within the community in exchange for goods and services;

(b) A MEASURE OF VALUE in that the value of all other commodities and services can be measured or expressed in terms of the commodity used as money, i.e. it is a common denominator of value;

(c) A STORE OF VALUE in that the passage of time should not cause its power to command a given quantity of goods or services either to increase or to decrease;

(d) A STANDARD FOR DEFERRED PAYMENTS, which follows from its being a store of value and which means that where a creditor and debtor agree upon payment at some future date in terms of money, for goods or services rendered immediately, the money shall, when the future date arrives, still represent a command over a similar quantity of goods or services and that no hardship or loss is suffered by either party by reason of the debt having been expressed in terms of money; in other words, money must possess a purchasing power which remains reasonably stable even over lengthy periods.

Narrow and Wide Meanings of Money.

Some difference of opinion exists as to the precise meaning which should be accorded to the two terms, "Money" and "Currency." Each is often used to describe either the actual coins and paper money in use in a country, or any credit instruments which convey the right to wealth in terms of any given unit, or to cover both these classes together. The practical interpretation placed on these terms is that "currency" is used to describe any generally accepted coin, note or credit instrument capable of

transferring the property in a stated number of units of account as used in any given country, i.e. "Currency" is the generic term, while "Money" is used to describe the actual money in the form of coin or notes or any form which passes freely from hand to hand as the recognized medium of exchange within a country. Thus when we speak of dealing in German, French, etc., "currency," we should mean the buying and selling of the right to a certain number of the units of account of that country, such right being expressed usually in the form of a credit instrument but possibly in the shape of gold bullion or actual coin or notes, while when we speak of dealing in German, French, etc., "money," we should mean the buying and selling of the actual medium of exchange in internal use in that country in the form of coin, or notes, or whale's teeth, or whatever the customary medium may be.

Metallic Money.

Reference to the list of general qualities which should be possessed by a substance to render it capable of acting as an efficient medium of exchange will show that the choice of suitable substances is comparatively limited. The essential attribute of stability of value means that both the supply of and demand for the commodity must be maintained in a fairly constant equilibrium, as any variation between the supply of and demand for the commodity itself would lead to variations in its value in terms of other commodities. By a process of gradual elimination the principal countries of the world narrowed their choice of a substance for use as the standard unit of exchange and of account to the "precious" metals gold and silver. For a time attempts were made in several countries to use both metals together, one being kept at a certain ratio to the other. This system, known as "Bi-metallism," is dealt with in Chapter III.

Eventually the margin of fluctuation between the supply of and demand for silver proved to be so much greater than that of gold that silver was discarded as a principal form of money and gold became almost universally accepted as the substance most suitable as the basis of a monetary system.

The main reasons for this choice may be summarized as follows:

(a) it possesses almost to the full every one of the desirable attributes of a medium of exchange, from which it follows that

(b) its use in the arts and for commercial purposes makes it desirable in itself, i.e. it has intrinsic worth;

(c) except during the periods when exploration of previously unknown parts of the globe resulted in the discovery of new sources of supply (which in themselves rendered possible the general adoption of gold as a monetary standard by providing the quantity needed), the annual output of gold has hitherto been barely sufficient to meet the expanding requirements of the world for the metal for all purposes. This ensured the necessary equilibrium between supply and demand which alone will maintain the stability of value of gold in terms of other commodities. The present tendency is for the existing mines to become "worked out," thus reducing the supply, and for world demand to increase in proportion at least to the growth in population and wealth;

(d) once it has been refined, each particle of gold has the same value as any other; gold can be easily worked into the form of coins; its weight for value permits a small bulk to represent a high value; it can be easily recognized by its colour and ring and can be tested for genuineness and, even if unmixed with alloy, will wear for many years without much loss by abrasion and without any deterioration of its essential qualities.

With the adoption of a metal for use as a medium of exchange comes the need for some method of showing the weight and value of each piece of metal used. Obviously, in any community, some authority (usually the State) must be responsible for the proper marking of the pieces of metal, and in most civilized countries to-day the Government has assumed, in fact monopolizes, this responsibility, measures being taken to prevent and punish counterfeiting or damaging of the money issued. Even in China, where almost from time immemorial the native money has been a sycee or "shoe" of silver bearing the "chop" or stamped mark of the local banker as a token of the weight of pure silver which it is alleged to contain, modern opinion of Young China is in favour of a properly controlled Government issue of money based on gold. The process of authenticating each piece of metal eventually led to the working of an exactly measured quantity of the metal into the form of a disc bearing a design or inscription on both sides, known as a coin. With the further march of civilization came more perfect processes of coining or minting, while each country began to make

laws prescribing the weight and purity of the metal required to mint one standard coin. The details of the State Minting of coins are discussed more fully in Chapter III.

Paper (Faith) Money.

It is a little difficult to draw a clear-cut distinction between a piece of paper issued as an actual substitute for a certain number of metal coins and performing all the functions of such coins, and a piece of paper which performs the functions of "money" simply because of the confidence placed in the issuer by the rest of the community. Where paper money is freely issued in exchange for the quantity of the standard metal which it purports to represent, and is as freely taken back by the responsible authority and the same quantity of standard metal given in return, there is no difference whatever between the use of such paper as a measure of value and as a store of value and the use of actual coined metal for that purpose. In fact, the use of paper money as a substitute for actual coins is a saving in wear and waste of the metal as well as giving greater portability, since one piece of paper can represent many coins, e.g. a £50 note. Where, however, paper money does not represent the deposit of an equivalent amount of standard metal the element of "credit" enters, and there are great dangers attending the over-creation of credit. These dangers are discussed on later pages.

The medium of exchange which performs the bulk of the money work in any community is paper, which is normally accepted in the faith that it will be equally acceptable in, or even outside, the community. This paper is usually a written promise to pay (a bank-note) issued by or under the authority of the State.

By a gradual process the note issue of this country has become concentrated in the hands of the Bank of England, under Government authority, with the exception of small local issues by commercial banks, but in most countries the issue of paper money is entirely under the control of the State, even though the actual issue is made by the Central Banking Authority. The essential attribute of paper money is that it should be accepted by the members of the community within which it circulates as if it were actually the quantity of metal which it represents, and that it should consequently pass freely from hand to hand without question. This prevents other paper promises to pay, such as cheques and

bills, from being regarded as paper *money*, even though the actual paper money may be to a large extent based on "credit" in the same way as are cheques and bills.

"Convertible" and "Inconvertible."

As has been stated, the ideal form of paper money was considered to be that which was freely exchangeable for gold and *vice versa*, and where such a state of affairs exists the issue is said to be fully convertible paper money. Such paper is sometimes known as "bullion certificates," as each piece of paper represents and is a promise to repay an equivalent amount of bullion. Such were the certificates issued by the United States Treasury. Modern developments in the use of paper money, however, have shown that, as in the case of bank deposits, only a certain proportion of the outstanding issue is likely to be presented for repayment at any one time, the bulk of the issue being in continuous use by the community for the performance of the necessary money work. Therefore the practice has grown up of permitting the issue of paper currency backed as to a certain percentage by gold, or the standard metal, and as to the remainder by approved securities or credit instruments. The relative proportions of the backing may be fixed by custom or by law. In this country the Bank of England note issue is fixed by statute. Whatever the issue may be, only £260,000,000 (the *fiduciary* issue) may be backed by securities under normal conditions. Any issue in excess of this amount must be backed in full by gold. If conditions demand an increase in the "fiduciary" issue in excess of this amount, Treasury sanction must be obtained, but it may be assumed that the Bank could *reduce* the amount of the "fiduciary" issue on its own responsibility should conditions warrant such a step. Thus *there is no legal percentage of gold cover to our note issue*, but reasonable convertibility is assured by limiting the amount of notes which may be issued on "credit" backing, and it remains for future legislation to reverse the present position and to fix a *minimum* percentage of gold backing to the issue, leaving the balance to be covered by securities.

The post-war reconstruction of currencies has led to a greatly increased demand for gold for the purpose of backing issues of paper currency, and the use of such currency has become general because it effects an economy in the use of the metal by permitting a smaller

quantity to serve as the basis of many currencies than would be the case if actual coins had to be minted and put into circulation. The principle of providing only a percentage of gold backing against the total issue of 'paper has' become almost universally adopted, the percentage fixed being in all cases very much more than sufficient to cover even abnormal encashments of the notes. For example, the National Bank of Belgium is required to hold at least 30 per cent of the total of all its sight liabilities (including its note circulation) in gold; the Bank of France must hold in gold at least 35 per cent of the total note circulation plus current credit accounts; the German Reichsbank must hold in gold not less than 30 per cent of its total note circulation,¹ while the National Bank of Switzerland must hold cover for at least 40 per cent of its note circulation in the form of Swiss gold coin, gold bullion or foreign gold coin. It will be noticed that the minimum gold cover required is 30 per cent, and even in these cases it is required to be supplemented by a further 10 per cent of cover to be held in the form of rights to the currency of other gold standard countries, which is practically equivalent to gold. After the return of this country to a gold standard in 1925, the gold coin and bullion held by the Bank of England as cover for the issue in excess of the fiduciary issue was normally about 35 per cent of the total issue. It would therefore appear that the world in general is now prepared to accept as fully convertible for practical purposes any note issue of which roughly one-third is covered by actual gold holdings, and it must be admitted that such systems of currency provide a country with a cheap form of money and avoid the heavy loss of interest involved if the State or Central Bank had to purchase sufficient gold to provide a full metallic currency, as well as preventing the demand for gold for currency purposes from completely overwhelming the supply.

Finally, there is the type of paper money issued, usually by impoverished states, without any gold backing whatever. When a Government begins to issue coins of the standard metal which are less than the legally fixed weight and fineness it "debases" the coinage. If notes are issued with no backing whatever, this is equal to complete debasement of the coinage. The paper has no value in itself, and though it may serve as an internal medium of exchange as long as the total amount issued is strictly limited to the money

¹ Temporarily suspended since 1931; the others since 1936.

needs of the country, it has always been found that a Government which once permits the issue of such inconvertible paper has the utmost difficulty in resisting the temptation to continue to finance itself by further issues.

Inconvertible paper is, in effect, a compulsory loan from the community since the Government enforces its acceptance by the people in payment of sums due to them. On the other hand, it has to accept payment to it of taxes and other dues, and should there be any form of money current in the community which has intrinsic value it will be hoarded or used for export, and the inconvertible paper will be passed on internally as quickly as possible.

The effects of an over-issue of inconvertible paper on a country's international relations are dealt with in Chapter V.

Gresham's Law.

The effect of having two or more media of exchange circulating together in a country was an early discovery doubtfully attributed to Sir Thomas Gresham in the time of Queen Elizabeth. The statement is commonly known as "Gresham's Law," and in its simplest form may be expressed thus: "Bad money drives out good money, but good money can never drive out bad money." This may be more fully expressed by applying it to three separate cases:

(a) if there is a standard currency of only one metal, the coins of which vary in weight or quality but circulate at the same nominal value, the worst coins will tend to drive the better from circulation since the latter will be hoarded or exported, but the better can never drive out the worse;

(b) where standard coins of two metals circulate together at a legally fixed ratio, one to the other, and one metal has a greater intrinsic value than the other, the cheaper metal, i.e. that which is over valued by the legal ratio, will tend to drive the other from circulation;

(c) where inconvertible paper money circulates side by side with a standard metallic currency and the former is issued in excess, the inconvertible paper will tend to drive the metal from circulation.

Lord King's Law.

During the monetary crises which marked the latter part of the eighteenth century, the rise in the market price of bullion and the

adverse rates of exchange led to investigations being made as to the effects on the currency system of the volume of inconvertible paper which was in circulation at that time. The result was summarized by Lord King, as a kind of corollary to Gresham's Law, to the following effect, that where gold coins and inconvertible paper circulate together and the market price of gold exceeds the legal selling price of the central authority (this being inoperative since the paper is inconvertible), and where the value of the home currency in terms of other gold currencies has fallen below the point at which gold would have been purchased from the central authority for export, then the paper currency is depreciated and the difference between the market price of bullion and the legal selling price is the measure of that depreciation.

This was exemplified in the years immediately after the War and before the return of this country to a gold standard, when, our paper currency being inconvertible and the legal obligation on the Bank of England to sell gold at a fixed price having been suspended, the value of the pound in terms of the U.S. dollar (which was still on a gold basis) fell from the normal of about 4.86½ to as low as 3.20, while the price of bullion in the open market rose from the normal of just under £4 5s. per ounce to well over £5 thus enabling an exact measurement to be made of the depreciation of our paper currency in terms of gold. It was exemplified in an even more striking fashion after the suspension of gold payments by this country in 1931. For the first eighteen months the price of gold in London was fixed, at the daily meeting, on whichever principal gold currency showed the greatest appreciation in terms of sterling. With the suspension of gold payments by the U.S.A. in April, 1933, and by France in September, 1936, the London gold price was fixed daily on the current exchange rate between, in the former case, London and Paris, and in the latter, London and New York. See also Chapter VII.

Credit.

The simple definition of the term "credit" as used in a business sense is "trust," and it may be described as that confidence of one person in another which permits the one to entrust to the other something of value without immediate value being given in return. The granting of credit may be accomplished by according an

extension of time for the payment due in respect of goods or services, which is the form of credit generally granted by traders, or it may be by furnishing the individual with the means of increasing his immediate purchasing power, as is the case when the individual is granted a loan in money or a bank overdraft or has a bill discounted, thus anticipating the maturity of a debt due to him, or it may be in the form of according him financial credit, as is the case where a bank or any person or persons permits a bill to be drawn by another party, and so allows money to be raised on their good name and reputation.

The essential attribute of credit is that it implies confidence on the part of the creditor in the debtor that the latter will meet his eventual obligation promptly and fully. For the growth of an extensive credit system it is therefore necessary that it should be a generally accepted tenet of the business community that a reputation for solvency and prompt discharge of obligations must be preserved at all costs, and the legal code of the community must provide for the absolute security of property and give a genuine creditor legal rights for the enforcement of payment or penalties against a genuine debtor.

Creation and Utility of Credit.

Instances of the ways in which credit may be created have already been given, but the forms which such creation may take are many and varied. Although trust or confidence is the essence of credit it is customary for there to be in existence some tangible evidence of the debt created. Since credit involves a promise of repayment at some future time, written evidence of the existence of the debt is usually taken by the creditor from the debtor and such forms of evidence are known as *Credit Instruments*. These include government notes, bank notes, cheques, bills of exchange, promissory notes, postal orders, money orders, and other negotiable or semi-negotiable instruments; in fact any document representing a right to wealth in the form of money may be classed as an instrument capable of creating credit. For example, if a person has subscribed £1,000 in cash towards the capital of an industrial company and obtains a share certificate in exchange, he can, under certain conditions, pledge that security with his bank against an advance for the major portion of its current value, which gives him an immediate

further spending power, while his original cash has gone to increase the spending power of the company to whose capital he subscribed.

It may, therefore, be said that the creation of credit creates additional spending power in the community, and in this lies both its greatest use and its greatest danger.

The utility of credit instruments depends on the reputation of the debtor or party responsible for their eventual discharge. Government or bank notes may be made to pass current as money by law, but cheques and bills pass current only in the limited circle in which the names of the parties are known and are acceptable. The main functions of credit instruments are to act as a substitute for legal money in the facilitating of exchanges of goods and services, and so to economize the use of gold or other precious metal as a form of currency.

While the basis of the acceptability of any credit instrument is the confidence held in the ability of the responsible party eventually to discharge the instrument by payment in terms of the legal metal, usually gold, the use of metal as currency would not actually be economized if every credit instrument had to be discharged in this way.

The modern social system is so complex and the exchanges of goods and services are so numerous and so varied that each member of the community owes to, as well as is owed by, the rest of the community and only in the event of an individual who was a creditor on balance demanding payments in coined money would the need arise for any internal payments to be discharged by legal metal. The growth of the credit system, however, has rendered the payment of such individual balances by means of metal unnecessary. An individual receives his income in the form of credit instruments which, if in the form of paper money, he uses for the usual domestic payments, or which, in any other form, he pays into his bank. His expenditure, other than that made in the form of paper money, is made by means of cheques drawn on his banking account, and any excess of income over expenditure is shown by a steadily increasing sum standing to his credit in his banking account. A short consideration of the working of our banking system, and of the Bankers' Clearing Houses in particular, will show further how the everyday use of credit instruments economizes the use of coin or paper money and permits the concentration of comparatively

small amounts of individual wealth in the hands of relatively few banks and financial organizations.

Limits to the Creation of Credit.

In order to preserve a reasonable convertibility of credit in any form into legal money and, more particularly, into a precious metal which is acceptable for the purposes of international trade, the volume of credit existing in any community must bear a strict relationship to the amount of precious metal owned by that community. The metal need not be entirely in the physical possession of the community but may be represented by rights to such metal held by another community as, for example, where the note issue of a country is backed partly by an actual gold holding and partly by "gold exchange," i.e. credit instruments payable in other centres where payment can be legally demanded in gold and the gold withdrawn to the home centre. In all modern communities the basis of the use of credit instruments other than legal paper money is that they shall give the holder the right to demand payment in the form of legal coin or paper. If payment is made in legal paper the ability of the holder to demand gold (since gold is now the international medium of exchange) depends entirely on the degree of convertibility of the legal paper. Any credit system, therefore, must be based primarily on the proportion of gold or gold exchange backing to the legal note issue, having regard to the fact that in the majority of countries to-day, with the exception of the U.S.A.,¹ Canada,² Switzerland, and Sweden, the State or Central Bank holds the entire gold stock of the nation, and even in the case of the countries mentioned, the amounts held privately are not considerable. If, therefore, it is desired to turn credit instruments into gold the instrument must first be exchanged for notes and the notes then exchanged for gold. The volume of bank credit in a country is therefore built up as follows—

(a) a note issue based probably on one-third gold and two-thirds credit;

(b) credit created by the Central Bank against its own cash reserve in the form of notes and coin, i.e. it will hold, say,

¹ In 1934 the U.S.A. Treasury took over the entire gold holding of the Federal Reserve System.

² In March, 1935, the Central Bank of Canada took over the gold holdings of the Canadian Treasury and of the commercial banks in Canada.

40 per cent in cash against its total deposits, the remaining 60 per cent being covered by credit instruments in various forms;

(c) the commercial banks' cash reserves in the form of coin, notes, and balance at the Central Bank, representing, say, 10 per cent of their total liabilities, the balance being covered by credit instruments in various forms.

In each case the credit instruments held comprise certain proportions of obligations of the State in the form of Treasury Bills or Government Loans, certain securities for capital issues such as municipal or railway stocks, first class industrial debentures, stocks, and preference shares, etc., and certain obligations of leading firms and individuals in the shape of accepted bills of exchange, but the real volume of bank credit is to be found in the total of advances made by the Central Bank and the commercial banks. As was shown in my book on banking, banking practice in this country sets a limit of about 50 per cent as the total of the proportion of advances to deposits. Since certain other proportions of assets are already held in the form of credit instruments, any increase in the volume of credit by the commercial banks can only be effected by reducing the proportion of assets held in other forms, e.g. cash and premises, and increasing the proportion of advances, but a change in our present banking practice would be necessary to render this possible. It is the Central Bank, therefore, with its much higher proportion of cash to liabilities, which is in a position to increase or decrease the volume of bank credit in a country once the limit of the commercial banks has been reached. By increasing or decreasing the amount of its advances it can correspondingly increase or decrease the amount of its deposits and so raise or lower the amount of bank cash at the disposal of the other banks, or of its own customers. If, for example, the Central Bank has private deposits of £75 millions against which it has made advances of £25 millions, and it increases these advances to £50 millions, causing an increase in deposits to £100 millions, the commercial banks will eventually have their cash reserves increased by £25 millions by transfers to them of the amounts obtained by private individuals or by themselves from the Central Bank, which are necessarily required for commercial purposes. If, then, the commercial banks previously had a total of deposits of £1,750 millions against which they held

£175 millions in cash and balances at the Central Bank, their cash reserves will increase to £200 millions but their deposits to only £1,775 millions. Their advances previously will have been about £875 millions, but with a cash reserve sufficient to cover deposits of £2,000 millions they can proceed to purchase further bills and securities and to make further advances to customers to the extent of £225 millions since each purchase or advance results in a credit to a deposit account somewhere and the adjustment of proportions by individual banks leads to an eventual levelling out of the total proportion. Action by the Central Bank, therefore, is likely to produce nine times the effect on the total volume of bank credit in the country where such proportions are generally accepted, and the proportion of cash to deposits held by the Central Bank is therefore of vital importance, since, if the increase in bank credit becomes too large, the ability of the public to draw notes from the banks and so to obtain gold in exchange for notes may result in such large amounts of gold being withdrawn that the convertibility of the note issue is endangered. It is for this reason that changes in the official rate of interest (Bank Rate) are made, since a low Bank Rate encourages borrowing and so tends to expand credit, while a high Bank Rate discourages borrowing and encourages saving, so that in the latter case loans are paid off, credit is contracted, notes in circulation are paid in by depositors to the banks and by them to the Central Bank, and the cash reserves of the commercial banks and the Central Bank are both increased, while the volume of deposits is more than proportionately reduced by the repayments of advances.

The limits to the extension of individual credit are the estimated capacity of the borrower to repay and the corresponding willingness of lenders to grant him credit. In trade circles the status and resources of most firms in the trade are known, and reports on them can be obtained from the banks and from various institutions specializing in the supply of credit information, e.g. Seyds, Bradstreets, etc., and the amount of credit, i.e. deferred payment, which they can obtain varies accordingly. The ability of the private person to obtain such credit varies with the estimate of his status formed by the supplier, which often varies with the person's own power of creating an impression in the mind of a tradesman. The hire-purchase system is dealt with below.

Perils of Credit Inflation.

While the extent to which credit is being created can be readily seen in the case of a note issue or of bank advances, it is far from easy to keep a check on the amount of credit obtained by any private firm or individual. When the metallic reserve held against a note issue becomes obviously insufficient, a loss of confidence in the paper currency immediately ensues and forces are set in motion which, as will be seen later, tend to force either a withdrawal of part of the issue or eventually a reconstitution of the currency. Any excess of advances by an individual bank will result also in a loss of confidence, withdrawals of deposits, and eventual bankruptcy unless immediate steps are taken to rectify the position. Where, however, a private firm or person is obtaining credit in many directions, it is impossible for each lender to know exactly the extent of the borrower's liabilities unless the latter makes a full and truthful statement of his position. Consequently, the indiscriminate granting of credit by banks and traders is likely to lead to overtrading by firms and persons with a limited capital and, should any crisis arise, the inability of the firms and persons to whom too much credit has been granted to meet their obligations may lead in turn to the eventual bankruptcy of those who allowed the credit. The force of competition between both lenders of money and sellers of goods is always inclined to render it easy for more credit to be obtained by any party than is strictly justified, and this is particularly so since the development of the hire-purchase system. While it must be admitted that this system enables the individual to enjoy at once the possession of goods which he might never be sufficiently thrifty to be able to purchase outright for cash, and also encourages trade and stimulates production by enabling an immediate demand for goods to be created, at the same time it has a tendency to induce people to purchase articles which they would otherwise class as luxuries beyond their means and, by tempting them to mortgage their future prospects of savings for the immediate possession of such articles, often places them in the position of being unable to meet some sudden and unforeseen demand on their resources, such as illness or loss of employment, unless they surrender the article purchased and lose all or more than the sums they have already paid on account. Where extensive purchases on this system have been made by a community

and severe trade depression ensues, leading to less employment and reduced wages, the inability of many purchasers to continue their payments leads to markets becoming glutted with second-hand goods and this serves only further to depress trade and increase unemployment.

One of the greatest sources of the over-creation of credit is to be found in stock exchange operations and the over-inflation of the quoted value of securities. A stock exchange "boom" is usually started by some extra activity in a certain branch of trade. On the assumption that the profits of firms engaged in that trade will benefit considerably and that dividends will be consequently increased, the professional operators will begin to bid for the shares of such concerns and cause them to rise in price. The interest of the investing and speculating public is thereby aroused and buyers appear from all quarters. Not to be outdone, dealers in the shares of concerns having only the most remote connection with the trade in which the unusual activity prevails, promptly proceed to raise the prices of the securities in which they are interested, and they can usually inspire favourable notices in the daily Press as to the excellent prospects of capital appreciation in any and every share. Once more the gullible public rushes in and the "boom" in shares becomes general. At their increased market values, shares become the basis for increased advances which, in turn, mean increased bank deposits, and the additional credit passes from hand to hand as early buyers sell out and take their profit at the higher level, leaving the shares in possession of new buyers. It is difficult to explain the mass psychology which induces people to believe that the price of shares will continually mount higher and higher, and which allows an utter disregard of the elementary principles of finance which demand a reasonable return by way of interest on capital invested, but it is a curious fact that at such times the intrinsic value of shares is completely ignored and the public seems to become obsessed with the "get rich quick" fever. In due course sellers begin to outnumber buyers and the professional operators again step in and, by "selling short" large blocks of shares, force weak holders to throw out their shares on an already falling market until something approaching a selling panic is produced and share values are brought down to or below the level at which they started, and the wily professional quietly buys in the shares which he has

sold "short" and contemplates his pass book with satisfaction. The effect of such financially, socially, and ethically unsound operations is twofold. Weak holders of shares who have pledged their holdings with a bank or broker as security for the advance of part of the purchase money, find themselves unable to provide the difference between the value at which they were pledged and the value then current, and must be "nursed" by the lenders if wholesale bankruptcies are to be avoided. This means that a certain portion of the credit which has been created becomes "frozen," i.e. incapable of immediate liquidation, and thus a certain portion of the loanable funds of the financial community is locked up, with the result that genuine trade borrowers may not be able to satisfy their requirements. Further, the task of repayment of such loans by borrowers means that their savings for some time to come must be devoted to this end and their immediate purchasing power is therefore curtailed, leading to a general falling-off in the demand for ordinary goods and services, with consequent depression of trade, while the increase in bank deposits, which still remains as a result of the creation of extra credit, has passed into the hands of the few instead of remaining in the hands of the many. The few are already sufficiently provided with the ordinary requirements of life, and so are not likely to spend their increased wealth in the purchase of consumable goods.

Speculation in commodities or in real estate is also likely to produce similar effects. The money values of such things are artificially forced up to uneconomic levels; the original speculative buyers sell out at a profit, genuine buyers find the inflated cost too heavy to make purchases worth while and so hold off; the value, in consequence, starts to fall and is helped by speculative sales, and those who bought at the top, hoping for a further rise, are left "holding the baby" and must pay their losses out of savings, thereby curtailing their immediate purchasing power in other directions. The main difference is that no one is compelled to buy stocks or shares, but the primary products of the earth, as well as land and houses, are essentials to any community. Consequently, the values of securities can fall to nothing if savings are not available for investment or speculation, but there is always a demand for the essential commodities, and any fall in values results in those producers who are least fitted to produce and who are working on a bare margin

of profit being driven out of production, thus reducing the total supply and tending to bring it into equilibrium with the current volume of demand and so preventing a further fall in values.

Prices and the Value of Money.

It has been stated that money has to act as a common denominator of value and as a store of value. This implies that the value of goods and services in exchange for others is measured in terms of money and that, consequently, money itself can be said to have a value in terms of the goods or services for which it can be exchanged. The ratio between a certain quantity of money and the quantity of goods or services for which it will exchange is known as the "*price*" of those goods or services, and the quantity of the latter which a given sum of money will command is known as the "*purchasing power of money.*"

The level of prices or the varying purchasing power of money is one of the most complex of all economic problems, and many diverse views and theories are held by the leading economists of the day. It is only necessary to consider that a primary function of money is to permit the expression of debts payable in the future in such a form that the eventual payment involves no loss or hardship on either debtor or creditor, to realize that the command of money over goods and services, i.e. its purchasing power, should vary as little as possible even over long periods; in other words, the object of those responsible for the monetary system of a community should be the maintenance of a reasonably stable price level. The output of commodities necessarily varies through both natural and mechanical causes, e.g. good or bad harvests, insect or vegetable pests, invention of new methods and machinery, etc., and the current value of any commodity or service will always depend on its supply relative to its demand at any given time. Thus, the exchange value of any individual item is bound to vary in terms of other items, and, through them, in terms of money from time to time. But such variations are eventually smoothed out by the operation of the normal economic forces of demand and supply.

But when we have a widespread rise or fall in the value of goods and services *generally*, i.e. a change in the general purchasing power of money, this implies a variation in the value of money, that is, a change in the general level of prices. In order to observe

such changes, modern economic science has devoted increasing attention to the statistical system of measuring the general level of prices by means of what are known as "Index Numbers." By this system, a careful selection of certain commodities in general use is made and the money values of these, at certain regularly recurring periods, are recorded. Falls in the values of some, owing to any special causes affecting those items in particular, are offset by any rises in the values of others, also due to any special causes, while, given a general equilibrium of supply and demand, there should be very little variation in the total shown. If such variations appear and cannot be accounted for by natural causes, then it is assumed that a change has taken place in the value and purchasing power of money itself.

To compile an Index Number presents some difficulty, and however ingeniously compiled it can only be approximate. It is virtually impossible to calculate exactly the relative importance in the life of a community of any one commodity or service and, even in a small country such as this, the standard of living varies to some extent in different parts so that what is looked upon as a necessity of life in one district may be a semi-luxury in another, and the taste of Lancashire for clogs and shawls may have no counterpart in Surrey. Retail prices are far more subject to influences of this nature than are wholesale prices since, for instance, imported eggs may be more extensively used and so command a better retail price in one district than another, whereas the wholesale price for imported eggs reflects the general level of their value throughout the country. The most important Price Index Numbers are therefore based on wholesale prices. Moreover, in order that the more important items should have the greater effect upon the resulting index number, the quotations are "weighted." Thus, if *wheat* is regarded as being twice as important as *beef* a rise of 10 per cent in wheat counts as much as a rise of 20 per cent in beef.

The Board of Trade Index Number is one of wholesale prices. It considers a large number of commodities and is the generally accepted method by which we can establish a comparison between our prices and those ruling in other countries. It is the geometric mean of the monthly average wholesale prices of 150 commodities, expressed as a percentage of the 1924 average.

The Ministry of Labour's "Cost of Living" Index Number is one

of retail prices. The Ministry, through the work of some hundreds of skilled observers in town and country over the whole land, attempts the difficult task of ascertaining, month by month, the retail cost of various items upon which the working-class household spends its income. These costs are then worked out as percentages of costs relating to similar items in June, 1914. The average increases are "weighted," i.e. combined in accordance with the typical pre-War working-family expenditure. This proportion is assumed to be: Food, 60; Rent, 16; Clothing, 12; Fuel and Light, 8; Miscellaneous (including soap, soda, ironmongery, brushes, crockery, tobacco, fares, newspapers) 4. The list makes no pretension to be an exhaustive budget; but the rather large assumption is made that other necessary expenditure in the working-class budget will show a corresponding variation.

The Index Number is an average. It sets aside the irregularity of individual prices and replaces it by the regularity of prices in general. Provided that we select with wisdom the various goods on our list and give to each its due importance, we get a reasonably solid basis for action in modifying existing contracts. If our method of measuring changes commands confidence, we remove one source of friction at all events.

Theories of Money.

Attempts to explain the causes of variations in the general purchasing power of money, i.e. of rises and falls in the general level of prices, have been made by economists from early times, and each fresh attempt is set out as a new "Theory of Money." All attempt to set out not only an explanation of why the purchasing power of money should vary but also a scheme by which such variations may be eliminated, or minimized, in order to ensure that changes in the values of commodities shall be governed purely by factors affecting the commodities themselves, and so permit the free working of economic forces and the development of the community socially and economically without friction caused by defects in the system of exchange. Briefly, it is held that the product of all labour is used in the purchase of the labour of others, or in savings which can be directed into promoting labour, and that the ability of each to consume (and thereby promote the labour of others) depends on the ability of others to consume the product

of the labour of the first. In other words, specialization and the division of labour leads to our taking in each other's washing, and the transfer of each different parcel of washing must be facilitated and not hampered or rendered costly by any defect in the means of transfer.

Quantity Theory of Money.

One much-discussed theory of the value of money contends that the purchasing power, or value, of money depends upon the quantity of money in existence at any given time, and on the rapidity with which that quantity passes from hand to hand. This theory is known as the Quantity Theory of Money and, in its simplest form, may be expressed as follows: In any community, at any given time, there are a certain number of exchanges of goods and services which need to be facilitated, that is, there is a certain amount of money-work to be done. This money-work demands the existence of a certain number of units of money which must pass from hand to hand sufficiently quickly to permit of the total number of exchanges being completed as fast as they appear. Thus, if a community has to effect 100 exchanges in one week, and there are 100 units of money in existence in the community, and each unit changes hands once during the week, the money-work of the community is nicely adjusted to the quantity of money and its rapidity of circulation. If, however, the number of units of money available or the number of times each unit changes hands during the period, is altered, exchanges are made too easy or too difficult according as to whether the amount of money or its rapidity of circulation is increased or decreased, and the usual factors of demand and supply will operate to change the exchange value of each piece of money until that value is adjusted to the amount of money-work to be done.

Therefore, continuing the above example, if the number of weekly exchanges in the community remains at 100 but the number of units of money available is increased to 200, the supply of money will be double the demand for it, and its utility will be halved, with the result that its desirability will decrease and only one-half of the former quantity of goods and services will be tendered for each unit; in other words, its purchasing power will be reduced to one-half, and prices will be doubled in terms of money.

Similarly, if the number of exchanges remains at 100, and the number of money units at 100, but each unit changes hands twice in one week instead of once, the effect is the same as if the number of money units had been doubled, since each unit then performs the work of two, and the purchasing power of money will gradually decrease to one-half, which is the same as saying that prices in terms of money will be doubled.

Like most theories dealing with economic phenomena, this theory has its limitations and must be applied with reservations ; but its basic truth has been proved over and over again. Increase the number of money units or the rapidity of their circulation, e.g. through a growing lack of confidence in the currency, without a corresponding increase in goods bought, and prices rise; diminish the number, and prices fall. The amazing increases in prices during war-time multiplication of currencies are recent instances both of increases in the number of actual units and of increased velocity of circulation due to loss of confidence.

As long as metal itself served as the chief medium of exchange, prices tended to vary with the total quantity of that metal in existence and, in each community, with the power of that community to acquire and put into circulation more of the metal than its needs justified. An undue acquisition of metal, if put into circulation, caused such a rise in prices as would cause a falling off in purchases and an increase in imports from other centres with lower price levels, resulting in a movement of metal in payment of debts until the decrease of metal in one centre, and the increase in others caused an adjustment of the respective price levels to a common level. This is the basis of the Gold Standard Theory and of the Purchasing Power Parity Theory of the Foreign Exchanges, which is referred to again later.

The enormous development of "credit" in the modern economic system has rendered this simple working of the Quantity Theory much more complicated, and has greatly obscured the effects which should result from a community being over or under supplied with the necessary quantity of the medium of exchange. Where the quantity of legal money is so vastly inflated by the use of credit instruments, representing spending power, and where no possible control can be exercised as to how that spending power shall be used, grave potentialities for harm exist.

The manner in which the spending power is used is of the first importance. Primary producers and manufacturers each depend upon the consuming power of the other for the absorption of the products of each. Every prudent individual endeavours to maintain a margin between his income and his expenditure, and this margin constitutes his *savings*. Through our modern banking and financial machinery, the small savings of the individual can be made available in bulk for the requirements of agriculture and industry, but modern concepts of the pyramiding of credit have frequently led to bulk savings being used (and lost) in purely financial operations. The greater part of the mass of war and post-war credit is in the hands of the few, and the immediate consuming power of the few is strictly limited. Unless the surplus is used in providing the masses with consuming power, the wheel of production is slowed down, since it is useless to produce if the product cannot be consumed.

In the opinion of many, much of the recent world distress—starvation in the midst of plenty—is due to the mis-direction of money into channels not directly concerned with production and consumption, e.g. Government and Municipal Loans. The wealth, or accumulated spending power, is there and the consuming power of the masses remains. The problem is to place the purchasing power in the hands of those who will use it for the purchase of consumption goods, and so, by giving a fresh stimulus to production, promote employment in the primary industries, which, in turn, will give fresh purchasing power to those employed therein to be passed on to those engaged in other branches of production and distribution.

Space does not permit of the problem being more than cursorily examined, but the point must be borne in mind when considering many aspects of internal and international banking and finance, and particularly in any consideration of trade cycles and financial crises.

Other Theories of Money.

Many other theories have been put forward from time to time by eminent economists, most of them being based on the Quantity Theory, but aiming at a more full and exact exposition of the relation of money, credit, and prices. The modern endeavour is to expound a theory in mathematical form, and to arrive at a formula which, when its constituents are known, will express that relationship and its variations exactly.

Professor Cannan accepts the view that money is a commodity. But he argues that the total volume of money in existence is so large that the normal fluctuations in its volume are too small, relative to the total, to have an effect comparable with the effect produced by alterations in the supply of other commodities and that, therefore, money cannot be regarded as being governed strictly by the operation of the law of supply and demand. He also argues that the demand for money is not produced by the number of transactions to be financed, but by the willingness of individuals to hold money. It is this "unspent margin" that constitutes the "quantity of money" and with it the value of the monetary unit. So "we think of the demand for houses as coming not from the persons who buy and re-sell or lease and sub-lease houses, but from the persons who occupy houses." This theory does not disagree with the view that the purchasing power of money varies with the relation between the demand for and the supply of it, but differs from the orthodox as to the factors constituting and affecting demand and supply.

The American economist, Irving Fisher, puts the Quantity Theory in this form: "The general level of prices tends to vary directly with the quantity of money and its rapidity of circulation (i.e. its supply), and inversely with the activity of exchange (i.e. the demand for money indicated by the number of goods exchanged multiplied by their prices)." He denotes this "equation of exchange" by calling the price level P , the quantity of money in circulation M , the velocity of circulation V , and the volume of trade T , arriving therefore at the following equation—

$$P \propto \frac{M \times V}{T}$$

or as

$$PT = MV$$

This is elaborated to include credit instruments when used as money, by denoting such instruments as M' and their velocity of circulation as V' , and the equation is then expressed as—

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

Professor J. M. Keynes has offered two or three mathematical solutions of the Quantity Theory, each of which goes deeper into fundamental causes and embraces a wider view than is usually

attempted. His most recent and most involved formulation he calls a "Pure Theory of Money," and he takes four main factors, output, earnings, liquid and capital consumption, and savings. Obviously, a work of two stout volumes cannot be summarized in a paragraph, and those who wish to pursue the question further must read Mr. Keynes' own masterly exposition of his theory, but he expresses it, in its simplest form, as—

$$P = \frac{E}{O} + \frac{I' - S}{R}$$

where $I' - S$ is the difference between the flows of the cost of new investment and saving, and R is the rate of flow of consumption goods. That is, Price equals the ratio of Earnings to Output plus the ratio between the margin between new investment and savings, and the rate of flow of consumption goods.

He eventually reaches the conclusion that, as savings do not vary so much as investment, *variations in the investment factor* mainly determine the cyclical fluctuations of price about the mean set by the relation of earnings to output. This would seem to put forward a contention that variations in the market values of securities, mainly due to stock exchange operations, are amongst the causes of fluctuations in prices, and the more this question is investigated, the more it seems that the somewhat limited services to the community performed by stock exchanges are very much more than offset by the dangers and disasters which seem to accompany their, at present, uncontrolled operations.

Effects of Price Variations.

The innumerable processes attached to production and distribution under modern conditions result in production having to be commenced a long way ahead of consumption; in other words, the wants of consumers have to be anticipated and estimated by producers. A reasonable prospect of a normal rate of profit is necessary to induce the flow of capital needed to finance production and to inspire the requisite enterprise and energy in producers to embark on an output in advance of consumption. The rate of profit depends on the costs of production and distribution and the selling price. If, therefore, costs of raw materials vary sharply or a sudden rise or fall in wages takes place, extra profits are made if

such movements are favourable to the producer, but any increased cost is reflected in an increase in the selling price. This results in a falling-off in demand, and the total output arranged for is not absorbed, so that the producers are left with a stock of goods on their hands unless such goods are sold at a lower price, which represents a loss to the producer. The ideal of the economic system is to ensure regular and steadily increasing production to meet the needs of the increase in population and wealth, as well as any new wants which may arise. Anything, therefore, which tends to make the reward of production speculative or hazardous operates against the proper development of the economic system, and a reasonably stable level of prices of primary and finished products (labour, rent, cost of capital, etc.) is an essential to the economic well-being of the world. The forces of Nature, such as good or bad harvests, insect pests, floods, earthquakes, etc., cannot be controlled, but their effects are to some extent smoothed out since they are usually local in character, and misfortunes in one part of the world are offset by better conditions elsewhere. It is the man-made economic factors which need investigation, and which have to be controlled or guarded against.

With regard to the consuming power of the community, there are, broadly speaking, two classes of consumers: (a) consumers of immediate goods, i.e. of the actual output of production, and (b) consumers of capital goods, i.e. investors. Naturally, the consuming power of immediate goods of the individual varies with his station in life, but the vast majority of a community are salary or wage earners, or belong to the *rentier* class of persons with fixed incomes or incomes derived from investment. Such persons find great difficulty in adjusting their expenditure to a varying price level. This is due to the fact that a producer who sees a rising price level regards the increased margin between cost price and selling price as an extra profit for himself, and only passes on a part of that extra profit, in the shape of increased salaries and wages, reluctantly and probably under pressure from a labour organization. On the other hand, a producer faced with falling prices, and therefore with decreased profits, endeavours to get back part or all of the difference by immediately reducing salaries and wages, or by reducing his output and discharging some of his employees. Consequently, a "lag" always supervenes between a rise in prices

and a rise in wages, and a similar "lag" between a fall in wages and a fall in prices.

A reasonably stable price level, together with a reasonably stable level of wages and employment, is consequently fervently to be desired, and the efforts of politicians, financiers, business men, and labour organizations are assumed to be directed towards this end. While a rising price level is accompanied by increased production in view of the possible larger profits of industry, which, in turn, means increased employment and probably a rise in the general level of wages, the ultimate benefit to the majority is small since they are at first faced with higher prices on the same income, and subsequently receive a larger income to meet the higher prices (and possibly some relief from taxation owing to the reduction of unemployment and the increased taxable incomes of the whole community) only for a comparatively short period, as it is a curious economic phenomenon that any trade "boom" is followed by a "depression," one of the earliest effects of which is a fall in wages and a reduction in employment.

A further effect of fluctuation in the general level of prices is that the altered purchasing power of money means that payments of past debts involve loss to either debtors or creditors. A fall in prices during the currency of a debt expressed in terms of money means that the debtor will have to pay over to the creditor a sum which has a greater purchasing power than had the original amount, while, where prices have risen, the creditor will receive a sum of which the purchasing power is less than that possessed by the amount at the time the advance was made. This fact has frequently led governments deliberately to depreciate the currency, either by inflation of the issue of paper money or by the over-creation of credit, since, by so doing, they are enabled to pay off indebtedness incurred under the former purchasing power of the unit by means of a unit representing a greatly diminished command over goods and services. The fall in world prices was a basic cause, first, of the breakdown of successive schemes for the payment of Reparations and War Debts, and, secondly, of the commercial and financial crisis in the U.S.A. which led to the suspension of gold payments there in April, 1933. In both cases the burdens placed on debtors in terms of money became so onerous with the steady rise in the value of money in terms of goods and

services, i.e. the general fall in prices, as to force drastic measures of relief.

“Inflation” and “Deflation.”

When the available amount of money and credit, i.e. the total volume of “currency,” within a country is expanded beyond the current needs of the community at the ruling level of prices and rapidity of exchange of commodities and money, *inflation* is said to have taken place. Inflation may be the deliberate act of a government, as mentioned above, or it may be the result of banking and financial policy by the over-creation of credit, or it may result from a rise in commodity and/or security values induced by speculation. During the War, the governments of most countries were forced, by the pressing need for money with which to carry on hostilities, to inflate both the legal money and the volume of credit instruments by the issue of increasing quantities of inconvertible paper money, and by the issue of government loans, bonds, and treasury bills. In every case such inflation was followed by apparent prosperity, since prices, profits, and wages, all rose, but the increase in wealth was expressed in terms of units which no longer had the same purchasing power and, except for the few who made colossal increases to their paper wealth, was to a large extent illusory. In some cases, notably that of Germany, inflation of the currency continued more and more swiftly, and the currency became discredited, wealth was exported from the country in whatever form was possible to countries which still preserved some gold backing to their currencies, prices fluctuated violently, and the currency became almost useless as a measure of current value and entirely so as a store of value, until inflation was stopped or the old currency discarded and a new one introduced. The danger to the credit and economic life of a country under such conditions is obvious.

Much the same phenomena were shown in the early stages of the “experiment” in the U.S.A. in the latter part of 1933. Inflation took place by means of various loans raised under government auspices, the dollar was “devalued” by raising the internal price of gold, exchanges moved against the country and capital was exported. But the opposite effects of rising prices and wages were not experienced to the full. Compulsory wage increases were made

and a certain rise in prices took place, but world conditions and competition set a temporary limit to this rise, and the depreciated exchange was actually partially offset by a further fall in gold prices, i.e. the inflation in the U.S.A. was partly countered by a certain deflation in other parts of the world.

Inflation of the money and credit of a country which is still on a gold basis does not result in such disastrous consequences, but it causes a derangement of prices, and, consequently, of the economic life of the community, proportionate to its volume. The over-creation of credit, or the inflation of security values, leads to an excess supply of money-units and a rising price level. Over-trading and over-production ensue but, owing to the lag in internal consuming power as represented by wages and to the falling off in the foreign demand for home goods owing to the high internal prices and to increased imports caused by purchases from centres with a lower price level, the "boom" is always short lived. The adverse balance of trade results in gold being exported to settle the difference and this, by reducing the basis of the credit structure, causes a contraction in the total volume of credit until an approximate equilibrium between the volume of money and the need for it is restored but, in the meantime, a serious dislocation of trade and industry will have been caused.

Deflation is said to take place when the total volume of money and credit available in a community is reduced, either fortuitously or deliberately, after a period during which that volume would appear to have been in excess of requirements. If the previous state of inflation has been the deliberate act of a government, taxation must be increased, and national expenditure reduced in order that a credit balance may be obtained which is wiped out by the notes or securities representing this balance being cancelled. If the inflation has been by the over-creation of credit, interest rates must be raised to discourage borrowing and encourage saving, repayment of loans must be enforced even if forced sales of goods and securities are thereby engendered, and the granting of further credit must be strictly limited. This contraction of currency and credit will discourage trade and industry, which will cause a fall in wages and an increase in unemployment, while a fall in prices will follow slowly. Security values will have fallen with the rise in interest rates, and investment capital will therefore show a decreased

book value. The consuming power of the whole community is consequently diminished, but the deliberate process of raising the value of money, i.e. its purchasing power, to a world level results eventually in prices also being brought down to a world level, but the process must always be very gradual if extreme hardships to the majority of the members of the community and undue disturbance of the economic life of all are to be avoided.

Reflation is a term coined to denote a condition of affairs where deflation has been carried out too fast or too far. If a policy of deflation has resulted in too great a fall in prices and too great discouragement of trade and industry, obviously the volume of currency and credit available has been rendered too small. A certain resort to the processes of inflation may then be necessary, but as the result is not inflation as such, the processes used are covered by the term "reflation" to convey the distinction.

CHAPTER II

TRADE CYCLES AND COMMERCIAL AND FINANCIAL CRISES

OBSERVATION of the fluctuations in the trade activity of many nations has resulted in the discovery that this activity alternately waxes and wanes with some sort of regularity. From a normal activity, trade gradually seems to develop an added impetus, enterprise is stimulated, production is increased to meet an anticipated increase in demand, employment increases, while with the first signs of increased demand, prices begin to rise, which further encourages production, credit has to be expanded to meet trade requirements, and speculation begins to take a part in forcing up prices and capital values. The wave of prosperity mounts ever higher until producers begin to realize that the extra cost of production due to higher wages, less efficient workmen, over-straining of machinery, extra cost of credit and capital owing to high interest rates, etc., are absorbing all the additional profit due to the increased output, while the demand for, or the ability to consume, certain classes of goods shows signs of saturation. At this point, expert speculators in both commodities and securities, begin to unload their holdings and a fall in wholesale and capital values commences. Producers follow suit and begin to offer stocks on hand at lower prices in the hope of disposing of them while some sort of profit still remains. At the same time, they curtail production, reduce the number of their workers, thus increasing unemployment, and reduce the wages of those left. The consequent loss of general purchasing power affects the total demand, and prices fall still lower in an attempt to induce buyers to come forward.

In the meantime, those who have bought commodities and securities at the high values will be "cutting losses," which they must make good out of savings, thus further reducing the current general spending power. The commencement of the downward trend will also be marked by the calling-in of loans and a general contraction of credit; in fact, restriction of bank credit and the raising of interest charges to a high level frequently precipitates and accelerates the downward swing of the trade pendulum. If credit

has been greatly inflated and speculation rife, the downward swing may be very sharp, losses through forced sales may be so heavy as to result in several bankruptcies and a commercial and financial crisis may develop.

In any event, the downward swing usually carries trade, prices, wages, and employment below the normal, and this in due course works its own cure. Production is curtailed to a point below the actual needs of the community while, wages having fallen to a low level and credit and capital costs being also cheap owing to the lack of demand for accommodation, costs of production are low.

The current need of the community for essential commodities causes demand to show signs of exceeding supply which is reflected by slight rises in prices. Immediately hopes of better times begin to revive in the minds of producers, and they are encouraged to attempt once again to anticipate a possible increase in demand.

The machinery of commerce is set revolving at a slightly higher speed, employment increases, small increases of wages slowly follow the rise in prices, the spending power of the community is proportionately increased, with a corresponding effect on demand, and the pendulum is again sent on its upward swing. This almost automatic sequence of events is known as a "Trade Cycle," and experience shows that the period between the crest of each successive wave is from seven to ten years.

Commercial and Financial Crises.

From the time when the early machinery of trade and finance first made speculation possible, each wave of trade prosperity has been accompanied by speculation in commodity and capital values. Within limits, speculation in commodities tends to set bounds to the fluctuations in prices and to encourage production, since those who have bought speculatively have helped to stimulate production, and their sales at higher prices steady the market and assist in satisfying the demand, while those who have sold speculatively thereby depressing prices, will have consequently tended to curtail production and, if their anticipations of a reduced demand are correct, their re-purchases at a lower level will help to steady a falling market. This holds good, however, only in the case of commodities the production of which is capable of adjustment to a varying demand. *It does not, therefore, apply to speculation in*

securities since the amount of any capital stock in existence is fixed and speculation cannot cause that amount to vary.

While the speculation of enterprise, or intelligent attempts to forecast and profit by variations in supply and demand, have certain uses, they have also grave dangers, and the rising tide of trade prosperity too often is made to carry with it much flotsam and jetsam in the shape of weak speculators who commit themselves to purchases for amounts much beyond their ability to finance, in the hope of making large profits on a small capital. It is such speculators who are the underlying cause of a downward turn being given to the wheel of the trade cycle. All the time that prices are rising they are continually buying, re-selling a part at a higher price, buying more at a higher price still, re-selling part again, re-buying, and so on. There comes a time when those who have granted the credit necessary to finance these deals, whether traders or bankers, realize that the speculators are over-trading and that their commitments are beyond their ability to pay. Pressure is therefore exerted to obtain payment of credit instruments and advances, and to do this the speculators must sell their holdings. Demand having already slackened owing to the rise in prices, the unloading of such stocks on an unwilling market precipitates a fall in prices which is intensified by the psychology of buyers which bids them hold off for still lower prices. When over-trading of this nature has been excessive and the consequent losses are too heavy for the speculators to meet in cash, failures result which may cause embarrassment, or even failure in turn, on the part of those traders to whom the debts are due. This constitutes a commercial crisis and, should this be of any magnitude, the resulting failure of both speculators and genuine traders to repay advances or to meet bills discounted may result in banks who have extended such credit becoming embarrassed in their turn and, if their resources are not large, they may even be forced to suspend payment. This constitutes a financial crisis, but it may be stated that, of recent years, a financial crisis has first been caused by over-speculation in securities (and the subsequent calling-in of loans and sales to meet losses), and the decreased spending power which necessarily follows a stock exchange crisis, have produced a commercial crisis through the forced liquidation of goods to repay advances and the decreased demand.

No better example of this exists than that of the American crisis

which began in the autumn of 1929. An orgy of stock exchange speculation, which had involved all classes, from millionaires to shoe-blacks, was followed by a devastating "slump" in security values. Thousands were rendered penniless, banks found themselves with enormous amounts of bad debts and "frozen" advances. The resulting curtailment of spending power affected the economic system of the entire country and spread even to Europe, and was undoubtedly the chief factor in the disastrous fall in world prices which took place during the following two years.

Theories of Trade Cycles.

Many theories have been advanced to account for the periodicity of trade. What is known as the *Disproportionate Production Theory* holds that from time to time a certain industry will, owing to natural or mechanical advantages, produce more than the current demand can consume. The resulting curtailment of production in that industry causes a decrease in the spending power of those employed in it which, in turn, affects the earnings of those engaged in other industries. The decrease in spending power spreads like ripples caused by a stone thrown into a pond until prices, employment, and wages are down to a bare existence level. The normal influences of the steady increase of population and the increase of wealth due to savings then operate to cause a steady increase in demand until production is again encouraged to anticipate demand and the cycle starts again.

The *Over-production of Capital Goods Theory* holds that since a large proportion of the total income of a community passes into the hands of a comparatively small number of wealthy people, and since the ability of such people to absorb consumable goods is limited, and a large part of their incomes is consequently invested in capital goods (land, property, stocks and shares), there is always a tendency for too great a proportion of the national income to pass into such capital goods. At first, the encouragement given to production leads to rising prices (owing to the demand for raw materials), increased employment, and increased spending power, but, gradually, production outstrips demand since quite a large proportion of the profits of industry do not accrue to the consuming classes but to the investment class and are again passed on by them for re-investment in industry, i.e. in the further acquisition of capital goods.

Consequently, production finds that its output is not being consumed and curtailment ensues with the usual results of falling prices, less employment, lower wages and decreased spending power. Recovery from a bare existence level eventually takes place by the natural annual increase in demand inducing the fresh consumption of capital goods, and the cycle recommences.

The *Monetary Theory* is based on the Quantity Theory of Money, and holds that the increase of currency and credit continually tends to be in advance of the natural increase in the consuming power and wealth of the world. Following a period of depression, as soon as the growth of natural demand begins to show itself, credit is at once created to enable production to anticipate demand. This expansion of credit spreads, through speculation in commodities and securities, and always tends to exceed the increase in demand due to increased prosperity.

There comes a point at which the addition to the spending power of the community so far exceeds the money-work to be done that prices rise to a level at which demand begins to fall off, production is curtailed and credit contracts sharply, causing a sudden fall in prices with the usual effects of forced sales, decreased production, lower wages, and less employment.

The *Psychological Theory* holds that the state of mind of the business community is the most important factor in producing the trade cycle. Under the influence of rising prices due to the normal increase of world demand, enterprise is stimulated and leading industrialists are encouraged to launch out into schemes of development, while a general atmosphere of optimism pervades financiers and business men alike. This optimism leads to the over-estimation of future demand, and production is increased to a greater extent than is justified by the existing consuming power. When the fall in prices due to over-production commences, the business community becomes imbued with pessimism, every effort is made to contract instead of to expand commitments, and the falling off in demand thus occasioned results in a further sharp fall in prices with the usual effects. This condition prevails until something occurs to replace the atmosphere of pessimism with one of optimism and the cycle begins again. This theory also holds that natural and economic events, such as good or bad harvests, floods or earthquakes, new methods of production, political and industrial disturbances,

etc., are highly important in that they are largely responsible in determining the attitude of mind of the leaders of finance and industry.

Examination of the incidents accompanying trade cycles over a long period does not permit of any one of these theories being entirely proved. It seems probable that much truth is contained in each of them, but that the final explanation would comprise factors from each of them.

The following is a brief outline of the principal crises, marking the turn downwards of the trade cycle, which have occurred in this country since the beginning of the nineteenth century.

1814.

At the conclusion of the Napoleonic Wars the atmosphere of relief caused a wave of feverish speculation, accentuated by a scarcity of commodities due to bad harvests and the interruption of supplies from the Continent. At the same time, to supply the credit needed, a great inflation of the note issues of the private banks took place. This was followed by an abundant harvest and the resumption of imports from abroad, which led to a sharp fall in prices, the collapse of speculation, and the failure of 89 banks through inability to redeem their excessive note issues. The reduction in the volume of currency gradually improved its value, and equilibrium of money and prices was eventually approximately established, while stability was eventually restored by the resumption of cash payments by the Bank of England in 1821. This evidently marked the upward swing of the trade pendulum.

1825.

The increase in general prosperity which by this time had taken place, led to a fresh outbreak of speculation, particularly in mining shares, and the resulting inflation of values and over-expansion of credit eventually produced a crisis which involved many banking failures. It was again found that the country banks had once more been guilty of the over-issue of small notes, and a law was then passed forbidding the issue of notes under the value of £5 by the country banks as well as by the Bank of England.

1836-1837.

Another period of prosperity followed, the apex of which was marked by an outbreak of speculation in railway shares. The

over-expansion of credit was increased by excessive issues of notes by many country banks. The same conditions obtained in the United States, and as soon as a crisis, accompanied by banking failures, developed there, it was followed by a crisis here. The state of the over-expansion of credit and the over-issues of notes revealed by this crisis was mainly responsible for many of the provisions of The Bank Charter Act of 1844.

1847.

This crisis was brought about by the rapid development of railways. The continuous subscriptions of capital for this purpose led to a severe shortage of funds for normal commercial requirements. In the meantime, speculation in railway shares had again been rife, and special "exchange banks" had been formed to make advances and grant credits against stock exchange securities and so to facilitate speculation. The scarcity of loanable funds caused Bank Rate to be raised to 8 per cent in October, 1847, and the resulting contraction of credit caused a sharp fall in the values of commodities and securities, resulting in severe losses to genuine traders as well as to the speculators. A general feeling of distrust spread rapidly, and "runs" were made on many banks. So severe did the panic become that the Bank of England obtained the sanction of Parliament to a temporary suspension of the Bank Charter Act, which gave it power to issue notes in excess of the Fiduciary Issue, and to suspend cash payments in case of need. The mere knowledge, however, that this sanction had been given proved sufficient to restore confidence, and although new notes were printed, the need for their issue did not arise and cash payments were not suspended by the Bank.

1857.

A wave of prosperity, due to rising prices following the gold discoveries in California and Australia, having set in, a further outbreak of speculation in railways, shipping, and mining shares occurred in this country and in the U.S.A. Again the effects of over-creation of credit and excessive speculation produced a crisis, first on the New York Stock Exchange (accompanied by the failure of several American banks), and then in this country. Several banks and financial houses failed, and in November, 1857, the Government

again authorized the suspension of the Bank Charter Act. On this occasion the Bank of England availed itself of this authority, and issued £2,000,000 in notes, of which about one-half was actually put into circulation. This action, together with the knowledge that the Bank Act had been suspended, was sufficient to allay the panic and confidence gradually revived. It was also observed by a Select Committee of the House of Commons, appointed to inquire into this crisis, that one of the main contributory factors was the large volume of accommodation paper which had been created by banks and financial houses, and which had resulted in a great inflation of credit.

1866.

Following the passing of the Companies Acts of 1858 to 1862, much speculative company promoting took place, while the American Civil War led to wide fluctuations in the price of cotton and much speculation in that commodity. An excessive extension of credit on the part of certain houses, especially by the firm of Overend Gurney & Co., Ltd., eventually led to a crisis when, on Friday, the 11th of May (still remembered as "Black Friday"), this great discount house suspended payment with liabilities of about £18,500,000. A panic immediately set in and "runs" on all the banks commenced, causing such demands on the Bank of England by other banks for assistance that Bank Rate was raised to 10 per cent, and once more the Government authorized the suspension of the Bank Act. On this occasion the news that this authority had been given was sufficient to allay immediate anxiety but widespread distress was caused and Bank Rate remained at 10 per cent for three months, as the damage to British credit was so severe that gold to replenish the reserve was attracted only very slowly in spite of the high rates of interest.

1878.

This year was marked by the failure of the City of Glasgow Bank through the over-extension of credit to a few firms on insufficient security. It had also increased the volume of its acceptances much beyond its strength, but the position had been hidden by the issue of falsified balance sheets. This failure subsequently involved other banks and several large firms of bill-brokers. The resulting loss of

confidence, following depression of trade in America after another crisis there, and the outbreak of the Russo-Turkish War, caused a severe contraction of credit with the usual effects of depressed trade and increased unemployment.

1890.

Once more, a period of prosperity was followed by the creation of a large number of over-capitalized joint-stock companies, and by excessive speculation in securities and commodities, with a resulting inflation of credit. The usual turn of the pendulum came with a sudden loss of confidence in South American securities, in which speculation had been rife, and the great merchant and banking house of Baring Bros. & Co., which had enormous interests in such securities, found itself in difficulties. The failure of such an important concern, with international connections, would have produced so grave a crisis and such severe damage to British credit that the Bank of England took the then unprecedented step of calling on the other banks to join with it in forming a guarantee fund to cover the immediate liabilities of the firm, chiefly the outstanding acceptances. This prompt and bold action prevented a general crisis and no actual panic took place. Thanks to the assistance given, the firm was able to tide over its difficulties and a new joint-stock company was subsequently formed, known as Baring Bros. & Co., Ltd., to continue the business, and this company is still in existence as a leading finance and banking house of the highest reputation and prestige.

1893.

One result of the Baring crisis was a loss of confidence on the part of investors and speculators in the capital issues of new countries, and a certain withdrawal of funds already invested abroad took place. Australia was among the countries affected by these withdrawals, as, for some time previously, the Australian banks had been offering high rates of interest and had attracted large sums on deposit, which caused a certain inflation of credit. The withdrawal of a large part of these deposits caused a sudden contraction of credit and produced a crisis in Australia but, although several banks there suspended payment and State intervention was necessary to prevent panic, nothing more than uneasiness was caused in London.

1900.

While severe crises were experienced in the U.S.A. and Germany, owing to excessive land speculation in the former, and over-capitalization of certain industries in the latter country, strict discrimination in the extension of credit by the commercial banks acting in conjunction with the Bank of England, prevented a crisis from developing in this country. The London and Globe Insurance Company was the only concern of note to go into liquidation, and this was more the result of unwise underwriting than of commercial and financial conditions.

1907.

This year marked a most serious banking crisis in the United States, the effects of which were felt all over Europe and particularly in London. The rapid development of the enormous natural resources of the U.S.A. had led to a high wave of prosperity which encouraged all forms of speculation, inflation of credit, and over-trading. The banking system of the country, largely owing to the parochially restrictive banking laws of each State of the Union, was still in an elementary state and consisted of a very large number of small local banks with no system of co-operation. As a result, as soon as production over-reached itself and a fall in values and a contraction of credit set in, the necessary banking facilities were not available to tide over the period of crisis, and each small bank had to stand or fall on its own resources. Wholesale failures of banks and trading firms took place, distrust was prevalent, and credit became severely restricted, and foreign creditors found it almost impossible to obtain remittances from America. Further, an excessive issue of inconvertible paper there caused a heavy premium on gold, which resulted in the paradoxical situation of a country in the throes of a financial crisis receiving large shipments of gold from its creditors, and although the value of the paper dollar in terms of the pound was so low as to have called for the shipment of gold from New York to London under normal conditions, so heavy did the drain of gold from London become that the Bank of England was forced to raise Bank Rate to a figure which not only stopped the flow of gold to New York, but even brought in over £3,000,000 in gold from France, owing to the attractiveness of London for investments at such interest rates.

1914.

The outbreak of the Great War brought about a crisis of a special kind, and of which it may be said that it transcended any previous crisis which the world had known. The unusual incidents both immediately prior to and after the declaration of war by this country were so numerous that it is possible here to present them only in a broad view. For nearly a month prior to the 4th of August, 1914, a steady selling of securities, mainly on German account, had been noticeable on all the principal stock exchanges of the world. Following the ultimatum of Austria to Serbia on the 24th July, the selling pressure became so acute everywhere that security values and the exchange values of currencies became demoralized. On 31st July the London Stock Exchange closed and did not re-open until 4th January, 1915. This important step resulted in what might be called a panic, and "runs" took place on all the banks. On 31st July the Bank of England changed its official rate three times in the one day, raising it from 4 per cent to 8 per cent, and to 10 per cent on 1st August. The 2nd August being August Bank Holiday, gave a short breathing space, and the Bank Holiday was extended to cover the 4th, 5th, and 6th August by an Order in Council. One of the most serious factors was the large amount in first-class acceptances which is always outstanding in London owing to its position as an international money centre. Many of these acceptances were those of German and Austrian branch banks and houses in London, or of other concerns for German account, and the compulsory closing of all enemy concerns in this country and the severing of communications with Germany immediately upon the declaration of war added to the difficulties of the situation. France had already declared a moratorium of one month for the payment of all maturing bills, and this step was followed here by the passage of a Bill declaring a moratorium on all bills of exchange, other than cheques and demand drafts, accepted before the 4th August.

The effect of a "Moratorium" is to cause the temporary postponement, by legal authority, of the payment of debts included under the moratory law until the date fixed for the moratorium to expire. The effect of this first moratory law was to extend the due date of all bills accepted before 4th August by one month, and the moratorium was shortly afterwards extended to include cheques,

demand bills, and payments generally, up to 4th September, with certain exceptions such as wages and salaries, rates and taxes, bank notes, freight, savings bank deposits, dividends on trustee stocks, etc. The Government was also empowered to suspend temporarily all kinds of payments in case of need.

The next step was to mobilize the gold within the country, and to make provision for an emergency currency. An appeal was issued to the nation not to hoard gold but to pay it into the banks, and the banks themselves gradually transferred their stocks of gold to the Bank of England until, at the conclusion of the War, and prior to our return to a gold standard, the entire stock of gold of the nation (apart from negligible amounts held privately) was concentrated in the hands of the Bank of England. At the same time the Government arranged for the issue of its own notes (known as Currency Notes) for £1 and 10s., which were made full legal tender and, until these notes attained general circulation, postal orders were also made legal tender for a short time. The new notes were issued through the Bank of England to the commercial banks in the form of advances against the security of a floating charge on the assets of the borrowing bank, but the advance to each bank was limited to 20 per cent of its liabilities on current and deposit accounts. These steps centralized the control of the gold in circulation, and provided the country with the necessary medium of exchange, in place of the gold coins paid into the banks, and to meet the greatly extended demand for cash payments, as well as providing the banks with liquid funds to meet the demands of depositors.

In the meantime the breakdown in the foreign exchanges due to the impossibility of making remittances, and the stoppage of discount facilities owing to the moratorium and to the general loss of confidence, were creating great difficulties and, on 12th of August, the Government announced that it would indemnify the Bank of England against any loss incurred in connection with any bills which it might discount, if accepted prior to 4th August, *without recourse to the holder*. This resulted in a wholesale re-discounting of bills with the Bank by holders, such as banks, discount houses, and bill brokers, who wished to be relieved of their liability, but it was soon realized that the liability of acceptors, drawers, and prior endorsers (who, of course, consisted largely of the banks, accepting and discounting houses and bill brokers), still remained, even though

the moratorium had postponed the date of payment of such bills. Consequently, on 4th September, i.e. the expiry date of the original moratorium, a further announcement was made that drawers and endorsers of approved pre-moratorium bills would be held discharged from their liabilities on the bills, while the acceptors of such bills would, in case of need, be furnished with the funds to meet the bills at maturity, pending the arrival of cover from the party for whose account the acceptance had been given. Further, any balance which might remain due from approved acceptors in respect of such assistance, was made a *second charge* on their assets, thus leaving them free to carry on business with their existing assets, and removing all obstacles to the discounting of their post-moratorium acceptances.

As a result of these measures a very large amount of bills was re-discounted with the Bank of England and the total of assistance granted under the two proclamations was officially stated to be about £120,000,000. As soon as communications and the working of the exchanges became somewhat restored, remittances began to come in, and this indebtedness was gradually discharged, though a certain portion had to remain outstanding until after the War.

Bank Rate was reduced to 6 per cent on 6th August, and to 5 per cent on 8th August, and the original moratory laws were subsequently extended to 4th November, but even with some restoration of financial order and confidence, the weak link in the chain proved to be the stock and commodity exchanges, where speculative positions remained open. On the London Stock Exchange the short term borrowings from banks and others were estimated at about £80,000,000, and special arrangements were made to "nurse" this very large baby. The banks undertook not to press for repayment of loans for at least twelve months, while the Bank of England, acting for the Government, undertook to finance other lenders up to 60 per cent of the value, as on 29th July, of the securities held against such loans. This enabled stock exchange members to make corresponding arrangements with each other and with their clients, but the eventual result was that most stock exchange loans were "frozen" until after the War. Similar arrangements were made on the cotton and other exchanges, and all genuine cases of hardship in every commercial sphere received prompt and sympathetic assistance from the banks.

Considerable additions were made to the gold holding of the Bank of England during the first three months of the War, the total of Coin and Bullion in the Issue Department rising from £26,000,000 on 5th of August, to £72,000,000 on 18th November. Of this, large amounts were the result of an effort to restore exchange facilities within the Empire, and were represented by the "ear-marking" of gold for account of the Bank of England in Canada, India, South Africa, New Zealand, and Australia. A large sum was also sent from New York to Ottawa and held there for account of the Bank of England in order to avoid the risk of shipping gold through the War Zone to England.

A period of steady inflation now commenced. In addition to the issue of Currency Notes, which were of course inconvertible, Treasury Bills were issued for successively larger totals (the amount of £90,000,000 issued in the first 3 months of the war eventually reached a total of over £1,100,000,000), and in November, 1914, the first War Loan for £350,000,000 was issued, to be followed at intervals by further issues of varying size. This inflation was undoubtedly necessary to provide the funds needed to finance hostilities, not only for ourselves but for our Allies, but it is the subsequent results of this enormous accumulation of debt in the form of inflated national credit in each one of the belligerent countries, which give rise to the many profound problems which confront statesmen and financiers to-day.

1920.

The cessation of hostilities and the return to civil life of millions of men all over the world led to a general "boom" in industry. The energies and industrial organizations of the principal countries of the world had for so long been devoted to the production of war materials that the return to peace, with its consequent sudden demand for the needs of normal life, necessitated an equally sudden diversion of the energy and output of industry, for which it was not prepared. As a result, the demand for consumable goods led to an increased demand for primary products and raw materials, especially as stocks were at the lowest possible level, and prices, which had already risen owing to restricted output during the war and to the inflation of currency and credit, rose still higher. The stimulus thus given to industry and the temporary increase in spending

power due to the war-time profits and high wages of those who stayed at home, and the Government gratuities received by demobilized soldiers, led, in turn, to speculation in industrial shares, the over-capitalization of certain industries (notably the Lancashire cotton industry), and a further expansion of currency and credit. Gradually demand became satisfied and began to be overrun by production, while the first steps towards debt redemption and the reduction of the outstanding issue of Currency Notes were begun, accompanied by a general trend towards deflation through restricted bank credit. Trade began to decline and the depression was accentuated by the falling-off in demand from our foreign customers. Nearly all the Continental nations were struggling with highly inflated currencies, of which the exchange value and purchasing power abroad was depreciating daily. The Dominions and Japan were endeavouring to meet the heavy additional national expenditure due to war debts by imposing additional taxation, and by deflating the existing volume of currency and credit, both of which curtailed their spending power. China was in the early stages of the revolution which dislocated trade and industry and, by reducing her ability to export, reduced her ability to import. India, besides suffering the decrease in general world consuming power, was also severely affected by the sharp fall in the gold price of silver, the latter metal having been until then her standard of value, and the fall in its value in terms of gold depriving her of a corresponding amount of purchasing power in gold using countries. The South American States found their purchasing power reduced by the fall in value of the primary products which formed their main exports, as well as having to deal with an increase in production (due to the temporary high level of prices) much above the existing world consuming power. Further, European conditions were considerably disturbed by the delay in settling the question of German reparations and inter-Allied war debts, and the resulting atmosphere of uneasiness reacted unfavourably on trade and enterprise. In this country no actual crisis took place, but the post-war atmosphere of optimism was dissipated and the temporary stimulus which had been given to industry disappeared. The heavy burden of taxation imposed in this country by successive governments in an endeavour to meet the cost of ever-increasing social services, and to reduce as quickly as possible the enormous amount of war

lebt, irrespective of amounts received from our debtors, began to make itself felt in the shape of increased cost of production and decreased spending power of the people. Wages began to fall and unemployment increased, while the fall in prices was materially hastened by the too rapid deflation carried out by the Government, the Bank of England, and the other banks, both before and after our return to a gold bullion standard in 1925. The trade depression was further increased by the General Strike of 1926, but, following the subsequent re-adjustment of conditions between capital and labour, a slight revival in trade took place which, helped by a steady return to currency stability by most of the other nations, seemed to offer promise of a great upward swing of the trade pendulum.

1929.

Once again, the first signs of trade revival were accompanied by heavy speculation in securities, particularly in the capital issues connected with recent inventions such as artificial silk, wireless, and gramophones, and in cement and newspaper shares. At the same time America was enjoying another wave of prosperity, partly due to her tariff system which operated to prevent the payment of war debts by means of goods, causing a steady influx of gold. This, in turn, caused an increase in the volume of credit there, though the Federal Reserve Bank "sterilized" much of the gold imports, and with steadily rising prices, speculation in commodities, real estate, and securities became general. Although "boom" conditions prevailed to some extent on all the stock exchanges of the world, the speculative fever in America exceeded anything which had hitherto been known. All classes of the community caught the fever, and security values were inflated out of all proportion to dividend-paying capacities. The Federal Reserve Authorities in New York (though other centres expressed disagreement with such a policy) endeavoured to check the continued upward movement in security values by restricting credit, but the demand for accommodation to finance speculative operations was so intense that speculators seemed to ignore entirely the cost of the money they needed, and the inroads made on their possible eventual profits, and "call money" for use in this connection commanded 8 to 10 per cent, and on occasion, as high as 20

per cent was paid. As a result, funds were attracted to New York from practically every other centre, and the demand so caused for American currency sent up its exchange value to a point at which gold shipments had to be made. Large amounts in gold left this country for New York, and the Reserve of the Bank of England became so depleted that Bank Rate was raised in successive stages from $4\frac{1}{2}$ to $6\frac{1}{2}$ per cent, while, no doubt in agreed co-operation, the Federal Reserve Bank also raised its official rate.

The contraction of credit and the increased cost of borrowing thus produced, led to a break in security values on the London Stock Exchange, which was at once followed by what is known as the "Hatry Crisis," caused by the failure of a well-known financier, Clarence Hatry, and his associates, for the enormous sum of over £13,000,000. Hatry was subsequently tried on a charge of fraud in connection with his operations and sentenced to imprisonment. The shock to confidence caused by the disclosure of this position resulted in a general collapse of security values and several other failures followed. The selling panic spread rapidly to New York, where it reached unprecedented proportions, and where the collapse in values was so dramatic and spectacular that the New York Stock Exchange opened for only about two hours daily for a week, hoping, by limiting the facilities for dealing, to stem the flood of selling orders which poured in from all quarters. The situation on both sides of the Atlantic was eventually brought under control by the action of the banks in assisting large operators to take big amounts of securities off the market, and so relieve the selling pressure, but the losses suffered by the investing and speculating public were so severe that normal business on almost every stock exchange was practically at a standstill for over a year, while prices of securities either sagged still further or were with difficulty maintained at their existing low level. Consequently, the large sums advanced by banks against securities had to remain "frozen" for a considerable period owing to the impossibility of realizing the securities except at a heavy loss, thereby seriously restricting the funds available for the financing of genuine trade requirements. Further, the world-wide losses of the general public, the atmosphere of caution and pessimism which this induced, and the shock to confidence and credit, involved a heavy decrease both in the power and in the will to consume immediate goods. On the other hand, production, encouraged by

he previous inflation of security values, had far outstripped even the normal increase in consuming power, and producers of primary as well as manufactured articles found themselves in possession of existing and prospective stocks far in excess of possible sales. A collapse in commodity values followed which intensified the general depression, and world trade touched its lowest level for many years, while the numbers of unemployed in nearly every country reached new high records. A possible revival of trade in America which might have spread elsewhere, was severely hindered by several minor banking failures in the U.S.A. at the end of 1930, due to unwise financing of speculators in the great "boom" of the previous year.

1931 and After.

The eventual effects of this sequence of events have not spent themselves even at the time of writing. There can be no doubt that the utterly reckless wave of sheer gambling which swept over the world in 1928 and 1929, thanks to a financial organization which provided facilities superior to anything ever offered by the Casino at Monte Carlo or the Irish Sweepstakes (in which, at least, one's losses are limited to the sum paid for tickets!), has involved millions of innocent persons who never had a ghost of a chance of benefiting from any of the chimerical profits of the gamblers. The cataclysmic results on the economic system of the world and the almost mortal blow dealt to "capitalism," as hitherto known, are sketched in a later chapter, but a decade at least will be necessary before a detached and adequate historical view of this period can be presented.

In conclusion, examination of these crises shows that, with the exception of any due to the effects of the War, they appear to owe their origin to inflation in one form or another. Such inflation may be direct, as by the over-issue of paper money or over-borrowing by Governments, or by an over-extension of credit by banks and financial houses, or by the undue raising of security values through speculation. Of these, the first two can be controlled by wise government finance and by prudent banking methods and a policy of co-operation between the Central Bank and the commercial banks.

The third, which appears to exist whenever any other form of

inflation is present and has, on several occasions, been responsible for the major part of the inflation leading to a crisis, should be controlled by limiting severely the banking accommodation granted to anyone against any form of stock exchange security, supplemented, if necessary, by legislation on the lines of "Leeman's Act." A further suggestion is conveyed by a paragraph which appeared in *The Times* of 28th November, 1933, which ran: "In order to put an end to gambling on the Warsaw Stock Exchange a law has been promulgated providing that the validity of debts arising from speculation on margin accounts will not be recognized in law."

CHAPTER III

MONETARY SYSTEMS

It has already been stated that the strict application of the term "*money*" is to the actual legal tender money in use in a country, and that of the term "*currency*" to anything that passes current in the discharge of debts both internally and externally. It is usual, however, when considering the means employed as the internal medium of exchange, to apply the term "*money*" to actual minted coins, and the term "*currency*" to such paper money as may be legally authorized, generally accepted, or of which the use is forced on the community. Since under modern conditions, it is the universal practice to economize the usage of metal by the adoption of paper money for internal use, it may be said that every country now possesses a composite currency system. There have been, however, many stages in the evolution of the modern conception of a currency system, and the chief monetary standards and currency systems, both practical and theoretical, are dealt with below.

Monometallism.

This monetary system, as its name denotes, consists in the employment of one metal as the basis of the standard coin and national unit of account. Under a pure monometallic standard only the one metal would be coined and made legal tender. As has already been explained, gold has gradually become to be generally accepted as the most desirable measure of value, and the currency systems of the world are based on this metal. For motives of economy, various modifications of the true monometallic standard have taken place and the various types may be summarized thus—

Gold Specie Standard, under which full-weight gold coins of the required legal fineness circulate freely, gold in coin or bullion is allowed unhindered ingress and egress, the Central Authority in every way prepared to buy or sell gold in unlimited quantities at legally fixed prices, and minting charges are negligible.

Gold Bullion Standard, under which no gold coins are in circulation, but the internal needs of the country are met by the use of

paper money and subsidiary coins, the free import and export of gold in bulk is permitted, and the Central Authority is always prepared to buy or sell gold of a given fineness in unlimited quantities at legally fixed prices.

Gold Exchange Standard, under which the national unit of account is based on the standard unit of a Gold Specie or Bullion Standard country, paper money and subsidiary coins are used for internal purposes, but the external value of the national unit is maintained at about the fixed ratio with the gold unit through operations in the purchase or sale of the gold currency against the national unit by the Central Authority.

A Composite Legal Tender System is now usual under any mono-metallic standard. Under this system the standard money consists of coins of the standard metal (usually gold), or of official paper money which is freely convertible into gold or the right to gold, either of which are made legal tender to an unlimited amount. For the smaller domestic needs of the community subsidiary coins of a baser metal, such as silver, bronze, or nickel are minted, but these are made legal tender for a limited amount only.

As such subsidiary coins must have a lower intrinsic or metallic value than their legal or nominal value (in order to prevent them from being melted down or exported for profit), they are known as "*Token*" coins.

Bi-metallism (Double Standard).

Again, as the name implies, this system makes use of two metals, usually gold and silver. In the Middle Ages both these metals were comparatively scarce, and they therefore acquired a certain value in themselves and were used almost indiscriminately for monetary purposes. The development of economic science not having reached the stage where accurate observation and deduction could be made, the effects of variations in the supply of and demand for each metal went unchecked. Until 1717 England possessed a Silver Standard Currency, but gold coins also circulated, and in that year a definite Bi-metallic System was introduced. The continual comparative cheapness of silver caused Gresham's Law to operate, and constant difficulty was experienced in maintaining full-weight gold coins in circulation as, in spite of continual legal changes in the fixed ratio of the value of gold and silver, there was

nearly always a profit in the melting down or exporting of full-weight gold coins, and only the worn and clipped coins were passed on. After a century of ineffective legislation to combat this evil, the Bi-metallic Standard was finally abandoned in this country and a Gold Standard was introduced in 1816.

France also made many attempts to maintain a Bi-metallic Currency, and her efforts continued from the middle of the eighteenth century until 1880. The ratio of gold to silver was constantly being changed, but it was found, after long experience, that the under-valued metal was exported while the over-valued metal was imported. Thus, from 1820 to 1850, when the market value of silver was *below* the legal value, i.e. silver was over-valued internally, silver was imported into France and gold exported. Following the great discoveries in California and Australia from 1850 to 1866, the value of gold cheapened while that of silver rose, and during this period the market value of silver was *above* the legal value, i.e. it was under-valued internally, and large amounts of silver were consequently exported while gold was imported. Several neighbouring countries having also adopted a Bi-metallic Standard and having also experienced the same ill-effects of variations in the supply of the two metals, the prospect of a greatly increased supply of gold led to concerted action being taken by the countries interested to preserve the Bi-metallic System. In 1865, what was known as the "*Latin Union*" was formed by France, Belgium, Switzerland, and Italy, and was joined by Greece in 1868. The Union prepared a Convention which came into force in August, 1869, which not only fixed a common ratio of $15\frac{1}{2}$ to 1 as between silver and gold, but instituted a uniform system of currency under which coins issued in any one of the countries circulated freely in the others. The gold coin was a five franc piece weighing 1.61290 grammes of gold nine-tenths fine, while the silver unit was a five franc piece weighing 25 grammes. Owing to the existing high market price of silver, the silver coinage soon almost disappeared from circulation but, in 1871, the production of silver having greatly increased, the market value began to fall steadily, and so much silver was presented for coinage, as soon as the market value fell below the legal value, that, in 1879, the coinage of five franc silver pieces was discontinued and remained suspended until the outbreak of War. This led to the system being contemptuously referred to as the "*étalon boiteux*" or "*limping*"

standard, as silver, being the weaker metal, was regarded as "limping" with difficulty behind the stronger metal. The Latin Union remained in academic existence until 1926, when it was formally dissolved owing to the wide divergencies in the value of the units of currency of the countries composing the Union through the effects of the War, those countries engaged in the War having greatly inflated and depreciated currencies, while those who remained neutral had benefited considerably. The U.S.A. also had a Bi-metallic Standard until the adoption of the Gold Standard in 1900, but even then the standard silver dollar remained unlimited legal tender and, owing to the presence of a certain clause in the Gold Standard Act of that country, it would appear that the Act would permit of a return to a Bi-metallic Standard should the condition of world prices for gold and silver warrant such a step.

In addition to the true Bi-metallic Standard, under which both metals are maintained in circulation at a fixed ratio, a refinement of the Bi-metallic System exists, the *Parallel Standard*. Under this standard of currency both metals are minted and purchased freely by the Central Authority, but the ratio between them is varied to accord with fluctuations in the market price of one metal in terms of the other. This variation prevents the operation of Gresham's Law.

A type of system which has lately received attention and which is sometimes confused with Bi-metallism, is "Symmetallism" or the Joint Standard.

This system tries to combine the benefits of a single standard with the flexibility of bi-metallism. Bi-metallism merely doubles the risk of a sudden discovery of precious metals, and Professor Marshall proposed a scheme whereby neither gold nor silver became the measure of money, but *both*. The standard coin would be composed of so many units of silver and so many of gold. This, it is maintained, would minimize the risk of violent fluctuations due to gold or silver discoveries; for both metals would have to be found to augment the quantity of money beyond the ordinary.

A further argument has been found for this system, under the present demand for "reflation," in that the remonetization of silver, it is suggested, would provide a monetary expansion without allowing scope for "competitive" or "progressive" inflation.

During and immediately after the War, the market price of silver

rose to a record figure owing to decreased production and increased demand through the absorption of silver by India and the Far East (due to favourable trade balances), and to the extended use of silver for subsidiary coins to economize the use of gold, and the large amount used for striking medals and decorations. After the conclusion of peace, the high price of the metal greatly stimulated production, while consumption fell away rapidly owing to depression of trade in the silver-using countries and the cessation of the other special demands. As a result, the market price of silver fell steadily, and the fall was accelerated by the discovery and exploitation of new methods of producing silver as a by-product in other industries and by the demonetization of silver by several countries (by a reduction in the fineness of the metal used or by the substitution of some other metal for the minting of subsidiary coins), especially in the case of India where, in 1927, the Silver Standard was abandoned and a currency system based on gold was introduced. From a record high value of over 7s. per oz., silver had fallen to under 1s. per oz. by the beginning of 1931, causing heavy loss to those countries, notably China, where values were measured in silver, and to all those concerned in the production of the metal. The consequent curtailment of purchasing power in terms of gold in such quarters was held to be an important factor in the depression of trade, and several proposals were advanced for extending the use of silver as coinage, suspending the sales caused by demonetization, and for other steps to restore the metal to a reasonable market value. The supporters of the various forms of Bi-metallism maintained that the fall in prices was in a large measure due to a growing disparity between the supply of and demand for gold, leading to a rise in the value of gold, that the production of silver was much more to be relied upon, and that some combination of the two metals as a basis for world currencies would result in smaller fluctuations in the market value of each and would make for greater stability of prices generally. They also contended that if a ratio between gold and silver were to be fixed by international agreement and maintained by co-operation between the Central Banks, Bullion Markets, and Producers, the operation of Gresham's Law would be prevented. At the time of writing, no steps in this direction have been taken, but it seems probable that, in view of the universal adoption of gold as a measure of value (even China and

the smaller Far Eastern States being in course of instituting currencies based on gold), the renewed use of silver for major monetary purposes, and as any kind of measure of value and store of value, would prove generally unacceptable.

Currency by Weight.

This was the primitive form of currency in use before the practice of issuing a stated weight and value of money in the form of a coin was adopted. It consists simply in arriving at the value or purchasing power of a piece of metal by weighing it, and this system still prevails to some extent in China and the less advanced small states. It must also be employed where the coins composing a currency are much worn or clipped.

Unrestricted Currency by Tale.

This system has operated in districts subject to international control or during a period of early development by colonists of several nations and means that, there being no national unit of currency, the money of other countries forms the currency system and each unit is accepted according to its nominal value. In its early days, Hong Kong used the Mexican Silver Dollar as its principal currency.

Multiple Legal Tender.

This system applies to the use of more than one kind of money, each kind being full legal tender. It may consist of coins of two metals, as in Bi-metallism, or it may consist of coins and paper money. In the latter case, if the paper money is fully convertible, the system becomes one of a composite legal tender. If the paper is depreciated through inconvertibility and over-issue, the coins will be driven out of circulation by the operation of Gresham's Law in the same way as is the more valuable metal under Bi-metallism.

Currency Exchange Standard.

This system is merely an extension of the principle of the Gold Exchange Standard, but applies to cases where the currency of a country is maintained at a fixed ratio with the currency of another country. The home unit need not have any metallic basis and need not be linked to any metal, but fluctuates entirely with the value of the other currency, This other currency, in turn, need not be

linked to any metal but is merely the basis of the measure of value in both countries. At the present time the Irish Free State has adopted a Currency Exchange Standard which is actually a Sterling Exchange Standard, since the Irish pound is said to be the exact equivalent of the English pound, and is maintained at that parity by the Irish Government. As long as this country maintained a Gold Standard, the Irish currency was on a Gold Exchange Standard, but since the suspension of gold payments by this country, the international value of the Irish currency has fluctuated with the international value of the English pound, and so has been on a Currency or Sterling Exchange Standard.

The Tabular Standard.

Many eminent economists have from time to time stated theories for a currency standard not associated entirely with any metal and designed to prevent fluctuations in commodity prices due to the relative scarcity or abundance of the metal on which a metallic standard is based. It is not possible here to go fully into the argument involved, but it may be stated briefly that the basis of a Tabular (or Isometric) Standard is that of an index number. Such a standard requires strict control of the volume of currency and credit by a Central Authority, and this volume must be carefully regulated in accordance with movements in a tabular figure arrived at by means of a composite series of index numbers of the internal values of capital and consumable goods and services. The special advantage of such a system, should it work in practice as it does in theory, is that it should ensure a more or less constant purchasing power of money, and so avoid any injustice to either debtor or creditor in respect of deferred payments and should also, by maintaining an almost stable level of money prices, allow costs of production to be accurately determined for long periods ahead, flatten out to a large extent the "waves" of the trade cycle, and render wage disputes much more easy of adjustment. The counter-arguments are that internal price stability is useless unless the whole world agreed to adopt managed currencies and to attain universal stability of prices, and that prices in any one country must, of necessity, conform approximately to those ruling elsewhere if both the import and export trade of the country are to be maintained. There is also the difficulty of so controlling the currency

that variations in the volume of currency and credit coincide with, instead of as at present following, variations in the relation between the demand for and supply of goods and services, which naturally cause variations in prices. It is also possible that a managed currency would be far more liable to State interference and manipulation than can be the case with any metallic standard. This is the theory on which President Roosevelt was assumed to be working in the course of his "experiment" in the U.S.A., which commenced in 1933. His economic advisers were alleged to have persuaded him of the advantages of a "commodity dollar," i.e. a unit of account which should be so "managed" by government control as to maintain a constant purchasing power in terms of internal goods and services, more or less regardless of its international exchange value, its gold equivalent, or its financial status.

Inconvertible Paper.

This system of currency ordinarily possesses no backing of value in any form; in its simplest form it is the issue of paper money in terms of the national unit of account, but with no metallic backing and with no relation to or link with any other currency which is on a more stable basis. There is, consequently, no right on the part of holders of such paper money to exchange it for metal or for the right to some other currency, and the paper can circulate as an internal medium of exchange only on the strength of the authority issuing and enforcing it. Being of no value in itself, such money is known as "*Fiat Money*," and its purchasing power internally must vary with the confidence held in the issuing authority and with the volume issued, while it will be accepted externally only on the basis of its current internal purchasing power. Such a currency may be made to function efficiently as an internal medium of exchange if issued by an established government, and if the issue is strictly regulated to the needs of the community, but its principle is unsound and its use is usually accompanied by great over-issue, i.e. severe inflation, with the resulting bad effects of wide fluctuations in prices, restricted enterprise, and general loss of confidence. Where a paper currency is "inconvertible" internally (as under a Gold Bullion Standard) or where the right of conversion is temporarily suspended or withheld (as under a suspension of gold payments), the backing of gold and/or securities will still remain and the evil

effects of an unbacked inconvertible paper currency may be largely avoided.

State Minting of Coins.

It has already been stated that State control of a coinage is a carefully guarded privilege, and that the standard metal is minted into the form of a coin with a design stamped on both sides and the edges, or rims, "milled" in the case of coins of higher values. The standard or quality of the metal used in all classes of coins is set out by law, and they must, therefore, be each of a certain *fineness* and weight of metal, subject to a very small variation, known as a *remedy allowance*. *Fineness* is the proportion of fine or pure metal to alloy contained in the standard metal. An alloy is needed for coins minted from gold or silver in order to harden these comparatively soft metals and to increase their durability in the form of coins. *Fine metal* is therefore the pure metal without the addition of an alloy, while *Standard metal* is the mixture of the pure metal and alloy used for coinage purposes. The standard of fineness of gold in this country is eleven-twelfths fine, i.e. eleven parts fine metal and one part of alloy in every twelve parts, or twenty-two carats fine in every twenty-four carats, while the silver standard is .925 fine, i.e. 925 parts pure metal in every 1,000, though since 1920 the standard metal for the minting of silver coins has been reduced to .500 fine, i.e. 500 parts pure metal in every 1,000. The U.S.A. and most Continental countries have adopted a fineness of nine-tenths for their standard gold coins, i.e. nine parts pure metal in every ten, which is slightly less fine than the British standard.

Before modern machinery was available with adjustments making it possible to effect accurate measurements, it was the custom in this country to have coins fresh from the mint examined, weighed, and tested by a jury composed of London Merchants. This ceremony was called the "*Trial of the Pyx*" and is still carried out, though with modern methods of minting it is now merely the relic of an old custom and is quite unnecessary.

Minting Charges.

Where the State levies a charge for turning metal into coins, this charge will either be the actual cost of minting or will exceed that cost. In the first case the charge is "mintage" or "brassage"

(French, *brasser*, to stir melted metals together). In most countries to-day, however, the laws provide for the gratuitous minting of the standard metal. This means that any person is free to present metal to the State Mint to be minted into coins without charge, but owing to the almost universal suspension of the internal circulation of gold coins (which now form the sole *standard* coinage of most countries), these laws are in abeyance.

Where the State makes a profit over the cost of minting, the charge is known as "seigniorage" (the sovereign's due), and it may be levied either by imposing a charge in excess of the minting costs on the person presenting the bullion for minting, or by abstracting a certain amount of the precious metal and substituting alloy, the value of the metal abstracted exceeding the minting cost. It was the imposition of too heavy a seigniorage in former times which was frequently the cause of a depreciated currency, since the coins were debased by the admixture of alloy to such an extent that they were no longer intrinsically of their nominal value and so could only be used for the purposes of foreign trade as of the value of the amount of pure metal which they actually contained.

Sweating or Clipping or Abrasion.

Other forms of debasement of a standard coin leading to its depreciation through loss of intrinsic value are the illegal and deliberate reduction of the weight of minted coins and the loss of weight occasioned by continual usage through the coin being allowed to remain too long in circulation. In the first case the weight of newly minted coins may be reduced by (a) *sweating*, which consists in the abstraction of metal by shaking coins together in a bag, and (b) *clipping*, which means the clipping away of small portions of metal from the edge of a coin, a practice against which the device of indenting the edges ("milling") now affords adequate protection.

Legal Tender and Token Money.

In order to ensure that the currency issued by or under the authority of the State shall be generally accepted by the community as a medium of exchange, it is the practice for the State to designate by law the extent to which every form of legal currency can legally be tendered in discharge of debts. Certain forms of currency, such as the standard gold coin of a gold standard country

or the standard gold and silver coins of a bi-metallic country, will be declared by the State to be the legal standard of value and *unlimited legal tender*, i.e. such currency must be accepted by a creditor, if tendered to him in payment of a debt or for commodities, up to an unlimited amount, and refusal to accept such legal tender places the creditor *prima facie* in the wrong.

Owing to the difficulty of minting coins of the precious metals, especially gold, of an intrinsic value small enough to be used for all classes of transactions, the lower values of the standard unit of account are expressed by coins of a cheaper metal for small denominations. They are invariably made limited legal tender and they are known as *Token Coins* because their intrinsic value is always fixed below their face value, and they are therefore of more value as coins than as bullion. Their use as legal tender is limited by the legal fixing of a maximum amount of each class of coin which may legally be tendered in satisfaction of a debt, and they circulate because of their use in satisfying the needs of the community for the making of small payments, and because they represent the right, in bulk, to the equivalent in the standard metal of the country. As they are of a low intrinsic value, the State makes a considerable profit on their issue, but the total volume is nowadays restricted to the needs of the country in order to avoid any risk of a premium on the standard metal and the operation of Gresham's Law.

The profit thus made by the State is without doubt a seigniorage—and the issue of paper money by a State may be considered as the issue of token money on which the seigniorage charge is almost the whole of the paper money issued.

The British Monetary System.

It has already been explained how this country passed from a Silver Standard Currency to a Bi-metallic Currency, and that, owing to the difficulties experienced in adjusting the legal ratio between the two metals to conform to the constant variations in the market prices, the free coinage of silver was abandoned in 1816, and gold was adopted as the sole standard of value. It has been explained elsewhere how, prior to the War, the country possessed a full Gold Specie Standard, as gold coins circulated freely, a free gold market existed, no hindrance whatever was placed on the free import and export of gold, and, under the Bank Charter Act of

1844, the Bank of England was legally compelled to exchange notes for gold (which was equivalent through the weight and fineness of the sovereign, to a sale of gold at a price of £3 17s. 10½d. per standard ounce), and to buy gold bullion at the price of £3 17s. 9d. per standard ounce. The suspension of both the Bank Charter Act and our free gold market lasted from August, 1914, to April, 1925, and, during that time, the country had an inconvertible paper system of currency but which was "managed" to a large extent, as regards the maintenance of its external value, by the Government and the Bank of England. In April, 1925, the Gold Standard Act was passed which restored our free gold market but which changed our standard of currency from a Gold Specie Standard to a Gold Bullion Standard, since the right of free coinage and the minting of gold coins for internal circulation remained suspended and, in substitution, the Bank of England was placed under the legal obligation of buying all gold offered to it at the price of £3 17s. 9d. per standard ounce as before, but was to be obliged to sell gold for export only and then in a minimum quantity of one bar containing about 400 ounces fine, at the price of £3 17s. 10½d. per ounce standard. It should be noted that, prior to the War, the Mint accepted gold for coinage, in reasonable amounts and of the required fineness, at the rate of £3 17s. 10½d. per ounce standard which meant that, in effect, gold could be both bought and sold at the same price either from the Bank, in the first case, or to the Mint in the second case, but as a certain amount of time was lost in the minting process the resulting loss of interest to the seller reduced the net amount which he eventually received to approximately the Bank's buying price of £3 17s. 9d. per ounce standard. The difference existing between the buying and selling prices of the Bank, therefore, is merely intended, not as a profit, but as compensation to the Bank for the cost and loss of interest which would be occasioned should it wish to have any gold which it may have purchased converted into sovereigns. With the passage of the Gold Standard (Amendment) Act in September, 1931, the legal obligation of the Bank to sell gold was suspended, though its liability to *buy* gold at the statutory price remains.

British Coinage.

The standard coin of this country is the gold sovereign, but a gold half-sovereign was coined, and the subsidiary coinage consists

of silver and copper token coins. The coinage of the country is issued under the Coinage Acts of 1891 and 1920, which provide as follows—

Gold coins shall consist of the sovereign, containing 123·27447 grains of standard gold eleven-twelfths, i.e. 22 carats, fine, and of the half-sovereign of exactly one-half the weight and of the same fineness. These coins were unlimited legal tender for the payment of debts. A "remedy allowance" of two parts in 1,000 of fineness and of $\frac{2}{10}$ ths of a grain for the sovereign, and of $\frac{3}{20}$ ths for the half-sovereign, of weight were permitted. For the coins to remain legal tender their respective weights were not allowed to be reduced by abrasion to below 122 $\frac{1}{2}$ grains and 61 $\frac{7}{8}$ grains. Sovereigns were formerly coined not only at the Mint on Tower Hill, London, but also at Pretoria (these bearing the distinctive letters, S.A.) and at the three Australian Mints of Sydney, Melbourne, and Perth. Silver coins are limited legal tender and can only be tendered in discharge of debts up to and including forty shillings. The Coinage Act, 1891, provided for the issue of the crown, double florin, half-crown, florin, shilling, sixpence, fourpenny, threepenny, twopenny, and penny silver pieces. Of these, the double florin and the crown are no longer coined, and fourpenny, twopenny, and penny silver pieces are issued only as "*Maundy Money*." The old "right standard" of silver was $\frac{3}{4}$ ths, or ·925 fine, and the Act provided that five shillings and one sixpence should be coined from every ounce of standard silver. As the market price of silver was for many years only about 2s. 6d. per ounce, the State made a good profit (seigniorage) when turning silver into coin. Now, since the Coinage Act of 1920 has made "silver" only half-pure¹ the profit comes to about 9d. in the shilling; for an ounce of fine silver (costing 2s. 6d.) becomes 11s.

Copper coins are made of a mixture of copper, tin, and zinc, and are coined in the penny, halfpenny, and farthing piece. They are limited legal tender and can only be tendered in payment of debts of up to and including one shilling. Two new half-pennies weigh over 30 grains more than a new penny, the standard weight of the penny being 145·83333, and that of the half-penny 87·5 grains, while the farthing weighs just half as much as the half-penny.

¹ I.e. only 500 fine.

Paper Currency.

The Monetary Standard of this country is one of composite legal tender since it comprises metallic and paper money circulating as unlimited or limited legal tender. Prior to the War, the notes issued by the Bank of England and its branches were the only form of legal paper money. These notes were issued for a minimum sum of £5, and in various larger denominations, but were legal tender only for the payments of amounts of over £5, except by the Bank itself or its branches. The Currency Notes of £1 and 10s. issued by the Treasury from 1914 to 1928, were made legal tender for the payment of any amount, i.e. unlimited legal tender. Under the Currency and Bank Notes Act of 1928, the Government issue of notes was transferred to the Bank of England, which was specially empowered to effect the withdrawal from circulation of the existing Currency Notes and to issue its own notes of £1 and 10s. in place of the notes so withdrawn.

The paper currency of this country now consists of Bank of England notes only. Bank Notes for £1 and 10s. are unlimited legal tender. Bank Notes of £5 or over are also unlimited legal tender under the Act of 1928, but, obviously, they will only be used as legal tender for the payments of amounts of at least the face value of any note, e.g. a £5 note would be used only for the payment of a debt of £5 or over, a £10 note for a debt of £10 or over, etc., as it must always be borne in mind that while a creditor puts himself in the wrong if he refuses payment of a debt where the exact amount is offered to him in legal tender money, *no one can be compelled to give change*. Thus, a £5 note is legal tender for a penny tram fare, but the whole property in the note must be handed over to discharge the debt of a penny and change cannot be demanded.

CHAPTER IV

THE THEORY OF FOREIGN EXCHANGE; MINT PARITY AND THE PURCHASING POWER PARITY

THE international exchange of goods and services naturally involves payments by the nationals of one country to another. In primitive communities such payments are made by means of *barter*.

The fisherman exchanges a part of his catch with the trapper for so many rabbit skins; the man who tills the soil pays for the labour of another to build him a hut by means of a certain portion of his crop. The introduction of a recognized form of money greatly simplified the internal exchange of goods and services, but, the process of evolution being very gradual and intercourse between communities being at first limited, different standards of value and forms of money were adopted by different communities. As tribes grew into nations and as trade became international, the problem arose of how to discharge a debt where the article which gave rise to the debt was expressed in different terms by the debtor and the creditor.

Where the value of an article can be expressed in terms of something common to both parties, the transfer of that something is all that is necessary to complete the transaction, but where the denominator of value differs, either the debtor must purchase or acquire sufficient of the denominator of value obtaining in the creditor's country, or the creditor must be content to accept payment in terms of the standard of value obtaining in the debtor's country and use it there or exchange it in some way for his own standard of value. It is, then, the fact that the various nations of the world each have their own unit of money, forming the basis of their standard of value, which gives rise to the need for exchanging one form of money for another in order that trade between nations may be made possible, and each successive development in international commercial and financial relations makes this need greater. Even if every nation possessed the same unit of account there is always the "geographical factor," i.e. the fact that money in one centre must be transferred to another centre in order that it

shall be available for the making of payments, and the time taken in effecting this must vary with the distance between the two centres.

Certain forms of credit instruments or book entries may be made immediately available in another centre, but the standard of value on which they are based must have bulk if it is to have intrinsic value, and any temporary balance of indebtedness between the two centres must be discharged by the transfer of a sufficient quantity of the common standard of value in bulk. Consequently, even between countries using the same unit of account, a variation in the value of units held in one country as against units held in the other can exist, owing to the loss of interest and expense involved in transferring any quantity of the standard of value from one country to another.

Definition of "Foreign Exchange."

Foreign Exchange may be defined as that section of economic science which deals with the means and methods by which rights to wealth expressed in one country's currency are converted into rights to wealth in terms of another country's currency. It involves the investigation of the method by which the currency of one country is exchanged for that of another, the causes which render such exchanges necessary, the forms which exchanges may take, and the ratios or equivalent values at which such exchanges are effected.

The expression "Foreign Exchange" is also popularly used to denote a foreign currency, e.g. a bank is said to buy or sell "Foreign Exchange," meaning that it buys or sells rights to foreign currencies or the foreign moneys themselves. Again, the expression "Foreign Exchanges" or "Exchanges" is used, particularly by the Press, to describe the ratios, or rates of exchange, at which currencies exchange for one another.

The Rate of Exchange is the price of one currency in terms of another or, in other words, the number of units of one currency which exchange for a given number of units of another currency. The price or rate of exchange of one currency in terms of others cannot be fixed but varies continuously with variations in the existing relation between the world demand for and the supply of that currency. In order to arrive at a starting-point for the calculation of a ratio between two currencies, two main methods

of arriving at a basis of comparison are adopted (which are dealt with below), and it is found, in practice, that the actual rates of exchange fluctuate around these basic ratios according to the continual variations in the demand for and supply of the various currencies.

The Mint Par of Exchange.

Gold having become the almost universal standard of value and if all the principal currency units of the world are either linked to gold or to some gold currency by the laws of the respective countries, the obvious method of arriving at the ratio of value of the standard units of two such countries is to compare their respective gold values, i.e. the actual or theoretical amount of pure gold which each contains. This method of comparison is known as the *Mint Par of Exchange* or the *Mint Parity*, and may be defined thus: *where two countries use the same metal as the basis of their currencies, the Mint Par of Exchange between them is the number of units of the one currency which should legally contain the same amount of pure metal as does, legally, a given number of units of the other currency.* The calculation is merely one of Compound Proportion, but is more usually carried out by means of the arithmetical process known as the "Chain Method" or "Chain Rule," which is dealt with in Chapter X. Assume that the English sovereign contains 123·27447 grains of gold $\frac{1}{2}$ ths fine, while 10 U.S.A. gold dollars contain 258 grains of gold $\frac{9}{10}$ ths fine. From these data it can be ascertained that £1 contains as much pure gold as would a coin of \$4·8665, if such a piece were coined, and the *Mint Par* between this country and the U.S.A. would be £1 = \$4·8665. By similar comparisons the *Mint Pars* between any two countries using the same metal as their standard of value can be calculated, but it must be understood that any *Mint Par* is merely a theoretical measurement of the value of one standard coin in terms of another standard coin. It takes no account of practical variations in the weight or fineness of actual coins, due to abrasion or remedy allowance, and is a purely arbitrary basis of comparison. It may not be possible to obtain gold coins in either of any two countries, and the free import or export of gold may not be permitted, so that actual transference of coins would be impossible, but as long as the existing coinage laws of the two countries remain unchanged the *Mint Par* between

them will also remain unaltered as it is a theoretical rate of exchange based on the laws themselves.

In any event, the "geographical factor" involves expense and loss of interest for coins to be moved from one centre to another, and it can never be said that the possession of, say, a sovereign in London would enable the holder to exchange it, as a coin, immediately for \$4.8665 in New York.

The Purchasing Power Parity Theory.

The great inflation of the currencies of nearly all the belligerent nations which took place during and just after the War led to the almost total abandonment of any attempt to retain a gold backing or even a gold basis to such currencies, and, in the absence of the normal limits to movements in rates of exchange set by the cost of moving gold from one centre to another, the exchange value of the currencies depreciated far beyond all precedent, while fluctuations in rates of exchange, or the price of one currency in terms of others, occurred almost every minute of the day. These wild fluctuations were undoubtedly due in a large measure to the activity of speculators who operated in exchanges in the same way as in securities, selling currencies which they did not possess, or buying them without any real need, in the hope of profiting from a fall or rise in their exchange value respectively, and the need for a new basis of comparison of currency values became apparent.

Professor Gustav Cassel, of Stockholm, at length advanced the theory that, under normal conditions, people do not buy a currency for the sake of owning it, but because the possession of it enables them to satisfy some want to better advantage than if they owned some other currency. This led to the evolution of the Purchasing Power Parity Theory of the exchanges which may be enunciated as follows—

The Purchasing Power Parity between any two countries is that amount of the currency of one country which endows the holder with the same amount of purchasing power, i.e. command over goods and services, as would a stated amount of the currency of the other country. While the value of the unit of one currency in terms of units of the other will vary over short periods, or at any particular time, in accordance with fluctuations in the market conditions of supply and demand, yet, in the long run, that value will be

determined by the relative command over goods, services, and securities of similar status, i.e. purchasing power, which each unit of currency possesses in its own country.

The theory may be illustrated by assuming that a suit of clothes costs £5 in England, or \$25 in the U.S.A. If the rate of exchange between the two countries is £1 equals \$5, a suit will cost the same in either country and the exchange is at the Purchasing Power Par. If the exchange is £1 equals \$4, it is cheaper for an American to buy his suit in this country, since, by spending only \$20, he can purchase £5 which will buy him a suit. The resulting demand for suits in this country and the falling-off in demand for suits in America, will normally tend to cause a rise in price here and a fall there, while the offering of dollars in exchange for pounds will tend to raise the value of the latter in terms of the former, i.e. more dollars per pound will have to be offered to induce fresh sellers of pounds to come forward. This process will continue until the price of suits rises to, say, £5 10s. here, and falls to \$23 in America, while the rate of exchange of the pound in terms of dollars rises to \$4.25, when it is no longer profitable for an American buyer to make his purchase here. A gradual adjustment of internal prices and the rate of exchange will then take place until an approximate Purchasing Power Par is again reached.

To take a further illustration, if a Japanese can purchase for 10 yen either £1 or 124 French francs, and if a metre of cloth costs £1 in Bradford or 123.50 fcs. in Lyons, the Japanese, wishing to purchase a metre of cloth, would obviously buy it in France, since by spending 10 yen, he would obtain his cloth and have a balance of 50 centimes, while for the same sum spent in this country he would obtain his cloth only. The resulting change in the direction of world trade would tend to cause a rise in the French internal price level, and a fall in that of this country, together with a rise in the exchange value of the franc, and a fall in that of the pound, until the combination of internal prices and external exchange value of the currency arrived at the level which made it equally cheap for a foreigner to buy in either country.

The theory can only be approximate since it is impossible accurately to estimate the effects of tariffs and customs duties, the strength of existing trade relationships, national prejudices and slogans, varying national tastes and similar psychological

influences, but its basic truth is self-evident and, if regard is paid to its limitations, it can form a most useful guide both in explaining, and to some extent in forecasting, movements in exchange values.

The Theory Applied to Two Gold Standard Countries.

Between the principal countries of the world which work on some effective form of gold standard, the Purchasing Power Par becomes equivalent to the relative purchasing power of gold in any two countries. If a certain group of commodities and/or services costs 50 units of currency in country A, and a similar group costs 100 units of currency in country B, each unit having the same theoretical gold content, then the higher internal purchasing power of the units of A should be reflected in a higher external value in terms of the units of B, and the rate of exchange should be approximately $1A$ equals $2B$. If the free movement of gold between the two countries is permitted, and if for any reason the current rate of exchange is quoted as $2A$ equals $3B$, buyers in B will send their gold to A, as, by sending sufficient gold which in their own country would purchase only $1\frac{1}{2}$ groups of commodities and/or services in their own country, they can purchase 2 similar groups in country A. The resulting flow of gold from B to A will contract credit and raise the value of money in B which, together with the falling off in demand, will cause a fall in prices there, and the increase of gold in A will cause an expansion of credit, a fall in the value of money, and an increase in the demand for goods and services, which will tend to raise prices. These two movements will continue until the net cost to country B of buying in country A, i.e. the cost of A units in terms of B units together with internal prices in A, shows very little difference to the cost of similar items purchased internally in B. In other words, if the gold parity between the pound and the French franc is $\pounds 1$ equals 124.2134 fcs., but a representative group of commodities costs $\pounds 1$ in this country, but only 123.50 fcs. in France, English buyers will make their purchases in France if the current rate of exchange enables them to buy more than 123.50 fcs. for each pound. If the rate of exchange is standing at the gold parity, the demand for francs will cause them steadily to become dearer, and if the market price reaches the point at which it is as cheap to pay the cost of transferring gold from London to

Paris, gold will be sent to obtain francs with which to make purchases in France. The reduction in the basis of currency and credit here will cause a rise in the value of money and a fall in prices, while the increase in the gold reserve in France will cause an increase in currency and credit, a fall in the value of money, and a rise in prices. The fall in prices in one country and the rise in prices in the other will be accelerated by the falling-off and the increase, respectively, in the demand for commodities in the two countries. When this movement in the two prices levels, combined with the movement in the rate of exchange, makes it no longer profitable for English buyers to buy French francs with which to buy French goods, the demand for both French currency and French goods will die down, the appreciation in the exchange value of the franc and the rise in prices in France will cease, and, after temporary oscillations, the rate of exchange will tend to rest at the point which represents the current purchasing power of the pound in terms of francs, say, 123.95 fcs. to the £1.

The Theory Applied to Inconvertible Paper Currencies.

The truth of the theory is even more evident in considering the rate of exchange between a Gold Standard country and a country having an inconvertible unbacked paper currency, or between two countries with such paper currencies. As such countries do not permit the export of gold in discharge of debts, their currencies can possess an external value only commensurate with the right to goods and services which they convey to the holder. No one will accept such a currency in discharge of a debt unless he is satisfied that the amount he receives will give him the same purchasing power as if he had received payment in terms of his own currency. The external value of the currencies of such countries will therefore fluctuate with the internal purchasing power. If the index number for a representative group of commodities is 100 in a Gold Standard country and 500 in a country with an inconvertible paper currency, the rate of exchange between the two countries would tend towards the point at which one gold unit would purchase 5 paper units. In practice, an inconvertible paper currency is so subject to sudden inflation that its current internal purchasing power is difficult to ascertain, and its external value is, consequently, subject to wide fluctuations.

External Undervaluation or Overvaluation.

Where the external exchange value of a currency gives to a buyer of that currency a greater command over goods and services than the amount of his own currency which he has expended would give him in his own country, the currency is said to be "Undervalued" externally. Where the external value of a currency is so high that a buyer obtains fewer goods and services than he could obtain by spending the same amount in his own country, the currency is said to be "Overvalued" externally. In either case, an adjustment of internal price levels and external exchange value takes place until approximate equilibrium of purchasing power is reached.

International Prices.

It cannot be emphasized too strongly that the external (or international) selling price of a country's goods is its internal price *cum* the exchange value of its currency unit. In other words, a depreciated or devalued currency will result in a lower exchange value, which can offset, at least temporarily, any rise in the internal price level above world level. A foreign buyer of home goods, securities, or services must first buy the home currency (or offer the seller a foreign currency), and it is the yield of home currency units against the foreign currency units which determines whether the selling price internally is attractive externally.

A low exchange value of a currency will also tend to offset, or even render nugatory, a system of tariffs imposed by other countries against the country in question, since the ultimate net cost of the home goods to a foreign importer may still be cheaper to him, even after paying the import duties, than the cost of the same goods in his own country.

CHAPTER V

INTERNATIONAL INDEBTEDNESS, AND THE MAIN CAUSES OF FLUCTUATIONS IN THE EXCHANGES

As long as any community is self-contained and self-sufficing it need have no relations with other communities involving the creation of debts, but as soon as it enters into any transactions with other communities which result in payments having to be made by one to the other, the problem of the exchange of currencies at once arises. Since a currency is, for the purpose of international exchange, no more than a commodity which facilitates the exchange of other commodities, its value in exchange for other currencies is entirely subject to the law of supply and demand. If the supply of a currency, i.e. the amount generally offered for sale, at any given moment exceeds the existing demand for that currency, its value in exchange must tend to fall since sellers must offer more units of that currency in exchange for others to induce further buyers to come forward when the existing demand has been satisfied. Conversely, if the general demand for a currency at any given moment exceeds the current supply, the exchange value of that currency in terms of others must appreciate, since buyers must offer to accept fewer units of the currency in exchange for others or to give more of other units for the same number of units of the wanted currency as before, in order to bring out fresh sellers when the existing supply has been absorbed. It follows, therefore, that the exchange value of a currency, which is the "rate of exchange," fluctuates continuously with every variation in the relationship between the current supply of and demand for the currency, and all the factors which go to make up and to affect current supply and demand are, consequently, of the first importance in considering movements in rates of exchange.

Existing Balance of Indebtedness.

As will be seen from a study of the following paragraphs, the factors affecting the supply of and demand for a currency are numerous and varied, and some of them have only a psychological effect which can hardly be measured. It is quite impracticable for

his own currency by some means for that of his creditor, or the latter must find some means of exchanging for his own currency the right which he possesses to the currency of the debtor. Trade, however, is not one-sided, and there will be another Brazilian merchant who has bought, for example, hardware from a Sheffield merchant, and who has thereby incurred a debt due by Brazil to this country. If it is assumed that the two debts are each for £500, the situation will be that London merchant A owes £500 to Brazil merchant B, while Brazil merchant Y owes £500 to Sheffield merchant Z. The settlement of these two transactions might therefore be effected by B drawing a bill for £500 on A and selling it to Y in exchange for local currency at the prevailing rate of exchange between the pound and the milreis (the Brazilian currency), and by Y sending the bill to his creditor Z, who would thereupon present it to A and obtain payment in pounds. A would then have discharged his debt in his own currency, while Z would have received the amount due to him in his own currency. Similarly, B would have received a sufficient amount of his own currency to discharge the debt due to him by A and, by paying over this amount in his own currency, Y would have discharged his debt to Z.¹

This principle of the off-setting of debts is, of course, vastly more complicated in practice. Each nation trades with many others, and debts due by one nation to another may be offset by debts due to the first nation by a third, while, particularly in the case of this country, debts may arise due both to and by us in respect of trade between two other nations which is financed through London. Thus, in the example given above, the purchase of coffee might have been made by a Danish merchant and financed through London, so that, by accepting the drafts on London of the Brazilian exporter, this country would incur a debt to Brazil while Denmark would incur a debt to this country in respect of the financial facilities granted. The movements of tangible goods between nations can be checked, and their quantities and values can be recorded by the various State officials appointed for this purpose in every country, and trade in all commodities of which the import and export can be so recorded is known as "Visible Trade."

There are, however, many other items which give rise to debts

¹ Cf. Spalding's *Foreign Exchange and Foreign Bills*, p. 10, and Clare's *A.B.C. of the Foreign Exchanges*, p. 7.

between countries which are of so intangible a nature that the recording of the values of all such items is impracticable. For example, a ship owned by a British company may carry a mixed cargo from Liverpool to Shanghai, and may then take a cargo of rice to San Francisco, a cargo of wheat from that port to a Greek port, a cargo of currants from there to Boston, and finally arrive back in this country with a mixed cargo of American goods. The local agents of the vessel at each port will have collected the respective freights and will have made certain disbursements on account of re-victualling and re-fuelling the vessel. The ship-owners in this country will receive in due course the net amounts due to them in respect of the ship's voyages, but the various items cannot be made the subject of official statistics in every port, and no official record of the incomings and outgoings can therefore be kept. There are many similar intangible items and they are commonly known as the "*Invisible Trade*" of a country. They constitute invisible imports and exports; an import being something for which a country has to pay and an export being something for which it has to receive payment.

The principal "invisible" items are—

Freights. Sums earned by our vessels, whether carrying our own or foreign goods, are sums due to us for services exported. When British-owned goods are carried by foreign vessels, we incur a debt to the owning country for our import of their services.

Disbursements of British ships in foreign ports are an import by us of the goods and services so obtained, while disbursements of foreign ships in British ports cause debts due to us by the foreign countries for such services and goods.

Insurance Premiums for risks insured with British companies by foreigners are debts due to us for services exported, while risks insured by our nationals with foreign companies are our imports of services for which we must pay.

Commissions and Brokerages. Where, for example, a German buyer uses the services of a London wool-broker to buy Argentine wool at the London sales, and the purchase is financed by means of a credit opened in London, the German buyer and the Argentine seller both import the services of a London broker, while the German, in addition, imports the services of the London bank or Accepting House through whom the credit for payment of the purchase is

opened. All such charges, therefore, represent exports by the country rendering the service and imports by the country receiving it.

Tourists' Disbursements. When a national of one country visits another country, he spends a certain amount of money and presumably benefits in some way by his visit. His country may, therefore, be held to have imported, through him, a certain amount of health, enjoyment, and education, and the money spent abroad by the tourist represents the payment for these imports.

Profits sent home from branches or subsidiary concerns operating abroad represent, presumably, payment for facilities afforded to the foreign countries concerned and, therefore, of an import of services by them, as are *Royalties* on books, plays, films, etc.

Government Disbursements, such as reparations, maintenance of troops, police, and officials in foreign countries, pensions paid abroad, etc., represent payments for past or present imports of services. Reparation payments can be considered as the re-import of loss previously caused to others; pensions, as a past import of services, etc.

Sales of ships are not registered as part of the visible trade of a country, and must therefore be included under the invisible items, although of a tangible nature. For example, a British ship may be sold to a Dutch buyer while lying in a Belgian port.

Loans and Interest Payments. These are really the most important of the invisible items, though some economists include them under the heading of Stock Exchange operations. A loan obviously creates the need for a payment by the lender to the borrower or his assigns. As between nations, a loan by one to another is in effect an import of the paper promises to pay of the borrower. If the proceeds of the loan are withdrawn in cash, either in the form of credit instruments or bullion, it results in offerings of the currency of the lending country by the borrowing country, causing a tendency to depreciation in exchange value of the lender's currency. •

If the proceeds of the loan are spent by the borrower within the lending country, the result is an increase in the exports, visible or invisible or both, of the lender and the exchange value of the lender's currency is not affected. In any event, every foreign loan must eventually result in the export by the lender of goods, services, securities, or bullion to some other country, since those who purchase the lender's currency from the borrower will eventually use

it in the purchase of one or other of these items from the lender. Where a country is over-lending abroad and the resulting offerings of its currency cause such a depreciation in the exchange value that gold is taken from it as being the cheapest method of discharging the temporary adverse balance of indebtedness, the orthodox theory of money holds that the consequent reduction in the basis of the internal credit structure, and the contraction of credit and raising of interest rates which this causes, will result in a fall in home prices until the relative cheapness externally of the currency, combined with the low internal prices, makes the country a cheap market for foreigners to buy in and an increase in exports takes place until equilibrium between exchange values and internal prices with the world level is restored.

The payment of interest by borrowing countries to the lender is an invisible import of their paper promises to pay by the borrowers, and therefore constitutes a debt incurred by them to the lenders. Repayments of loans are again a re-import by the borrowing countries of their original paper promises to pay, and a debt is therefore due by them to the lenders.

The importance in the case of this country of these invisible items can be seen from the table given below.

BALANCES OF INCOME AND EXPENDITURE IN THE TRANSACTIONS (OTHER THAN THE LENDING AND REPAYMENT OF CAPITAL) BETWEEN THE UNITED KINGDOM AND ALL OTHER COUNTRIES

	1930	1931	1932	1935	1936	1937
	(In million £)					
Excess of imports of merchandise and bullion	392	408	311 ^a	261	345	443
Estimated excess or deficit of Government receipts overseas ¹	+ 21	+ 14	—	- 2	- 3	- 4
Estimated net national shipping income ²	105	80	70	70	85	130
Estimated net income from overseas investments	235	170	145	185	205	220
Estimated net receipts from short interest and commissions	55	30	25	30	30	35
Estimated net receipts from other sources	15	10	15	10	10	10
TOTAL	431	304	255	293	327	391
Estimated Total Balance on items specified above	+ 39	-104	-56	+ 32	-18	-52

¹ Including some items on loan accounts.

² Including disbursements by foreign ships in British ports.

³ Includes £24,000,000 debit balance of inter-Government War debt payments.

A brief examination of this table will show the highly important part played by our "invisible" trade in our national economy. Without the set-off afforded by our credit balance on "invisible" items, we should be quite unable to maintain the consistently adverse "visible" balances shown. The fall in world prices and the decreasing volume of world trade has made for a general reduction of the figures of the trade balance sheets of all nations, but this country was particularly hard hit by the world crisis of 1929 and the years following. Not only did the falling off in international trade mean a fall in the earnings of our mercantile marine, in the premiums due to our insurance companies, and in the commissions paid to our brokers, but, more important than any, our receipts in respect of interest on and capital repayments of our overseas investments were gravely affected. In the first place, the universal trade depression reduced or even eliminated the dividends paid by commercial concerns, and, in the second place, exchange difficulties (largely due to an excess of non-productive inter-government indebtedness) led to the extensive imposition of exchange restrictions which, in many cases, prevented the remittance to creditors of even such dividend and interest payments as were made internally. This was further accompanied by a succession of defaults on the parts of governments, states, and municipalities themselves, and, as the world's largest creditor country, we naturally suffered most from this wholesale forced moratorium. It will take many years for the position to be cleared up, and it is most probable that a good deal of the arrears will have to be written off as bad debts. Since it is only the *surplus* of gross incomings over gross outgoings that a nation can afford to use in making new overseas investments, the volume of our foreign lendings has, perforce, materially decreased; in fact, with the suspension of gold payments here in September, 1931, the Treasury placed a definite embargo on the issue of foreign loans here so as to prevent an unwelcome and really insupportable strain on the exchanges, and though these restrictions were sensibly relaxed in the latter half of 1933, a certain supervision is still exercised at the time of writing.

International Finance—Banking Operations.

The internationalization of banking and the facility and rapidity with which funds can be transferred from one centre to another

have rendered banking and financial operations a most powerful factor in movements in exchange rates. The trade between nations must, within a little, cancel itself out and the total world difference between gross imports and exports, both visible and invisible, can only be comparatively small, and, where any country is either over-importing or over-exporting, economic forces are at once set in motion which tend to correct the position. But where a portion of the national wealth of a country is transferred for employment elsewhere, there need be no compensating influx of wealth from other countries and, unless a gold standard is in strict operation, the economic effects are not felt internally for some time. The results of wholesale exports of capital are referred to below.

It is held in many quarters that, at the present time, the exchanges are very largely controlled by, and fluctuations in exchange rates due to, movements of balances or funds from one centre to another by the principal Central and commercial banks.

An enormous post-war increase in paper wealth has led to a proportionate increase in the volume of money which has to be kept in a more or less liquid form. A recent authoritative estimate of the amount of such liquid funds throughout the world was the enormous sum of £2,000,000,000! Insurance companies, financial trusts, companies of international scope, even individuals of more than ordinary wealth, all have come to regard the spreading of their risks and the distribution of their funds internationally as a part of their business. In many cases the interest yield which is obtained on such funds is of secondary importance to the imperative necessity of keeping the capital sum intact. An investment in a foreign centre by means of a purchase of the foreign currency, may result in a heavy capital loss if the foreign currency depreciates or is devalued, and some valuable commodity such as gold cannot be demanded and withdrawn from the country in case of need. Consequently, such economic and financial disturbances as have been witnessed during the past few years have led to sudden, rapid, and heavy movements of capital funds from each centre successively threatened with disaster. But these movements have, of themselves, intensified the troubles they were intended to avoid by the grave embarrassment caused to the centre from which the funds are withdrawn, by the depression of the exchange value of the currency which is offered for sale, and even by the too great

accumulation of funds in supposedly "safe" centres. Some centres are thus starved of short-term funds, while others are suffering from a plethora. A study of those later chapters of this book which summarize the financial breakdown of 1931 and onwards, will show the part played by these purely financial movements of money in forcing countries to suspend gold payments, impose tariffs, quotas and exchange restrictions, and to endeavour to control their exchanges—all to the extreme detriment of international trade.

On the other hand, under normal conditions, the free movement of short-term funds internationally is almost as important as the free functioning of international long-term lending, and may be likened to the need for branch banking all over any one country under modern economic conditions. Funds can be most usefully moved from one centre to another, both nationally and internationally, and, in the latter case, movements in interest rates should form the deciding factor, provided that the all-important factor of capital safety remains the same in both the centres concerned.

Again, the regulation of many post-war currencies and the various forms of exchange "control" which have been, perforce, adopted have required that Central Banks should maintain balances in other centres, but even such balances are liable to withdrawal should loss of capital appear possible.

Any of these operations, known as "transfers of floating balances," or "money arbitrage," necessarily involves the offering of one currency and a demand for another. Usually, a pure investment operation in another centre will be covered as regards the exchange risk by means of a "forward" deal, and this class of operation is dealt with in a later chapter. But where the cost of covering "forward" is prohibitive, or where a currency in which it is proposed to invest is on a gold standard and is already so cheap that it would be profitable to draw gold from that country should the currency become only slightly cheaper, foreign bankers and financial houses will make purchases of the currency for investment purposes "outright," and the resulting demand will cause a rapid appreciation in its exchange value. English banks, however, do not run "open" exchange positions and would always cover any deposit or investment in a foreign centre for their own account by a forward exchange operation.

Where a steady increase in industrial activity in any country

leads to a demand for bank credit and so to a rise in interest rates, capital will flow into that country from other centres with lower interest rates, and this voluntary lending will have the same effect on the exchanges as that of any other loan of which the proceeds are not spent within the lending country.

A very frequent cause of a rise in interest rates is speculative stock exchange activity. It has already been mentioned ¹how the U.S.A. stock exchange "boom" of 1928-29 led to short-term interest rates of 9 per cent and 10 per cent being quite common, and an enormous influx of funds from other centres took place with the result that the exchange value of the dollar became so high as to cause large sums in gold to be remitted there. It should be remembered that the available "pool" of currency and credit in any country is limited, and that to enable anyone to purchase a share in this "pool," someone must be found who will sell a right to a portion of the amount available. While, during any kind of "boom," credit tends to expand, yet funds are so much in demand that owners of that currency are less ready to sell, and a sufficient quantity of foreign units must be offered by foreign buyers to make it attractive for any owner of home units to part with them. In other words, the price of the home unit in terms of others steadily goes up until it is cheaper for foreign buyers to remit gold, which actually increases the "pool" of currency and credit available in the receiving country, and so obtain the right to its equivalent value in terms of home units, rather than pay the price demanded by sellers. By reason of their international connections, banks are usually able to move gold more cheaply than ordinary firms or individuals, and where transfers of funds to a certain centre have caused the rate of exchange on that centre to become unduly dear, they will obtain the right to funds in that centre by shipping gold.

Where an internal crisis develops in any centre, funds will be urgently needed at home, and balances held abroad will be drawn on to assist the supply of credit at home. This amounts to a forced repayment of loans made abroad, and the home currency will tend to appreciate rapidly in exchange value as against the currencies of the centres from which funds are being withdrawn.

In pre-war days, and for some time after the War, a frequent international banking operation was the drawing of what were

¹ See page 47.

known as *finance bills*. These drafts were really only accommodation bills, but acquired a first-class status owing to the names of the parties, who were usually banks of high standing. Their use was originally intended to obviate seasonal movements of gold in cases where definite seasonal fluctuations in the balance of indebtedness between two countries was to be expected. For instance, trade between this country and the U.S.A. had a definitely seasonal character in pre-war days. From January to August the balance was steadily in our favour, while for the rest of the year a violent swing in favour of the U.S.A. took place on account of her seasonal sales of wheat, cotton, and tobacco. The American banks made a practice of "taking up a position," i.e. speculating, in anticipation of these movements, and would sell sterling while it was in demand in the U.S.A. for the first seven months of the year and buy it back when the expected autumnal offerings of sterling there materialized. Thus, knowing that gold would move from New York to London if the price of pounds rose to something over \$4.90½ per £, the American banks let the domestic demand for sterling force the price (or rate of exchange) up to nearly \$4.90, and they would then begin to "sell short" of pounds, since they knew that the price could not rise much further. In order to provide the spot sterling so sold, they arranged acceptance credits in London, under which they drew three months bills in sterling, and by discounting these after acceptance, they were placed in possession of the spot sterling needed to cover their sales. The bills would be renewed at maturity for another three months, and by that time the seasonal offerings of sterling in the U.S.A. would have cheapened the pound considerably. Knowing that gold would move from London to New York if the exchange fell much below \$4.84½, the American bankers would begin to cover their short position as soon as the current rate neared \$4.85. These purchases of sterling served to meet the maturing acceptances of the London agent and the whole position was cleared up. The original drawing of the finance bill constituted an addition to the available supply of sterling and tended to lower the exchange value of the pound. The renewals of the acceptances did not affect the exchange, except as to the very small amount of sterling which had to be provided by the American drawer of the bill to meet the difference between the face amount of the maturing bill and the smaller sum obtained by discounting the renewal, and

which tended to cause a small demand for sterling. The final buying-in of sterling to meet the eventual maturing of the acceptance, of course, caused an appreciable demand for sterling and tended to improve the exchange value of the pound. In other words, the initial speculative sales of sterling in America largely prevented the pound becoming so dear there that gold would become the cheapest form of remittance, and the final closing up of the position by the purchase of sterling on an offered market, helped to prevent the pound from becoming so cheap that gold would have been moved from London to New York.

Such bills were also used as a method of raising funds for transfer from a cheap interest centre to a dear interest centre. For example, when money could be used at 8 per cent per annum in Berlin and at 4 per cent per annum only in London, the big German banks would arrange finance acceptance credits with their London correspondents, and by discounting the accepted bills at the London rate, could put themselves in immediate possession of sterling. They translated this sterling into their own currency by buying spot marks and re-selling them forward (or, in some cases, omitted this forward covering of the exchange risk and remained with a speculative "open position" as a "bear" of sterling) and then had the marks at once available for use in Germany at the higher interest rates prevailing there. American banks also made use of this practice during the period of exceptionally high interest rates in the U.S.A. in 1928, but the dangers of the existence of a large volume of such finance paper were so pronounced that the Bank of England made it known that such paper would no longer be regarded as acceptable for re-discount at the Bank. This, of course, practically put an end to the practice as far as London was concerned, since no bank or discount house would take the risk of filling its portfolio with bills which could not be re-discounted with the Bank should the need arise.

The growth of forward exchange facilities since the War has also helped to make possible the easy international transfer of floating funds without the use of bills of exchange. The uses and principles of forward exchange are dealt with in a later chapter. The existence of these facilities gave rise to another practice during the short period of comparative stability in 1928 and 1929 known as "Currency Deposits." Many big insurance companies and commercial

institutions are compelled to maintain assets abroad to cover their commitments in other countries, while financial concerns and individuals also "spread risks" by holding liquid assets in several of the principal world centres. The chief debtor countries are always in need of other currencies with which to discharge their debts as they fall due, and a regular business sprang up of lending, say, dollars and francs to Germany, Dutch florins to Belgium, Swiss francs to Austria, or variations and combinations of currencies and countries. The operation was by way of a "clean" loan, i.e. without the deposit of any collateral security, and depended entirely on the good name of the borrower. A London bank, for instance, would be asked to accept a currency deposit in dollars from one of its customers. The bank would allow interest at, or just below, the rate ruling in New York for fixed deposits, and would then re-lend the dollars to, say, a first-class German or Italian bank. The borrower would, of course, be charged a higher rate of interest and would use the dollars either in payment of an immediate obligation in dollars, or would translate them into his own currency for use internally.

As long as renewals of such deposits could be made, and as long as the credit of the ultimate borrowers held good, such classes of business as those outlined above could be carried on smoothly and profitably. But as soon as the credit of the party accommodated by a finance bill or of the ultimate borrower of liquid funds becomes a matter of doubt, then renewals are not easy to obtain, and if over-financing has been indulged in by such parties, they may find themselves unable to meet their commitments—with a proportionate loss to those who granted the facilities. Such a breakdown of confidence on a grand scale commenced with the disclosure of the unsound financial position of Austria in May, 1931, and caused a general careful review of world conditions by acceptors and lenders, as a result of which renewals were refused and loans called in on every side, borrowers found no new sources of supply with which to meet these calls and the whole edifice of international financing was shaken to its foundations. Countries suspended gold payments, governments fell into default, debtors pleaded for moratoria, and even at the time of writing (over five years later) we are still struggling to liquidate a mass of "frozen" credits and "standstill" bills.

Another financial operation, the results of which affect rates of exchange, is that of "*arbitrage in exchange.*" The term "*arbitrage*"

is applied to the simultaneous buying and selling of the same article in two or more markets. "*Arbitrage in exchange*" is, therefore, an operation in exchange by which professional dealers endeavour to profit by differences in the rates of exchange for the same currency, ruling in two or more centres at the same time. They buy up currency in a centre where it is cheap, and re-sell it in a centre where it is dear, the margin of difference constituting their profit. Quickness to seize on even momentary differences in prices and speed of execution being of the essence of such operations, they are now conducted by telephone or telegraph, whereas before the War, when fluctuations in rates of exchange were much smaller and less frequent, they could be carried out by letter. As an example of "arbitrage in exchange," a London exchange dealer may have a telephone call to Berlin and find that his banking client there is a buyer of sterling against marks at the rate of 20.36½ marks to the pound, while in the London market, there are sellers of marks against sterling at the rate of 20.35½ and buyers of marks at 20.36 marks to the pound. By selling sterling to his German client and receiving there-against marks at the rate of 20.36½ to the pound, and by re-selling these marks in London, but giving only 20.36 marks for each pound he obtains, the London dealer makes a profit of half a pfennig on each pound's worth in which he deals. Similarly, profits may be made by buying or selling dollars against pounds in New York at a certain rate, by means of cables exchanged between dealers in the two centres, and re-buying them or re-selling them in London at the slightly different rate which must prevail there to make the operation possible. Such dealings in the currencies of two countries carried out between centres in those countries are known as "*simple*" or "*direct*" arbitrage. It is quite possible, however, for dealings to be carried out in a third currency between two centres, or in four or more currencies between three or more centres simultaneously. Thus, a London dealer may be in telephonic communication with a Paris bank on one line and with a Dutch bank on another, while the Paris bank is speaking to Madrid and the Dutch bank to Berlin on other lines. The London dealer may then find that prices in the other centres are such that he can buy marks against sterling in Holland, sell the marks to Paris against pesetas, and sell the pesetas in London for sterling at such rates as will show him an eventual profit in sterling. Operations involving

more than two currencies and centres are known as "*compound*" or "*two-point (or three-point, etc.)*" arbitrage.

It can be seen that the effect of such operations is to narrow down fluctuations in rates, or to cause the world price of a currency to move in the same direction in all centres almost at once, since a demand for any currency in a certain centre is met by transfers of supplies of that currency from centres where the demand is not so great and the price is consequently lower. Any excessive supply of a currency in one centre is similarly transferred to other centres where the supply is smaller and world supply and demand are thus set-off against each other. Modern means of communication thus prevent the exchange value of a currency in any centre from varying for long from its value in other centres and in terms of all other currencies at any given time. The price of one currency in terms of another or others, arrived at by comparing the value of each in terms of another or others, is known as an "*arbitrated rate of exchange*," or, more shortly, as "*cross rates*." Thus, if 12.10 Dutch florins will purchase £1, and £1 will purchase 20.38 German Reichsmarks, the "*arbitrated rate*," or "*cross rate*," or price of florins in terms of marks, would be $1\frac{3}{4}$ marks (about) per florin, or $168\frac{1}{2}$ marks per 100 florins, or $59\frac{3}{8}$ florins per 100 marks.

The issue of Travellers' Letters of Credit, Circular Notes, Travellers' Cheques, etc., and the opening of credits for financing international trade are banking operations which affect exchange rates, but which arise out of visible or invisible trade. Personal and Commercial Credits are dealt with in a later chapter, but it may be said here that their effect is to give the person in whose favour they are opened, the right to the currency of the issuer. If a tourist, for instance, takes with him to a foreign country a Letter of Credit in terms of his own currency, issued by his banker at home, and cashes under it drafts on the home banker, the foreign bank purchasing such drafts becomes the owner of the right to so much of the home currency. The issue of any Credit, therefore, tends to turn the exchanges against the issuing country in the same way as would the visible or invisible trade import in respect of which the credit is issued.

Stock Exchange Operations.

Stocks and shares are bought and sold in the same way as commodities, except that the transfer of ownership from one person to

another is more cumbersome and more expensive than is the case with other articles. The progressive development of the world's social and economic system has meant that all financial operations have had to become larger in size and wider in application. Not only do Governments and Municipalities arrange to raise loans in other countries, to meet needs which the savings of their own people are not sufficient to meet at the time, but big industrial undertakings also invite international subscriptions to their capital. This has been particularly the case since the War and, with the modern tendency towards international combines of firms engaged in the same trade, foreign subsidiaries and affiliations of some home industry, cartels, rationalization schemes, etc., the internationalization of capital is likely to become still greater. Where a large concern is operating in several countries, its financial needs become rather too large for any one country to support, that is, no one bank is prepared to place too great a proportion of its funds at the disposal of one firm. It is only fair, therefore, that the banks and people of each of the countries which, presumably, receive some benefit from the operations of the concern should participate in financing it, and so international issues of industrial capital are now common. If such capital stock and shares are subscribed for internationally, it follows that they must be marketable internationally, and there are now many securities which can be dealt in on all the principal stock markets of the world.

When the owner of stock in one centre sells it in another, he creates a debt due to his country by the foreign country just as if he had made a sale of goods and, on occasion, sales of securities abroad by nationals of one country or purchases of securities in one country by others, can have important effects on the exchanges. Dealings in securities may be either for investment or for speculation, but the effect on the exchanges is the same. If, for example, a sudden activity in the automobile industry in the U.S.A. is apparent, other countries will wish to buy shares in American firms engaged in the industry, both for investment and for speculation for capital appreciation. The resulting demand for American currency to pay for such purchases will tend to cause an appreciation in its value.

Considerable effect can be produced on the exchanges by "hedging" operations on the part of holders of, or speculators in, certain classes of commodities and securities. For example, a Liverpool

cotton broker may buy or sell cotton, either "spot" or forward, in anticipation of a price movement in his favour. Since the sterling-dollar exchange has a direct influence on the sterling price of cotton, he will probably "hedge" the risk of exchange movements by a simultaneous operation in dollars, as a dearer dollar usually means a cheaper sterling price for cotton, while a cheaper dollar makes for a higher sterling cotton price in the absence of other factors. Thus, if forward dollars are at a premium, he would probably cover a sale of cotton, either "spot" or forward, by a forward sale of dollars, so that, should dollars become cheaper and lead to a rise in the sterling cotton price, his exchange profit would offset his loss on the cotton. Similarly, he might "hedge" a forward purchase of cotton by a purchase of "spot" dollars so that, if cotton became cheaper through a rise in the value of the dollar, the loss on the one transaction is covered very largely by the profit on the other. The operator's eventual profit, of course, consists more in the shrewd buying and selling of cotton than in lucky "hedging" operations, which are designed only to limit losses due to exchange movements.

Again, holders of, for instance, gold-mining shares will "bear" the currency of a country whose actions appear likely to be inimical both to its own interests and to the world price of gold. Thus, in 1933, when France remained the sole principal protagonist of the Gold Standard, many feared that the policy of the U.S.A. in quoting a steadily increasing dollar price for gold would cause an enormous flow of gold from France to the U.S.A. which might force France to suspend gold payments, might leave the world with no effective international monetary standard of value, and possibly lead to the evolution of some new monetary standard less dependent on gold, and so to a heavy fall in the world price of gold. Holders of gold-mining shares therefore "sold short" or "went a bear" of French francs because, were France to be forced to suspend gold payments, the franc would at once cheapen considerably in terms of other currencies. Even if such a fall in the world price of gold subsequently took place as to cause a severe fall in the value of gold-mining shares, the profit on the "bear" operation in French francs would partially, or perhaps entirely, offset this loss to the holders. Operations of this nature are usually for quite large amounts and may, on occasion, have a disproportionate effect on the exchange markets

of the world. In such cases the rates of exchange move sharply against the currency in which the "bears" are working until either a normal demand gradually absorbs the offerings, or the currency becomes so cheap that speculative buyers are tempted in, or an official "control" is placed on the exchange.

Occasionally an existing loan raised abroad in more than one centre is renewed or a "conversion" operation carried out. This means that existing holders, wherever they may be, are offered new terms for the renewal of their lendings. Naturally these terms will be based on conditions in that centre where they are most favourable to the borrower. If the price of the existing issue is lower in other centres and the rates of exchange on those centres are high (i.e. the other currencies are cheap), and if the conversion terms are at all attractive, the centre where credit conditions are good and security prices high, so that the new issue will probably be well received, will endeavour to buy up in other centres blocks of the existing issue for the purpose of conversion into the new issue. As a result, the exchanges on other centres will tend to turn against the operating centre, while the price of the security concerned in those other centres will tend to rise until the combination of dearer exchange and dearer security price renders the operation no longer attractive.

Similar effects are often produced by the encashment of coupons which are payable in more than one centre at fixed rates of exchange. Obviously any holder of an interest coupon payable in any one of several centres for a stated amount of the relative currency will send it for payment, when due, to the centre in which he will eventually receive the highest return in terms of his own currency. For example, if a certain coupon is said to be payable as to £1 in London, or \$4.86½ in New York or Montreal, or Fcs. 124.21 in Paris, and the current rates of exchange in London are: New York \$5.15, Montreal \$5.05, Paris 82½, an English holder would evidently make more out of his coupon by cashing it in Paris for Fcs. 124.21 and selling these francs for sterling at 82½, since this would yield him, roughly, 30s. as against the £1 which would be paid for the coupon in London, while, by cashing it in New York or Montreal, and then selling his dollars for sterling, he would receive only about 19s. and 19s. 4d. respectively. This is an extreme case, and such exchange rates have only prevailed for special reasons, but under

normal gold standard conditions it is quite easy for the New York and Montreal rates to be, say, $4.85\frac{1}{2}$ and $4.86\frac{1}{4}$ respectively. Under such conditions the selling of U.S. dollars through the encashment of coupons there could very well move the rate to parity (i.e. equality) with the Montreal rate.

Arbitrage is also carried out in stocks and shares, and the purchase of a share in a centre where its price is low and its re-sale in a centre where its price is high, tends to level out differences in the price in various centres. As with commodities, it is the internal price of the share combined with the international exchange value of the local currency which constitutes the international price, and stock arbitrage therefore tends to have the same effect on the exchanges as on the price of the security dealt in.

Long Term Factors.

Any economic condition which eventually tends to affect the purchasing power of a currency must eventually affect the international exchange value of that currency. Such effects are frequently hastened by the speculative dealings in exchange of professional operators and, in some cases, such exchange operations actually curtail or diminish the full effects of the economic cause.

A revival of trade activity in a country, or the adoption of improved methods of production, may induce a burst of foreign buying of the products of that country. The resulting demand for the local currency will be increased by a speculative demand on the part of exchange operators, and the consequent rise in its international price may make the external selling price of its goods sufficiently high to discourage further buying. This effect will be added to by the probable rise in stock exchange values, helped by foreign buying, causing an expansion of credit and a rise in prices.

The principal economic causes which may be described as long-term factors affecting exchanges are *currency and credit conditions* and *political and industrial outlook and events*. Financial interests in every country are always watching the statistics of other countries, both financial and commercial, as these show the probable trend of the internal, as well as of the external, value of the country's currency. If, for instance, the published figures of the note circulation of a country show a steady increase which does not appear to be justified by the state of internal trade, the assumption is that

over-issue is taking place and that the internal purchasing value of the currency will fall, i.e. internal prices will rise. This will have an adverse effect on the export trade of the country, and the foreign demand for its currency will tend to fall off eventually, causing a fall in its international exchange value. Exchange dealers abroad will, to some extent, anticipate this by "selling short" of the currency, thus immediately increasing the external supply relative to the demand. The fall in the international exchange value which results serves to offset the rise in internal prices and, if carried to the point at which gold is withdrawn from the country, the consequent reduction in the basis of currency and credit must cause a contraction in the latter which, in turn, causes a fall in internal prices. As long as gold can enter or leave a country freely, movements in prices and exchange rates, due to the internal volume of currency and credit being too great or too small, are counteracted by the effects on that volume of an efflux or an influx of gold, but where the currency has no gold backing or where any gold backing is not allowed to perform its proper function, the exchange value of the currency can fluctuate unrestricted.

No better example of the effects of falling trade, bad finance, and international psychology combined can be found than in the sequence of events since 1929, which is treated later in this book. For instance, in 1931 it was the obvious falling-off in our trade returns, our extravagant national expenditure, and our international banking position of having borrowed on short-term and lent on long-term which aroused universal uneasiness as to our ultimate position. This fear expressed itself in the withdrawal by foreign owners of such funds as they had in London and could mobilize, and this they did either by selling pounds for foreign currencies or by shipping gold from London. This wholesale offering of pounds brought in the speculator, who sold pounds "short" in the hope that, if we were forced to abandon the Gold Standard, the exchange value of the pound would cheapen rapidly—in which view he turned out to be perfectly right. The pressure on our exchange resources and on our gold reserve proved to be irresistible at the time, and we were compelled to divorce the pound from gold for the time being and allow its exchange value to be determined solely by the factors of international supply and demand.

Such a movement of capital funds away from a country is known

as a "flight" of capital, and its effects on the exchange are severe in the extreme.

The national budget is another index to national finances which is closely scrutinized abroad. Evidence that a country is regulating its expenditure to its income is a "bull" point for the country since it tends towards a reduction in taxation, a lowering of overhead costs of production, and an increase in national savings. On the other hand, where it appears that a country is spending more than the state of its national prosperity justifies, adverse criticism is aroused since it is likely that an increase in taxation will have to be made, causing an increase of overhead costs and a reduction in the capacity for saving of the people. In the first case, speculators in exchange will "go long" of the currency, i.e. buy up currency in anticipation of a rise in its exchange value due to increased prosperity of the country, and in the second case, they will "sell short" of the currency in anticipation of a fall in its international value owing to the reduction of exports, due to high selling prices, and to the general falling-off in national prosperity.

The political outlook in a country is also a potent factor both in exchange speculation and in the international movement of capital. A stable government, the strict maintenance of law and order, the protection of property and of the rights of owners of wealth, will all induce an inflow of foreign capital, either for interest-gaining purposes or for safety, in spite of low interest rates. Political unrest, attempts to overthrow the government either by force or by constitutional methods, the growth of and possible accession to power of a body of political thought inimical to capital, will all induce the withdrawal of capital and prevent any further influx of funds from abroad. In the first case, speculators will be less active than in the second since beneficial effects are slower to mature than are evil effects, but, on the one hand, a steady appreciation in the exchange value of the currency may be looked for over a long term, while, on the other hand, an immediate depreciation in exchange value will take place owing to speculators "selling short" in anticipation of the offerings of the currency which are almost bound to take place through the withdrawals of foreign-owned funds.

Current events and the future outlook in the internal industrial situation of a country will have similar effects. Settled and

amicable conditions between capital and labour, a stable level of wages commensurate with selling prices on the level of world prices, evidence of enterprise and efficiency on the part of those responsible for the direction of industry, will all operate as long term factors in causing an appreciation of the international exchange value of the currency. Foreign capital will be induced to flow into home industries, and a demand for the currency will be manifest on financial, as well as on trade, account. Conversely, labour troubles, strikes and lock-outs, antagonism between capital and labour, too high costs of production, delay in adapting methods of production to new ideas and conditions, etc., will all, particularly the first two, have immediate effects on the exchange value of the currency, as speculators will at once "sell short" in the expectation of a falling-off in the trade of the country owing to diminished production and/or increased production costs.

It can be seen, therefore, that speculation plays a large part in accelerating the effects of economic factors, which would normally be manifest only after the lapse of some time, and that such speculation may operate to prevent the full normal effects of the cause from taking place or may produce effects in excess of the normal. With an almost general return to some sort of gold basis of the currencies of the world, the field for speculation would become more limited, since fluctuations in exchange rates would be confined to within the comparatively narrow margins represented by the rates at which gold could be moved profitably from one country to another, or by "control" operations on the part of the various national authorities. In such circumstances it is probable that long-term factors would be allowed to work themselves out unassisted by speculation, except on the sudden appearance of adverse factors, which will always attract the "bear" speculator.

CHAPTER VI

METHODS OF DISCHARGING INTERNATIONAL INDEBTEDNESS

As regards the greater part of the modern world, gold is the standard and measure of value and the basis of currency and credit. In theory, each one of the innumerable individual debts which arise between nations is capable of being settled by the transfer of gold, in the form of either coin or bullion. The very number and variety of such debts, however, absolutely precludes such a form of discharge in practice; the total amount of gold in the world is not sufficient to permit it to circulate in the necessary quantity, and ships and other forms of conveyance would find that much of their available carrying capacity was needed to carry the gold to pay for the goods carried in the remainder. The expense of settling each transaction by a transfer of gold would also be enormous, and the gold itself would suffer serious loss by abrasion through constant handling and packing.

The many advantages afforded by the use of credit instruments for the settlement of internal debts apply with even greater force to the settlement of international debts, and the development of the use of such instruments for this purpose has been concurrent with the development of international trading and financial relations. At the same time, the special needs of international relations have given rise to special forms of credit instruments but the basic principle remains the same, that the instrument shall be one which conveys a right to wealth in terms of the currency in which it is expressed, and that the names of the parties to it are of sufficient standing to make the instrument acceptable to a creditor in discharge of his debt.

In an example given early in the previous chapter it was shown how one credit instrument could be used to discharge two debts or more, and that creditors in countries with currencies of inferior standing were inclined to draw on their debtors in countries with a currency of a superior standing, while debtors in countries of the former class bought up such rights to wealth and remitted them to their creditors in countries of the latter class.

Banks Act as Clearing Houses for Debts.

The difficulties in the way of every debtor who has to find a local creditor who has drawn on a debtor in a country to which the local debtor wishes to remit, and for the exact amount which is required to be remitted, are obvious. Consequently, while it is true that the status of the currencies of a debtor and a creditor decides largely whether the creditor shall draw or the debtor remit, there must be some central pool into which drawings on other centres can be sold and out of which remittances required can be purchased.

The banks and financial houses dealing in exchange are the natural channels through which debts can be bought and sold and, in the same way as debts due internally can be sold to a bank or money dealer by discounting a bill, rights to wealth in terms of other currencies can also be sold to such concerns at the prevailing rates for the class of credit instruments concerned. Similarly, debtors can purchase from exchange dealers credit instruments in terms of other currencies to suit their requirements, so that creditors and debtors alike are saved the trouble of selling and buying to and from each other after many difficulties. The small toll levied by the exchange dealer in the shape of a difference in the prices at which he buys and sells the same class of instrument is negligible in comparison with the cost of the trouble saved to the individual, and this business of the buying and selling of international debts constitutes one of the most valuable international services rendered by the banks of to-day.

In order to conduct such a business, banks must maintain relations and keep current accounts with other banks in all the principal centres of the world. These accounts are fed by the remittance abroad for collection and credit of all the various credit instruments payable in a given country which have been bought up by the bank from its local customers. Arrangements are also made for overdrafts to be created in case of need or for other credit facilities to be granted, such as acceptance credits. Out of the supply of funds in a foreign centre thus acquired, the bank is able to meet the requirements of those of its customers who wish to buy the right to an amount of the foreign currency in question, and it will draw on its account abroad in any form desired by the customer. It is not often, therefore, that trade credit instruments pass through more than two hands, the drawer and the bank who negotiates, or

purchases, the instrument. Even if the owner of an instrument does not wish to sell it immediately to a bank, he will utilize the organization of the bank to have his debt collected in the foreign centre and the proceeds remitted home to him, less costs of collection. If the instrument is expressed in terms of the foreign currency, the collecting bank will have the proceeds credited to its account in the foreign centre and will exchange them into local currency, i.e. will buy the foreign currency in exchange for local currency at its ruling rate of exchange from its customer if he wishes.

The collection and the payment of debts and the exchanging of currencies, one for another, is, therefore, almost exclusively a banking function so that it can truly be said that modern banks, with their international relations and ramifications, act as clearing houses for the world's debts.

Principal Credit Instruments.

There are many forms of instruments conveying rights to wealth, but, for the purposes of international finance and exchange, they can be classified under a few main heads. Each form varies from another chiefly in the speed with which the right to wealth which it expresses can be turned into cash, and its price, or "present value", varies with the loss of interest and risk of capital loss which must be borne by the purchaser or owner. The different rates of exchange which are consequently applied to different classes of credit instruments are discussed in a later chapter, but brief references are made to this point in the definitions which follow.

Telegraphic, or Cable, Transfers. (T.T.s.)

A T.T. is an order for the payment of money sent by telegraph or cable. Its use has become much greater since the War, and it is obviously by far the quickest method of transferring money from one centre to another. The ability to execute such transfers must depend on the availability of funds in the other centre, and as only the banks and a few very large industrial concerns maintain current accounts abroad, their use is mainly confined to such institutions. Further, as no signature in writing, which could be compared with a specimen signature of the sender, can be included in the telegraphed instructions, a system of private codes by means of which the genuineness of the instructions can be tested and authenticated is

essential, and such a system can only be worked between concerns having close relations with each other. As, by arrangement, funds are paid out in the foreign centre usually on the same day that payment is made in the home centre in local currency, there is no gain or loss of interest. Also, as the use of such instruments is almost exclusive to institutions of the highest class, the risk of non-payment is negligible. T.T.s, therefore, form the safest and quickest mode of transfer of funds, and the principal means by which bankers' funds are moved from place to place for short-term investment and of making transfers of large amounts, on either financial or trade account. As there is no loss of interest, no risk, no stamp duties, and the charge made in the rate at which they are sold by the selling bank is comparatively small, they constitute the best value for money in the eyes of a purchaser who requires funds in another centre immediately, but because of these advantages, their price, or the rate of exchange which they command, is the dearest of any form of credit remittance. Finally, as every other class of credit instrument only commands a lower price, i.e. a worse rate of exchange for the seller, owing to a certain loss of interest or greater risk to the buyer, cost of stamp duties or other expenses, etc., *the price of T.T.s may be considered the basic rate of exchange between the two countries concerned, as at any given moment.* Variations in rates of interest, or in local conditions affecting the safety of a remittance, may cause fluctuations in the price of other forms of remittance while leaving the price of T.T.s unchanged, but any variations in the price of T.T.s will usually be reflected at once by changes in the prices of other forms of instrument, unless other factors, such as interest rates, move in the opposite way at the same time. A later consideration of the Dominion rates of exchange will show clearly that the T.T. rate of exchange is the basic rate on which all other rates of exchange are built up.

Mail Transfers. (M.T.s.)

A Mail Transfer is an order to pay sent by letter from principal to agent. It may be an order for an actual payment of cash to a third party, or for a credit to be passed to the account of the payee in the books of the agent. A current account between the signer and addressee is necessary, and such transfers perform all the functions of a cheque in effecting payment or transfer of funds but

are not negotiable or transferable, need no stamp, and eliminate the risk of a cheque or draft coming into wrong hands. They also save the purchaser the trouble of endorsing and forwarding on a cheque or draft, as the instructions for the payment or credit of the funds are given in writing to the selling bank and passed on in its letter to the agent in the foreign centre. The purchaser pays cash for the instrument on ordering it, but the selling bank is not debited for the payment by its agent abroad until the letter arrives. This results in a loss of interest to the purchaser, since he or his creditor will not have the use of the funds transferred until the arrival of the instructions in the other centre, and a gain in interest to the selling bank, since it receives payment here before it is debited abroad. This difference in interest value is made up by an allowance in the price at which the instrument is sold, i.e. it is cheaper to buy than a T.T. to the extent of the interest due, and a correspondingly larger number of foreign units per pound are given, or fewer pence per foreign unit demanded, than for a T.T. These instruments, again, are almost exclusively used by banks and the international type of merchant firm and, in such cases, the risk which attaches to them is negligible.

Guaranteed Mail Transfers. (G.M.T.s.)

The interest due in respect of an ordinary Mail Transfer obviously depends on the time taken in the transit of instructions from one centre to the other. In the case of centres some distance apart, the estimated date of arrival of the instructions in the foreign centre may not prove to be the actual date of arrival owing to the early or late arrival of the vessel carrying the mail. In such cases, an early arrival means an unexpected gain in interest to the purchaser or his nominee, since the funds are paid over sooner than was expected, and a corresponding loss to the selling bank, since allowance was made in the selling price for interest up to the estimated date of arrival on the assumption that the account with the agent would not be debited until that date, while the use of the funds in the home currency would be enjoyed in the meantime.

In order to obviate any such unexpected gains or losses of interest and to render dates of payment independent of the possible availability of a mail-carrying vessel, the practice has grown up of dealing in a special type of transfer known as a *Guaranteed Mail Transfer*.

This instrument is sold with an undertaking by the seller that the funds in question shall be paid over in the foreign centre on a fixed date, irrespective of the arrival of any mail, and the title arises from the fact that the date of payment is so fixed or "guaranteed." There is no additional security in the instrument itself as, in any event, where a bank accepts money to be transferred elsewhere, it must accept a certain responsibility for the eventual arrival of the funds in the other centre or for the return of the equivalent to the purchaser. A few banks in London, however, have professed to see in such instruments an additional liability for damages on the part of the selling bank in the event of anything preventing the eventual payment, and refuse to issue instruments requiring the inclusion of the word "guaranteed." In the great majority of cases, however, G.M.T.s are freely issued and taken, and they are now internationally recognized. Their great advantage is that they enable the interest margin between the ordinary T.T. date and the stated date of payment to be exactly calculated and a true price arrived at which is fair to both parties. In order to ensure that the instructions shall actually arrive by the fixed date, the seller does not trust to the ordinary mails but sends his instructions by "deferred" cable, i.e. a telegram sent by the cable company during slack hours and which may take a day to arrive, instead of a few minutes, but which can be relied on to arrive well in advance of the desired time. These again are mainly banking instruments, and they are largely used by professional dealers to employ, on an interest basis, funds which they may have available for short periods, say four to fourteen days, and which they can thus invest for an exact number of days irrespective of the presence or absence of a mail to the other centre.

Bills, Demand Drafts, Cheques, and Bankers' Drafts.

Though the volume of financial business now overshadows the balance of international indebtedness arising out of trade, and banking instruments of remittance are the most important from the point of view of the total amounts involved, yet the *number* of ordinary credit instruments used in the discharge of debts between nations is probably larger, though they may reach a smaller total amount. In the same way that the bill of exchange, sight draft, cheque, or banker's payment is used for the settlement of internal

debts, so such instruments may be used internationally, except that the liability of small firms or of individuals is less readily accepted by creditors.

Bills of exchange, as used internationally, may be divided into bank bills and trade bills and sub-divided again into long and short bills. It has already been shown how the greater security afforded by a bank bill causes it to command a better price (i.e. more advantageous to a seller) than that of a trade bill, and bank bills are much more used for the settlement of international debts than for internal purposes. Bank bills may arise out of financial operations or from bank credits opened in respect of commercial transactions. Trade bills are, of course, those drawn by one merchant firm or individual upon another, and do not usually appear in any discount market but are held and collected by the bank which purchases them from the owners in the first instance.

The tenor of a bill will depend upon the arrangement between the drawer and the drawee. Where new relations in trade are being opened up, it is usual for the seller to ask the buyer to arrange for payment by means of a bank credit, under which the seller will draw on a bank and will eventually obtain a bank acceptance which he can discount at the finest rate. This process involves the buyer in some expense and, as soon as relations between the two have become well established, he will ask the seller to draw on him direct and so save the cost of a bank credit. The seller will probably agree to draw sight drafts on the buyer, to which the shipping documents covering the relative goods will be attached and which will be handed over to the drawee by the collecting bank against payment of the draft.

The next stage may be that the seller allows a short term of credit to the buyer by sending him direct the documents covering the goods and trusting him to send an approved banker's draft in payment at once. This may be followed by the seller agreeing to accept the buyer's cheque in payment, to be forwarded by the buyer on the arrival of the documents. Eventually, the seller will have attained such confidence in the buyer that he will extend the period of credit allowed and draw at 30, 60, 90, 120, or more days after sight or date, and allow the buyer to obtain possession of the relative documents on his acceptance of such drafts.

Short bills are those drawn for periods not exceeding 30 days

after date or sight, or which have not more than this period to run before maturity, while long bills are those which have a tenor or an unexpired period of currency of more than 30 days.

Securities and Coupons.

References have been made in the previous chapter to the way in which issues of capital are tending steadily to become international in character, and to the fact that many stocks and shares can be dealt in on all the principal stock exchanges of the world. As a result, it is always possible for large dealers in exchange to feed their accounts abroad, or to utilize their foreign balances, respectively, by purchasing international securities in the home market and sending them abroad for sale and credit of proceeds, or buying them abroad with their foreign funds and having them sent home and sold there for the home currency, providing always that in each case the price of the security in the two markets, combined with the prevailing rates of exchange, and allowing for the heavy expenses involved, shows an eventual "outturn" of at least the same amount of foreign or home currency as could have been obtained by using the available funds in the purchase of any other form of remittance. Such operations, however, are handled by specialists in the offices of foreign banks, financial houses, and large stock-brokers, and are not usually undertaken by any of the leading British banks.

Similarly, the coupons for the payment of interest on many international securities are expressed as payable in any one of several centres at the option of the holder, at fixed rates of exchange. Exchange dealers are always ready to buy up any such coupons and they will then remit them for collection to the centre showing the greatest margin of profit over the fixed rates at which the coupons are expressed to be payable. For example, a coupon may be expressed as encashable for £1 in London, or for \$4.8665 in New York, or for \$4.8665 in Montreal. If the prevailing rates of exchange in London are \$4.85½ on New York, and \$4.86½ on Montreal, the holder of a coupon can obtain only £1 by cashing it in London, £1 plus over ½ cent by cashing it in Montreal, and £1 plus over ⅞ cent by cashing it in New York (less costs of collection in the two latter cases), if he takes payment at the fixed rate in Canadian or American dollars and converts the proceeds into sterling.

Exchange dealers can carry out such encashments in bulk to better advantage than an ordinary holder, and a large business is done in the purchase of such coupons. The rate of exchange applied to the purchase of all securities and coupons will vary from the basic T.T. rate by the loss of interest, and the expenses involved in their eventual collection.

Bullion.

As long as the supply of credit instruments relative to the demand is sufficient to maintain the price, or rate of exchange, of the currency of one country in terms of others at about the Mint Par rates, the fluctuating balance of indebtedness is evidently not either heavily in favour of that country or against it. But should any undue disturbance of the equilibrium between supply and demand in that currency take place, the price of credit instruments will move to a point at which it will be cheaper to discharge debts in gold. As the whole of the world's credit structure has been built up on a gold basis, this metal will always be accepted by a creditor in discharge of his debt, and even with the few remaining silver-using countries, the import or export of the white metal will always suffice to adjust any temporary discrepancy between the supply, and demand for, credit instruments.

The remittance of bullion, therefore, is the final method of settling any existing balance of indebtedness between any two countries, and such movements will take place whenever the rates of exchange justify the heavy expense involved, and provided that sufficient supplies of the metal can be respectively bought and sold in the debtor and creditor countries. This expense is so heavy that transfers of bullion are the most costly means of discharging international debts and, owing to the technical points involved and the saving of costs of transport by the remittance of large quantities at a time, these transfers are carried out mainly by banks or financial houses, as a final means of covering other exchange transactions, or, under special circumstances, by governments.

London as a Monetary Centre.

For many years London was supreme amongst the monetary centres of the world, and her position as the world's chief financial centre was due partly to chance and partly to the national

characteristics of her people, as the following summary of the main causes leading to this result shows—

1. From Elizabethan times, this country led the world in trade and industry, and our people possessed a genius for colonization. Wherever our ships and merchants traded, the pound sterling became in demand for the purpose of payment, and our colonists carried with them our monetary system as well as our laws.

2. This spread of our trade made the names of our leading merchants known all over the world, and our national temperament gave our traders and banks a reputation for honesty and fair dealing. This eventually resulted in banks and large merchant firms being asked to lend their names to bills on behalf of lesser-known firms in this and in other countries, and the use of the sterling bill as a means of payment became international.

3. This use of sterling as an international currency was given a great stimulus by the chance which led this country to be the first country in the world to adopt gold as the basis of her currency, and which meant that any debt expressed in sterling was thereby given a definite gold value. The gold basis also meant that the value of sterling in terms of other currencies could vary only within narrow limits, and the pound therefore became a stable currency and measure of value.

4. The establishment and maintenance of a free gold market in London gave the pound even greater prestige. The gold standard of currency meant that any person having the right to receive payment of a debt in sterling could demand payment of his debt in gold. The free gold market meant that, having obtained his gold, he could either sell it in exchange for some other currency or could withdraw the gold from the country if he wished. Similarly, a debtor whose debt was expressed in sterling could settle it, in case of need, by remitting gold to this country, and the quantity which he must remit was fixed by the gold basis of the pound, while the free gold market permitted the free import and disposal of such gold. Other countries adopted a gold standard of currency but did not permit free dealing in gold. They maintained a "one-way" gold market, which meant that while the responsible authority was usually ready to buy any gold offered to it at a price which might or might not be fixed, it would sell gold for export only when it felt inclined to do so, and usually possessed the legal right to encash notes in some other

medium than gold if it so wished. For example, the Bank of France for many years possessed the right to encash its notes in either gold or silver at its option, so that a foreign creditor could never be sure of receiving a stable measure of value in exchange for his debt.

5. Our leading position in the world's trade, together with our lead in shipping and insurance, made us the world's creditor, on balance, for year after year for many years. This excess of trading income over expenditure gave us an ability to lend money to other countries, and such loans had the double effect of increasing our trade, as the proceeds of a loan were usually withdrawn ultimately in the shape of goods or services and rarely by gold, and of increasing our annual income from abroad by the amount of interest due to us and repayments of some of the capital lent.

6. The growth of the use of the sterling bill for trading purposes and the necessity of setting up machinery for dealing with the issue and handling of foreign loans, led to the gradual building up of the organization now known as the Money and Discount Market and to the development of the Stock Exchange as a capital market. Here, again, the level-headedness of our banks and merchants soon made these markets the most efficient in the world, and even to-day no other centre possesses such a highly-organized, sound, and active money and discount market as exists in London. During the War, and until the re-establishment of the gold standard, the sterling bill suffered a temporary loss of prestige and strenuous efforts were made by Amsterdam and New York to secure pride of place as the world's financial centre, with the consequent profits, but while the dollar bill, in particular, attained some measure of popularity as an international currency for the time being, the lack of the necessary specialized organization in either centre and a certain unsuitability of temperament for such business, prevented both the dollar and the florin from becoming an international currency to the same extent as sterling had formerly been. Since the return of this country to a gold standard and a free gold market in 1925, the use of the sterling bill has again become universal amongst the nations outside Europe, and our old habit, as traders, of buying and selling in terms of sterling rather than in terms of the currency of our customers is re-asserting itself.

7. Finally, the geographical situation of this country between the

Old World and the New, our freedom, both as individuals and as a nation, the absence of any serious political upheavals, the ability of our captains of industry and finance, the quality of the work of our artisans, and our well-balanced, placid, national temperament, have all aided in gaining for us the confidence of other nations and a reputation for soundness and fair play.

CHAPTER VII

THE THEORY AND WORKING OF THE GOLD POINTS

REFERENCE has several times been made to the fact that, since gold is now so generally accepted as a measure of value, international as well as domestic debts can be discharged by a transfer of gold coin or bullion from the debtor to the creditor. It has also been stated that the Mint Par between two gold standard countries is the value of the pure gold contained in one unit expressed as the number of the other units which would contain the same amount of pure gold. In a country in which gold coins circulate freely, a debtor may effect payment by means of a credit instrument, bank notes, or gold coins and, since either of the former methods of payment can be instantly converted into gold, the creditor is prepared to accept any of these forms of payment indiscriminately. The debtor incurs no additional expense in the use of any one of these methods, and the creditor loses no more interest in respect of one method than of another. Even where debtor and creditor reside in different centres, the changing of a draft or note into gold is accomplished immediately on receipt, and credit instruments and gold become interchangeable as long as the debtor has a right to draw his draft.

The ability to effect payment in gold in another centre by means of a credit instrument, however, must depend upon whether the drawer has the right to funds which will enable the drawee to carry out his instructions. In a domestic banking system, the right to withdraw gold from a certain branch of one bank can be transferred immediately into a right to withdraw gold from another branch of the same bank, or even of another bank, and the adjustment of the gold holdings of the respective branches can be carried out by internal book-keeping or, in case of need, by remittances to and from the main stock at the Head Office, at the bank's expense.

International adjustments are not by any means so easily made, as the various domestic circles of banks existing in each country can adjust their internal affairs through their Central Bank, but no

system is yet working whereby international adjustments of gold holdings could be made in a similar fashion.

The Bank for International Settlements contains the germ of this possibility, and if the Central Banks of the principal countries of the world would deposit a reasonable proportion of their gold stocks with the B.I.S., it would enable this institution to debit and credit such banks with actual gold as and when the temporary state of international indebtedness demanded such transfers. Up to the present time, the deep rooted idea that a large gold holding is essential to the maintenance of national credit, and that "a bar of gold in the vaults is worth two in the B.I.S." in case of war or other emergency, has prevented any definite steps being taken towards this end.

Limits to the Exchange Price of Credit Instruments.

It has already been shown how the rate of exchange which the various forms of credit instruments will command varies with the speed at which they can be encashed after purchase, i.e. with the loss of interest to the purchaser, and with any necessary costs of collection and expenses of remittance, in addition to the varying status of the parties to the instrument. If in all countries full-weight gold coins circulated freely, and if the right to gold coins in one centre could be *immediately* transformed into the right to gold coins in another centre, the rates of exchange would never vary from the Mint Pars. In other words, if the supply of and demand for Telegraphic Transfers between two gold using countries were always evenly balanced, the exchange between those two centres would always be at the Mint Par. But it has been shown how many and varied are the influences affecting the relation between the demand for and supply of debts between nations, and the exchange dealers can sell rights to wealth in terms of other currencies only as long as they have at their disposal a balance in the other centre built up from the proceeds of debts due there which they have purchased, or credit facilities which enable them to draw even though their balances are exhausted. Similarly, they can only continue to buy up debts payable in other centres as long as there is a demand for remittances with which to pay debts due in those centres. The exchange price of other forms of credit instruments will always vary from the basic price of a T.T. to the extent of the loss of interest and

expense involved, while the basic price of the T.T. itself will vary with the demand for and supply of remittances between any two centres. As the basis of all credit instruments is gold, it follows that any serious discrepancy between the demand for and supply of such instruments can be adjusted by transferring gold to the centre whose currency is more in demand. But, as gold transfers must actually be made in fact and not by means of book entries, heavy expenses are incurred in making such transfers. These expenses are heavier than those involved by the use of any form of credit instrument, and the exchange price of credit remittances on one country can rise in a debtor country until the point is reached at which, for a given outlay in home currency, a debtor will obtain as much foreign currency by purchasing and paying all the expenses of shipping gold as he would by paying the market price for credit remittances, or when a creditor could obtain the same amount of home currency by the operation of withdrawing gold from the debtor country as he would by selling his draft on his debtor at the market price.

Definition of Gold Points.

These points in rates of exchange between two gold using countries are known as *Gold Points* or *Specie Points*, and they represent *the exchange prices at which it is as cheap to use gold in discharge of international debts as to use any form of credit instrument.* To take a simple example, the Australian sovereign and the English sovereign each contain the same amount of pure gold, and the two coins were interchangeable for monetary purposes. In the ordinary way, debts between the two countries are settled by means of credit instruments, but if, for instance, there is a temporary adverse balance of payments against Australia, the demand for remittances on London will steadily exceed the supply, the available balances of exchange dealers will become exhausted, even though they raise the prices at which they will sell remittances on London (to discourage buyers), the cost of obtaining credit facilities in London out of which to sell further remittances will make the price rise still higher, and, at last, the market price of a T.T. on London will be so high in terms of Australian pounds that a debtor there would find it as cheap to withdraw Australian sovereigns from his bank, pay all the expenses of transmission and incur the loss of interest on his

money while the gold was in transit, and eventually discharge his debt in London by paying over the gold coins, as to meet his debt by paying the market price in his own currency for a T.T. in sterling. In practice, owing to the saving of costs by making remittances in bulk and the economies effected by expert technical knowledge, shipments of bullion are invariably made by banks and financial houses, or by governments for official purposes. The saving in costs which can be made by a bank in the course of a large bullion shipment enables it to replenish its balances in the other centre by this means and still sell T.T.s to private buyers at a lower cost to such buyers than they could arrive at by shipping small amounts of gold individually.

Gold Points Not Fixed.

While the Mint Par of exchange remain the unalterable basis of comparison between two currencies on the same metallic standard as long as the Coinage Laws of the two countries remain unaltered, there are so many factors which determine the "outturn" (or product in terms of the other currency) of a gold shipment that the points in the rates of exchange at which such shipments become possible and desirable can alter from day to day. Further, the primary essential for transfers of bullion is that its exit from and entry to the two countries should be unhindered by legal or banking restrictions, and that the ability to obtain it in the one country and to sell it in the other should be untrammelled.

Causes of Variations in Gold Points.

Any alteration in any of the factors which determine the "outturn" of a bullion shipment will obviously alter the rate of exchange produced by transferring the metal, i.e. the Gold Point, and these various factors will now be considered in detail.

The Price of Gold.

Where full-weight gold coins circulate freely in the two countries, the rate produced by transferring such coins from one centre to the other (without allowing for the costs of the operation) will be the Mint Par as long as the Central Authority in each centre is compelled to issue and receive any gold coins as representing in currency their value in pure gold *at a fixed price for gold*, or if the two coins

can circulate in either country, as in the case of this country and Australia. As long as the Central Authority must both buy and sell gold, either pure or of a fixed fineness, at the same price and dealings in the metal are unrestricted, a free gold market at the fixed price exists, but dealers will automatically deal with the Central Authority, as no margin of profit exists by dealing outside. This was the case in the U.S.A., where the U.S. Treasury would both buy and sell fine gold at the price of \$20.67183 per ounce, and no outside market in gold existed; under such conditions, dealers can calculate exactly the number of units of currency which they must pay or will receive for gold bought from or sold to the Central Authority.

Where the Central Authority has legally fixed prices, one for buying and one for selling gold, or where it can vary its prices, or can even refuse to buy or sell should it wish to do so, a variable element is introduced into the calculation of the "out-turn" of a shipment. In the case of this country, the Bank of England is still compelled to buy all gold offered to it at the price of 77s. 9d. per *standard* ounce, and, until the suspension of gold payments, was bound to sell gold for export in amounts of not less than 400 oz. at the price of 77s. 10½d. per standard ounce troy. These prices are equivalent to roughly 84s. 9⅓d., and 84s. 11½d. per *fine* ounce, respectively, and there was therefore a margin between which bullionists could endeavour to deal in the outside market without recourse to the Bank of England. A buyer of gold in this country knew that he could always obtain it from the Bank at a price equivalent to 84s. 11½d. per ounce fine, but if he could buy it in the open market at, say, 84s. 10½d. per ounce, the cost of his remittance abroad was obviously less; in other words, to ship the amount of gold needed to produce a given amount of currency in another centre cost him less in his original outlay or, for the same outlay, he could obtain more foreign units eventually. Similarly, a seller of gold here could always sell it to the Bank at a price equivalent to 84s. 9⅓d. per fine ounce, but if he could obtain 84s. 10½d. in the open market he would receive a larger amount of sterling for a given amount of gold which cost him a given sum in another currency. *The price at which gold can be bought and sold in the two centres is therefore a factor of the first importance in arriving at a Gold Point, and the effects of variations in such prices are illustrated in the examples below.*

The Fineness of Gold and Refining Charges.

The next point is the legal fineness of gold in the two countries and, where this differs, whether the Central Authority will accept gold of a different fineness or whether it will require all gold to be brought to its own measure of fineness before purchasing it, in which case, refining charges will be incurred by the prospective seller. This point was well shown in the case of gold shipments from this country to France during 1930. Owing to a very heavy drain of gold, the Bank of England announced that it could no longer oblige purchasers by selling gold in fine bars, but would fall back on its legal right to sell only bars $\frac{1}{2}$ ths fine. The French standard of fineness is $\frac{9}{10}$ ths, but the Bank of France has the right to refuse to buy anything but fine gold or gold $\frac{9}{10}$ ths fine, and it informed the public that it was, at that time, prepared to buy only *fine* gold, so that all gold containing any proportion of alloy (as with bars bought from the Bank of England) would have to be refined before it could be sold to the Bank of France. This meant not only an additional expense to shippers of gold from this country to France on account of the costs of refining, but a further loss of interest during the time taken by the refining process and, as the facilities for refining both in London and in Paris were extremely limited, the refiners became so booked up that the process extended, at times, into as much as three weeks, so that the loss of interest was considerable. It should be noted that, when a gold shipment is being undertaken, no risk of fluctuations in the rate of exchange ruling in the market can be taken, but the currency which will be produced by the gold shipment must be sold as soon as the shipment is arranged. Under normal circumstances, the shipper must pay for his gold in the exporting centre at once, but will receive credit in the other centre only when the gold arrives, and he therefore sells his "outturn" for delivery on the estimated date of arrival of the gold and loses interest on the money locked up at the rate ruling in the exporting centre. In the case of these shipments to France, however, the chief object of making them was to obtain francs in Paris as quickly as possible to cover sales of francs which had been made at very high prices, i.e. few francs to the pound, owing to very pressing demands for immediate funds in Paris. These immediate demands could be met only by creating temporary overdrafts in Paris and covering these by the eventual "outturn"

of the gold shipments on arrival. Interest was therefore lost at the French overdraft rate which, owing to the unusual pressure for accommodation, was much higher than that in London. As a result, fine gold in the open market commanded a premium equal to the loss of interest plus the refining charges, since by buying gold $\frac{1}{2}$ ths fine from the Bank, even at a price equal to 84s. 11 $\frac{1}{2}$ d. per fine ounce, the buyer incurred costs which acted as an increase in price, and he would rather pay this increased price in the open market if, by doing so, he could save the trouble and delay of refining the standard gold. Consequently, when the charges and loss of interest equalled 1 $\frac{1}{2}$ d. per ounce, fine gold in the open market could be sold at 85s. 1d. per ounce, and when the refining charges were raised by the refiners (to take advantage of the opportunity of extra profit), and the delay in refining became still greater, the total extra cost equalled 2 $\frac{1}{2}$ d. per ounce, and fine gold in the open market was sold at 85s. 2d. per ounce. Gold shipments under these conditions became a matter of some hazard, and the exact Gold Point was almost impossible of calculation in advance. Normally, however, such hindrances either do not exist or are such that their cost and effects can be exactly calculated and allowed for.

In many instances, the receiving Central Authority will require the gold offered to it for sale to be accompanied by an Assay Certificate or will require to take assays of the consignment itself. In such cases, the *cost of assaying* must be allowed for by the shipper and a small additional loss of interest on the value of the bars reserved for assay and for which credit is not given until after the assay has been completed. Thus, the U.S. Mint will give immediate credit for about 97 per cent of a consignment of gold sold to it, but will only give credit for the remaining 3 per cent about three weeks or a month later, after the assay tests have been completed.

Freight, or Cost of Carriage.

This represents the actual cost of transporting the gold. Usually, a "through" rate of freight is obtained from the terminus in one centre to that in the other, to include carriage by rail, and/or air, and/or sea, with transshipment from one form of conveyance to another as required. The rate quoted will generally be lower for large than for small shipments and is charged on the declared value,

as the space occupied by a consignment of gold is quite out of proportion to its value. The market rates will vary with the competition between the various forms of transport and between different companies engaged in the same form.

Insurance.

This is the cost of the premiums which must be paid to cover the risks attaching to the movement of gold. Every possible risk is usually included in the policy of insurance, and the rate of premium will vary with the strength of competition between insurance companies, though a large consignment on one vessel or aeroplane will usually result in a higher average rate of premium being charged as the leading underwriters will not accept more than a certain share of risk in such a shipment except under the payment of a higher rate of premium for the last part of the total cover. Thus, where a shipment of £500,000 has to be insured, the first £250,000 of the risk on one vessel may be covered at the rate of, say, 1s. per cent, the next £100,000 at 1s. 6d. per cent, the next £100,000 at 2s. per cent, and the last £50,000 at 2s. 6d. per cent.

Loss of Interest.

This item, as already explained, represents the cost to the shipper of the funds locked up during the time the gold is in transit, as cash must be paid to obtain the gold, and the proceeds are available only after it has been moved to the other centre and accepted by the purchasing authority. This cost will vary with the prevailing rates of interest (the financing will be carried out either by using funds in the exporting centre or by overdrawing temporarily in the importing centre, whichever is the cheaper), and with the time taken in transit. In this latter connection, the Gold Point between two centres will vary from day to day where the ability to move gold depends upon whether or not a fast steamer is available, e.g. the movement of gold from London to New York can obviously be carried out more cheaply if, other factors remaining unaltered, shipment can be made by a vessel which can make the voyage in under six days, rather than by a slower vessel which may take eight or nine days. Further, where no boat is sailing for two or three days, the loss of interest would be increased if gold were purchased at once and held up until shipment.

Brokerage.

This item occurs only in London as a recognized charge as no other open gold market exists in which specialized bullion brokers work. Where gold is purchased in the open market, a bid can only be entered through a broker, and a commission of as high as $\frac{1}{4}$ per cent may be levied on small amounts bought for private parties, but for amounts of, say, £100,000 dealt in on behalf of regular market operators the charge may be as little as $\frac{1}{4}$ per mille. In cases where a shipper taking gold from the Central Authority has no facilities or labour available for the packing and handling of the gold, a firm of bullion merchants in any centre will undertake this service at a charge which can be agreed upon beforehand.

Packing and Handling, Boxing, and Agency Charges.

As stated above, gold taken from a Central Authority in the form of coin or bars must be carefully packed in stout wooden boxes or kegs, loaded into vans and carted to the terminus from which it is to be dispatched. On arrival at the other end, an agent of the shipper must take charge of it, have it unloaded from the train, vessel, or aeroplane, loaded into vans, and delivered to the purchasing authority. All these services must be allowed for in the cost of the shipment (even the boxes cost 5s. each), but they can be exactly ascertained in advance and form but a very small proportion of the total.

Calculation of Gold Points.

For theoretical purposes, Gold Points are usually calculated by making allowance for the percentage of each form of expense on the rate of exchange produced by buying bar gold in one centre and selling it in the other, or, where no variation between buying and selling prices exists in each centre, the Mint Par rate can be used. For exact calculation, however, it is necessary to compile a *pro forma* invoice by working out the precise total cost and eventual "outturn" of a stated quantity of gold. The following examples illustrate both the approximate and the exact methods of calculation.

(a) Gold purchased from the Bank of England at 77s. 10½d. per standard ounce and sold to the U.S. Mint at \$20·67183 per fine ounce, yields a gross "outturn" of \$4·8665 per £1 (or the Mint Par).

From the equivalent rate thus obtained must be *deducted* the costs of the shipment, as the expenses reduce the eventual number of dollars obtained for each pound used by increasing the number of pounds required to produce a given number of dollars.

The net rate, or *Outgoing Gold Point* from London to New York is therefore obtained thus—

Gross "outturn" per £		\$4.8665
Less, Freight at 3s. %	\$·0073	
Insurance at 1s. %	·00243	
Packing, cartage, and agency in New York at $\frac{1}{4}$ °/∞	001216	
Melting and assaying charges in New York at $\frac{1}{4}$ °/∞	·001216	
¹ Interest on 97% of shipment for 8 days at 3% p.a.	·00315	
¹ Interest on balance of 3% for 30 days at 3% p.a.	·0002	
	<hr/>	·015512
(Interest taken on New York terms of 1 year of 360 days)		<hr/> <u>\$4.850988</u>

The eventual yield of such a shipment is therefore—

$$£1 = \$4.850988 \text{ (or } \$4.85\frac{1}{2} \text{ nearest),}$$

and if the market price of T.T.s is such that *fewer* dollars are offered per pound than this figure, dealers will cover their requirements in New York by shipping gold from London rather than pay the price asked for credit remittances.

(b) To show the variable nature of Gold Points, if interest rates rise until money is worth 6 per cent per annum, and the other factors remain unchanged, the Gold Point will be altered thus—

Gross "outturn" per £		\$4.8665
Less, Charges as above, but with interest calculated at 6% p.a.		·018862
		<hr/> <u>\$4.847638</u>

The Outgoing Gold Point from London to New York then becomes—

$$£1 = \$4.847638 \text{ (or } \$4.84\frac{3}{4} \text{ nearest),}$$

and the number of dollars offered per pound in the market in the shape of credit remittances must fall below this figure to make gold shipments from London to New York profitable.

(c) But if gold can be purchased in the open market more

¹ See p. 113.

cheaply than from the Bank of England, the Gold Point again undergoes an alteration, if the costs of shipment remain unchanged. If gold can be purchased in the open market at a price of 84s. 10½d. per fine ounce and sold to the U.S. Mint at \$20·67183 per fine ounce, the gross "outturn" produces an equivalent rate of \$4·87112 per £1. This means that the eventual net "outturn" yields a greater number of dollars per £1, thus—

Gross "outturn" per £	\$4·87112
Less, Charges as above, worked on the new "outturn"	·015627
	\$4·855493

and the Outgoing Gold Point from London to New York is then—

$$£1 = \$4·855493 \text{ (or } \$4·85\frac{3}{8}\frac{5}{4} \text{ nearest).}$$

This should make clear the interdependence of the market price of gold and the rates of exchange between this country and others. The more nearly that any gold rate of exchange approaches the point at which gold could be purchased from the Bank and shipped abroad with profit, the higher will be the price which gold offered for sale in the open market will command, owing to competition between shippers. When exchange rates are well away from the Outgoing Gold Points, competition between buyers in the open market is correspondingly lacking, and the gold may eventually have to be sold to the Bank at its statutory buying price through lack of outside buyers.

Conversely, if certain exchanges stand at such levels as to induce an open market price for gold above the Bank's buying price, imports of gold may be attracted from other centres on which the rate of exchange has nearly reached the point at which it would be profitable to ship gold to London for sale to the Bank, rather than to give the number of foreign units demanded for each pound by the market price of credit remittances.

(d) The importance of this may be shown by the following examples of gold *imports* into this country.

Gold purchased from the U.S. Mint at \$20·67183 per fine ounce and sold to the Bank of England at 77s. 9d. per standard ounce yields a gross "outturn" of £1 for each \$4·87438 expended.

The costs of shipment, however, increase the number of dollars required to produce (or "lay down") a pound in London and so must be *added* to this figure.

The *Incoming Gold Point* from New York to London is therefore—

Initial cost in dollars per £	.	.	.	.	.	\$4.87438
Add, Usual charges, say, at 3 ^o / ₁₀₀ , total	.	.	.	.	.	.014623
						<u>\$4.889003</u>

If, therefore, the market price of credit remittances on London in terms of dollars rises over \$4.889003 (or \$4.88 $\frac{2}{3}$ nearest), gold will be the cheaper form of discharging debts due from America to this country.

(e) Should it be possible to sell gold in the open market at a better price per fine ounce than the equivalent of the Bank's statutory buying price per standard ounce, and the other factors remain unchanged, the Gold Point will be amended accordingly. If gold purchased from the U.S. Mint at \$20.67183 per fine ounce could be sold in the open market in London at 84s. 10 $\frac{1}{2}$ d. per fine ounce, for example, the Incoming Gold Point from New York to London would then be—

Initial cost in dollars per £	.	.	.	.	.	\$4.87112
Add, Usual charges, say, at 3 ^o / ₁₀₀	.	.	.	.	.	.014613
						<u>\$4.885733</u>

Gold would then be the cheapest method of discharging debts from America to this country should the market price of credit remittances on London in terms of dollars rise above \$4.885733 (or \$4.88 $\frac{3}{4}$ nearest) per £1.

Incoming and Outgoing Gold Points.

It can now be appreciated that there are two points in every rate of exchange between two gold standard countries at which gold tends to move from one to the other. As between this country and other gold standard countries, *the point in our rates of exchange at which gold tends to flow into this country is known as the Incoming Gold Point, while the point at which it tends to be exported by us is known as the Outgoing Gold Point* of the rate of exchange concerned. Many conditions operate to prevent both these points from being effective in many cases, as several countries are always ready to receive gold but endeavour to place obstacles in the way of gold leaving their borders. Owing to our constant endeavour to preserve a free gold market and to place no hindrances in the way

of the entirely free movement of bullion, both into and out of this country, it may be said that our Outgoing Gold Points were always operative, i.e. we were always liable to lose gold should the value of the pound cheapen to the necessary extent, but that our Incoming Gold Points were only partially operative, dependent on the willingness of the other centre concerned to allow gold to leave the country in terms of whose currency the pound had appreciated to the extent necessary to make gold shipments to us a profitable undertaking.

The exact working of the net "outturn" of a gold shipment is shown in the following *pro forma* invoices, as well as the precise equivalent rate of exchange which would be produced by such shipments—

(f) PRO FORMA INVOICE	
FOR THE SHIPMENT OF 100,000 OZ. FINE GOLD FROM PARIS TO LONDON	
Bank of France sells fine gold at 16,963.528 fcs. per kilo.	
100,000 oz. equals 3,110.35 kilos.	
3,110.35 kilos at 16,963.528 fcs. per kilo cost	Fcs. 52,762,509.30
Add, Cost of Freight at 1s. % ($\frac{1}{2}\%$ / 100)	26,350.00
Insurance at 6d. % ($\frac{1}{4}\%$ / 100)	13,175.00
Interest for 2 days at 3% p.a.	8,793.75
Packing, carting and agency charges.	2,081.95
Total cost	Fcs. 52,812,910.00
100,000 fine oz. sold to the Bank of England at 77s. 9d.	
per standard oz. yields	£424,090 18s. 2d.

Equivalent rate of exchange produced is

$$\frac{52812910}{424090909} = 124.5324$$

Therefore the Incoming Gold Point from France to this country under the above conditions is 124.53 $\frac{1}{4}$ fcs. to £1.

If the gold could be sold in the open market at 84s. 10 $\frac{1}{2}$ d. per fine ounce, the equivalent rate would be found to be 124.47 fcs. per £1, and if it could be sold as high as 84s. 11d. per fine ounce, the equivalent rate would be only 124.40 fcs. per £1. Thus, the lower the price which can be obtained for the gold by the shipper, the more francs must depreciate in terms of pounds before gold shipments become profitable.

(g) The German Reichsbank pays from Rms. 2,784—to Rms. 2,790—per kilo of fine gold, according to the strength of its desire

to increase its gold holding. It is here assumed that the Reichsbank pays its highest price for the gold offered to it.

PRO FORMA INVOICE

OF A SHIPMENT OF 100,000 OZ. FINE GOLD FROM LONDON TO BERLIN

	<i>£</i>	<i>s. d.</i>
Cost of 100,000 fine oz. bought from the Bank of		
England at 77s. 10½d. per standard oz.	424,772	14 6
<i>Add</i> , Cost of Freight by air at 1s. 6d. %	£320	
Insurance at 6d. %	107	
Interest for 2 days at 3% p.a.	70	
Packing, cartage and agency	26	
	523	- -
	<i>£</i> 425,295	14 6

“Outturn” of 100,000 fine oz. in Berlin.

100,000 oz. equals 3,110.35 kilos.

3,110.35 kilos sold to the Reichsbank at Rms. 2,790

per kilo yields Rms. 8,677,876.50

Less, Reichsbank assay charge of Rms. 6.00

per kilo 18,662.00

Net Return Rms. 8,659,214.50

Equivalent rate produced by the above operation is

$$\frac{8659214.50}{425295.725} = 20.36$$

Therefore the Outgoing Gold Point from London to Berlin under these conditions is £1 equals Rms. 20.36.

If gold can be purchased in the open market at a lower price than the equivalent of the Bank's statutory selling price, the “outturn” (and the equivalent rate produced) will be increased accordingly. Thus, if gold can be purchased in the open market at 84s. 11d. per fine ounce, the equivalent rate will be Rms. 20.37 per £1, and at 84s. 10½d. the equivalent rate will be Rms. 20.38 per £1.

As will be noticed, the foregoing examples are based on pre-1931 figures and so are merely illustrative of principles. When legally fixed prices for gold are everywhere re-established, these principles will still hold good but with new figures.

The arithmetical processes used in arriving at these rates, or for calculating the rate produced by buying gold of a certain fineness in one country at a stated price and selling it in terms of the currency of another country at a stated price for gold of the same or of a different fineness, are set out in Chapter X.

Gold in the Open Market.

As long as there remains one Central Authority, whether Government or State Bank, which is prepared to buy and sell gold at definitely fixed prices, so long will the price of any gold offered for sale elsewhere be determined largely by such fixed prices coupled with the rate of exchange on that country. From 1907 to 1933 the U.S. Mint was under a legal obligation to buy or sell gold in unlimited quantities at the uniform price of \$20·67183 per fine ounce. For some time after the War until the return of this country to a Gold Standard in 1925 the U.S. Mint remained the only source in the world of an unlimited supply of and demand for gold at a fixed price, and the price of gold in the London Bullion Market (which has consistently remained the outstanding market for "free" gold in the world) was based on the sterling-dollar rate of exchange. Any seller of gold knew that he could sell his gold to the U.S. Mint at the statutory price and could then sell the dollars so obtained for any other currency. If, therefore, the dollar exchange stood at \$4 per £, he could obtain a gross outturn of $20·67183 \div 4$, which gives £5·168 nearly, or £5 3s. 4d. per fine ounce. Allowing, say, 1s. per ounce for transmission costs, no seller of gold would accept less than 102s. 4d. for his gold in the London market, while no buyer would pay more than about 104s. 6d., since he could buy dollars and use them to buy gold from the U.S. Mint for shipment to London at this price. If dollars appreciated to \$3 per pound, the price of gold would rise correspondingly to $20·67183 \div 3$, which gives a basic price of about 137s. 10d. per fine ounce. The re-establishment of statutory prices at which the Bank of England bought and sold gold restored the exchange value of the pound as the basis of calculation of market gold prices, but, on the suspension of gold payments here in 1931, it became necessary to revert to the gold prices in France and the U.S.A., coupled with the relative rates of exchange. With two potential gold buyers, the London price had to be based on whichever currency was the *dearer* in terms of pounds, since a sale of gold in the country with the dear currency would produce the greater sum in sterling.

The suspension of gold payments by the U.S.A. in April, 1933, left the Bank of France as the only principal institution with legally fixed buying and selling prices for gold in unlimited quantities. From that date until the end of January, 1934, when an effective

gold-buying price was re-established in the U.S.A., the London gold price was based on the franc exchange and the buying price of the Bank of France. With the re-establishment of a fixed buying price for gold in the U.S.A. on 31st January, 1934, the price of gold in London once more depended on the relative buying prices for gold in France and in the U.S.A., combined with the respective rates of exchange. It being part of the policy of the American Administration to depreciate the value of the dollar, the buying price for gold was fixed eventually at \$35 per fine ounce, until further notice. This price was considerably above the current world level, and as the exchange value of the dollar obstinately refused to fall to a compensating level, adjustments in the London price of gold and in the franc-dollar and franc-sterling exchanges had to take place, accompanied by very heavy gold shipments from Europe to America.

The history of the struggle by France to avoid a second devaluation of her currency is dealt with in a later chapter, and it is sufficient to say here that the flight of capital from that country to London and New York, in spite of the efforts made to check it and the operations of the Exchange Control Funds, eventually forced France to suspend gold payments as from 26th September, 1936, and subsequently to fix a new gold content for the franc and variable official prices for the buying and selling of gold.

At the time of writing, although the free gold market in London has functioned without interruption, the various Exchange Control Funds are operating in the exchange markets of the world as occasion arises and are covering such dealings by gold payments between themselves. A temporary arrangement has been made between this country, the U.S.A., France, Belgium, Holland, and Switzerland that, pending the eventual establishment of definite prices in each country at which the Central Authority is prepared to buy and sell gold in unlimited quantities, all dealings by any one of these countries in the currencies of the others on any one day shall be held covered by an equivalent amount of gold valued at the price current on that day. Whether such gold is actually moved from one centre to another or is merely "earmarked" by the debtor in favour of the creditor country is not apparent but the effect is that the various funds are, for the time being, performing the functions of the Central Bank in relation to purchases and sales of gold and that exchange rates between these countries can be held stable by

such official gold operations or can be allowed to fluctuate in response to a world trend if the authorities think fit.

Under former conditions, the Bank of France had a legal margin between its buying and selling prices for gold and was also allowed to charge up to Fcs. 40 per kilo fine, when buying, to cover costs of melting and assaying. These prices per kilo fine were Fcs. 16963·528 for selling and Fcs. 16941·306 for buying, the latter price being subject to a deduction of Fcs. 22·222 (as fixed at that time by the Bank of France), for the costs of melting and assaying. As 31·1035 grammes equal 1 ounce, a "constant" can be obtained to show these prices as francs per fine ounce. The "selling constant" was

$$16963\cdot528 \times 31\cdot1035 \div 1000$$

which gives Fcs. 527·625 per fine ounce

while the "buying constant" was

$$16919\cdot084 \times 31\cdot1035 \div 1000$$

which gives Fcs. 526·2424 per fine ounce.

When new figures are legally fixed at which the Bank of France is to buy and sell gold in unlimited quantities, similar constants can be readily found by the same method.

As soon as such prices are generally established, the price of gold and the rates of exchange will once more become mutually interdependent and import and export Gold Points for the countries concerned will be possible of calculation. In the meantime, the legally fixed price ruling in the U.S.A. is the basis for the world price of gold and the exchange rates of the principal countries of the world. As was explained earlier in this chapter, the price of gold in the London Bullion Market is controlled by the price at which a buyer could buy, or a seller could sell, elsewhere, having regard to the rates of exchange prevailing at the time. For example, the costs of moving gold from London and selling it in New York may be taken as approximately five-eighths of one per cent (as set out below), to which must be added the charge of one-eighth of one per cent if the gold has to be purchased through a broker, making a total charge of $\frac{3}{4}$ per cent on the amount involved. This is equivalent to roughly 1s. per fine ounce with gold at about 142s. per fine ounce so that a simple division sum and an allowance for this total

cost will establish the arbitrated price for gold in London, thus—

T.T. rate, London on New York, \$4.88 $\frac{7}{8}$ - 4.89.

U.S. Mint pays \$35 per fine ounce.

Dollars produced by shipping gold from London to New York and sale to U.S. Mint can be sold in London at \$4.89 per £.

Each ounce of fine gold produces \$35 gross which, at \$4.89 per £, produce £ $\frac{35}{4.89}$ which is £7.15746, or £7 3s. 2d., or 143s. 2d.

From this gross yield must be deducted the total shipping and selling costs of 1s. per ounce so that a seller of gold in London would not accept less than 142s. 2d. per fine ounce, while no buyer would pay more than the total cost involved by buying dollars in London at \$4.88 $\frac{7}{8}$ per £, using these dollars in the purchase of gold from the U.S. Mint at \$35 per ounce and incurring shipping and buying costs of 1s. per ounce, which would make an approximate total cost of 144s. 3d. per fine ounce. Naturally, the quantity of gold which can be dealt in under such conditions depends, in the first place, on the quantity available in or which could be absorbed by the open market at a given price and, in the second place, on the ability of the exchange market to absorb or provide the necessary equivalent amount of foreign exchange. For instance, the offer of a million pounds worth of gold in the Bullion Market could only be taken by a gold and exchange arbitrage operator if the exchange market could absorb roughly five million dollars without changing the rate of exchange.

The following is an illustration of a gold and exchange arbitrage operation, setting out the costs in detail, but neglecting brokerage.

EXAMPLE OF ARBITRAGE IN GOLD AND EXCHANGE BETWEEN
LONDON AND NEW YORK

U.S. Mint both buys and sells gold at \$35 per fine ounce with a charge of $\frac{1}{4}$ per cent in either case.

Assume that the sterling-dollar exchange in London is \$4.88 $\frac{7}{8}$ -4.89 per £ and that gold can be bought in the open market in London at 142s. 3d. per fine ounce.

An operator buys 20,000 fine ounces in the London market, has the consignment shipped to New York and sells dollars thereagainst in the London exchange market.

Then, cost of 20,000 fine ounces at 142s. 3d. is £142,250.

Add costs of shipment, handling and sale—

Freight at 5s. 6d. %	. . . . .	2½	0/00
Insurance at 1s. %	. . . . .	½	”
Interest for 8 days on 97%	}	. . . . .	¼
Interest for 30 days on 3% 1/40%			
Mint Charge of ¼%	. . . . .	2½	”
Cartage at .04c. per 1,000 oz.	}	. . . . .	½
Melting charge \$1 per 1,000 oz.			
Loss on assay, packing and handling cargo			

Total ratio of costs 6½ 0/00

This is approximately ⅙% which, on the above is £889.0625

Total cost is therefore £143,139.0625

20,000 fine ounces sold in New York at \$35 per fine ounce realize \$700,000.

\$700,000 sold in the London market at \$4.89 per £ realize—

$$\frac{70000000}{489} = £143,149.283$$

Or, \$700,000 costing £143,139.0625 gives an equivalent rate of—

$$\frac{7000000000}{1431390625} = $4,890349 \text{ per } £$$

Alternatively, the sterling charges can be added to the sterling cost of the gold and the dollar charges deducted from the out-turn in New York of the consignment. In any event the result will be approximately the same and the profit on the operation will be found to be just over £10 sterling.

Premium on Gold.

The successive shocks to the confidence of owners of capital due to financial crises, stock exchange panics, and, above all, currency depreciation, have led in recent years to a tendency to hoard the only supposed universally acceptable store of wealth—gold. When panic and distrust are at their height, the age-old instinct of self-preservation leads mankind to secrete wealth in some tangible form. The Frenchman sews up bank notes in his mattress. The Scotsman keeps them in his tea caddy in the chimney corner. The African buries his ivory tusks in a secret place in the forest. The up-to-date method is to buy gold bars and lock them away in a safe-deposit. The relative eagerness to hoard is nowadays shown by the premium, or excess of price over the normal, which buyers are prepared to pay over the normal. It was for a time a commonplace to read in the financial columns of the newspapers that “the price of gold to-day at 132s. 10d. included a premium of 8½d.” This figure was arrived at by subtracting from the price actually paid by eager

buyers of gold in the London market, the basic price obtained by dividing the buying "constant" of the Bank of France by the franc-sterling rate ruling at the time of the "gold fixing." For example, on 30th January, 1934, the exchange rate at the time of the "gold fixing" was Fcs. $79\frac{9}{16}$ per £. Dividing this into the buying "constant" of 525.69 gives a basic gold price of 132s. $1\frac{1}{2}$ d. The price actually fixed was 132s. 10d. and the Press consequently stated that this price included a premium of $8\frac{1}{2}$ d. As will be seen, no account is taken of expenses of transport, which are at least $1\frac{1}{2}$ d. per ounce between London and Paris, but the premium is calculated on the assumption that a holder would be prepared to take deposit of the gold either in London or in Paris. Taking the other point of view that a buyer of gold would have to obtain it from the Bank of France if no gold were available in the London market, the current exchange rate of $79\frac{9}{16}$ would be divided into the French selling "constant" of 527.625. This gives an equivalent of 132s. 8d., which corresponds, roughly, with the actual London price if the shipping costs are added to the former or deducted from the latter. The "premium," therefore, is often more apparent than real.

With the collapse of the Continental gold "bloc" in September, 1936, and the consequent assumption that international equilibrium of exchanges would shortly be attained on the basis of the real purchasing powers and gold values of the respective currencies, the tendency to hoard gold privately disappeared and even for a time turned into a movement to dishoard existing stocks. No doubt this latter tendency will become even more pronounced when more definite stability of exchanges and gold prices is reached, but meanwhile a small premium may still be found to exist, especially if, for instance, a commercial demand for dollars comes forward when the exchange market is short of supplies and there is not much gold on offer in the Bullion Market. On the 16th November, 1936, for example, the sterling-dollar exchange rate was \$4.89 - $4.89\frac{1}{2}$ per £, so that the gold price would have to be based on the price at which dollars could be sold to the market, viz. $4.89\frac{1}{2}$. Dividing this into \$35 gives an equivalent of 143s. 1d. while the availability of a fast boat to New York reduced the shipping and selling costs to only 11d. per ounce, making a net price of 142s. 2d. Actually, the demand for the £240,000 of gold on offer was so keen as to cause buyers to be ready to pay 142s. $3\frac{1}{2}$ d. per fine ounce as the potential demand for

dollars appeared to be well in excess of the potential supply. A premium of $1\frac{1}{2}$ d. per ounce was thus established temporarily but, shortly afterwards, the sterling-dollar exchange moved in favour of the dollar to $\$4.88\frac{3}{4} - \frac{7}{8}$, thus rather more than restoring the parity.

CHAPTER VIII

EMPIRE EXCHANGES; THE SILVER AND PAPER EXCHANGES; THE GOLD EXCHANGE STANDARD AND INDIA

THE exchanges between this country and those Dominions using a unit of currency of one pound afford the simplest illustration of the principles on which are based rates of exchange for the different classes of remittances. The development of inter-Empire trade since the conclusion of the Ottawa Agreement gives such exchanges an added importance, and if the United Kingdom pound is the sun of the sterling system, then the Empire currencies (and any others whose fortunes have been linked to those of the pound), are the surrounding groups of satellites, each attracted to the central sun but also having an independent existence of its own. The establishment of Central Banks in India, New Zealand and Canada during recent years marks a further stage in the monetary development of the Empire and fresh changes may be in course of evolution.

An outstanding feature of the past years has been the comparative stability of interest rates in the Dominions. In some cases, a bank deposit rate of 3 per cent has remained unchanged for nearly 30 years, while, at the same time, normal lending rates have been from 6 per cent to 8 per cent. Such conditions are bound to exist in countries in an early stage of development, since capital must be strongly in demand and sufficient time has not elapsed for savings to accumulate to the size necessary to supply such capital. The apparently wide margin between deposit rates and loan rates is due to a variety of factors, chief among which are the absence of an organized money and discount market in most of the Dominions (which prevents the nice adjustment of surplus balances or temporary deficits between the commercial banks and brokers), the great distances and sparse population which have so far existed, the cost of moving cash between Head Office and branches and the high costs of administration, e.g. inspections, moving staff, etc. It is somewhat significant that the establishment of Central Banks referred to above has in each case been followed by a fall in interest rates and by a nearer approximation of loan to deposit rates. This

banking development, coupled with improved transport and communications bringing branches and Head Office closer together, may result in the gradual evolution of national money markets which will permit interest rates to be more responsive to current credit conditions and promote the freer flow of capital.

Quotations for the Empire Exchanges.

Only those members of the British Commonwealth of Nations whose currency unit is the same as our own have special quotation tables accorded them in the Press. A specimen of such a table appears below. Co-operation between banks in these countries is very close and, as local laws are unfavourable to the establishment of outside banks, a stronger banking "ring" exists in each of them than almost anywhere else in the world. The rates of exchange are discussed and fixed weekly by consultation between the individual Government, the Central Bank and the commercial banks, and very little variation in any of them has occurred for some time past. For many years quotations in London were made in terms of United Kingdom pounds per £100 of the currency of the Dominion concerned, while in each Dominion, the quotations were in terms of Dominion currency per £100 U.K. This gave rise to so much confusion and misunderstanding among the commercial community that first Australasia and then South Africa adopted the method of quoting for Dominion pounds per £100 U.K. on both sides, i.e. *quotations both in London and in the Empire centres are made in terms of Dominion pounds per £100 U.K.*

It will be observed that the table gives the usance or type of remittance quoted, and the buying or selling price for the class of remittance. These prices are those quoted by the exchange banks for the information of the general public, and are the extreme limits at which they will buy or sell. In certain cases, such as for large amounts or for special customers, some modification of these rates may be made. It should also be noted that no rates are quoted by the banks for *selling* 30, 60 and 90 days bills. This is because banks are never asked to *sell* long bills on places abroad by debtors in this country. In another place the reasons were given in full for the leading position occupied by London as a monetary centre and for the use of sterling as an international currency. Consequently, where a foreign creditor is prepared to allow credit to a British

debtor, he does so by drawing a long bill in sterling on London, since such an instrument will always command a ready sale in all parts of the world. Therefore it is said that "London draws few bills but accepts many," meaning that far more long bills are drawn on London than London draws on other centres.

TABLE OF EMPIRE EXCHANGE RATES
SOUTH AFRICAN EXCHANGE
BUYING RATES

	T.T.	Sight	30 Days' Sight	60 Days' Sight	90 Days' Sight
London on—					
¹ South Africa .	£100 $\frac{7}{8}$	£101 $\frac{3}{8}$	£101 $\frac{7}{8}$	£102 $\frac{3}{8}$	£102 $\frac{7}{8}$
¹ Rhodesia .	£100 $\frac{1}{4}$	£100 $\frac{1}{4}$	£101 $\frac{1}{4}$	£101 $\frac{1}{4}$	£102 $\frac{1}{4}$

SELLING RATES

	Sight	Telegraphic
London on—		
¹ South Africa	£100 $\frac{1}{4}$	£100 $\frac{1}{4}$
¹ Rhodesia	£99 $\frac{1}{4}$	£99 $\frac{1}{4}$

¹ Per £100 sterling.

DOMINION RATES

USANCE	¹ AUSTRALIA		¹ NEW ZEALAND	
	Buying	Selling	Buying	Selling
T.T.	%	%	%	%
Sight	—	125/-/-	—	124/-/-
30 days	126/7/6	125/1/3	125/10/-	124/1/3
60 days	126/17/6	—	126/-/-	—
90 days	127/7/6	—	126/10/-	—
	127/17/6	—	127/-/-	—

¹ Rates in London per £100 sterling.

If sent by direct air mail, rates are 5s. lower for Australia and 2s. 6d. lower for New Zealand, customers to pay postage.

Meaning of the Quotations.

The rates shown are the amounts in Dominion pounds which the exchange banks will ask or give in return for £100 U.K. Thus, the

South African exchange banks in London will ask £100 17s. 6d. S.Af. or offer £100 2s. 6d. S.Af. (either sum to be paid by Telegraphic Transfer to South Africa), against simultaneous payment of £100 U.K. in London. Similarly, the Australian banks in London will ask for £126 7s. 6d. Aust. or will offer £125 1s. 3d. Aust. (either being in the form of a sight draft on Australia), against immediate payment of £100 U.K. in London. *In every exchange the T.T. rate is the basic rate of exchange*, since the funds are usually paid over in each centre on the same day so that no loss of interest is involved, while there are no stamp charges, very small expenses and very little risk of capital loss. All variations shown by the other quoted rates from the basic T.T. rate are due either to a loss of interest, extra costs of collection, or increased risk of capital loss.

When a banker is asked to buy a sight draft, he pays out the home currency at once but receives credit in the local currency only when the draft has been presented and paid in the other centre. Consequently, he is deprived of the use of his funds from the date of purchase of the draft to the date of credit of proceeds and he recompenses himself for the resulting loss of interest either by paying fewer home units per foreign unit, or by demanding more foreign units per home unit, than would be the case were he dealing in T.T. This is clearly shown in the differences between the rates for T.T.'s and sight drafts in the table given above. Where a South African bank in London will pay out £100 U.K. for only £100 17s. 6d. S.Af. in the form of a T.T. on South Africa, it will only pay out £100 U.K. for £101 7s. 6d. S.Af. in the form of a sight draft. Other considerations enter into the calculation of the actual margin and these are dealt with later in this chapter, but the process is analogous to the ordinary process of "discounting" a bill. In this latter case, the "present value" of the instrument is arrived at by deducting from its face value a sum sufficient to cover loss of interest and expenses, so that the purchase money is less than the face value, whereas in the former process *the amount for which the instrument must be drawn* is adjusted to show a "present value" of £100 U.K.

If this simple principle is followed, it should be easy to understand that still more foreign units per home unit will be demanded by a buyer who is asked to purchase, say, a 30 days' sight bill. Not only must he wait for the instrument to arrive by mail, but he must

also suffer a further loss of interest while it is maturing. A bill at 30 days' *date* will be maturing during its passage to the other centre, but a bill at 30 days' *sight* must arrive in the other centre before it can be "sighted" and accepted, and only then begins to run towards its maturity. Therefore, the purchaser of a 30 d/s draft will be out of his money for the time taken in mailing plus the term of currency of the bill and will recompense himself by asking for an additional number of foreign units per home unit. In the case of 60, 90, or 120 d/s bills, the purchaser will suffer an increasingly greater loss of interest and will compensate himself accordingly by asking proportionately more and more foreign units per home unit. This is clearly shown by the buying rates in the table above. For each extra period of 30 days, the London offices of the Dominion banks require 10s. S.Af., Aust., or N.Z. per £100 U.K., respectively, but this margin is not composed exclusively of loss of interest as will be shown later.

On the selling side the quotations show, in the case of South Africa, that the banks in London will sell a T.T. or a *sight draft* on South Africa for £100 2s. 6d. S.A. against immediate payment of £100 U.K. and, in the case of Australia, that the banks in London will sell £125 Aust. in the shape of a T.T. or £125 1s. 3d. Aust. in the shape of a sight draft on Australia against immediate payment of £100 U.K. in either case. In exceptional cases rates will be quoted for the sale to customers of drafts "at tenor," e.g. 30, 60 or 90 days' sight, but these occasions are rare and the exchange rates applicable are a matter of negotiation between bank and customer. Quotations for "forward" dealings (the principles of which are explained later in this book), can also be obtained from the banks, but, up to the present, these appear to be based exclusively on interest rates in both centres, and show little, if any, saving on the quotation for the purchase or sale of ordinary credit instruments.

Calculation of Empire Exchange Rates.

As has already been stated, the quotations advertised in London (as in the above table), are fixed weekly, or more frequently should occasion arise, by the authorities in the Commonwealth or Dominion concerned. The London offices act only as the agents of their offices abroad, and, while their advice and opinions doubtless carry due weight, the main preoccupation with the maintenance of a reasonable

and equitable rate of exchange must rest with the other side. For one thing, the external obligations of the respective governments demand the provision of a certain amount of exchange and the rate at which this can be purchased materially affects the national finances. Further, it means that a sufficient demand from other countries for the home currency must be stimulated in order to provide an excess of offerings of other currencies in exchange for the home currency, so that the government can satisfy its requirements out of the surplus. On the other hand, home trade must not be unduly penalized by the fixing of an unjustifiably adverse exchange rate which would artificially stimulate exports and handicap imports, and *vice versa* were the rate to be fixed at too favourable a level.

The basic T.T. rate must therefore be the subject of most careful consideration by the authorities since it has a very important national aspect. The rates for sight and tenor remittances are more the concern of the commercial banks and of the individual, and the margins by which such quotations vary from the basic T.T. rate are based on known factors. The commercial banker is a dealer in money, hiring it from his depositors as cheaply as he can, and re-hiring it to his borrowers at as large a margin of profit as force of competition will allow. Where a person sells an "undue" credit instrument to a banker, the latter regards such a purchase as a loan of funds, and bases his purchase price on what it would cost him, in turn, to turn the instrument into ready cash, i.e. the price at which he could re-sell it. In the case of an instrument payable in a centre abroad, the obvious place in which such instruments can be turned into ready cash is in the foreign centre itself, and it is the price of money ruling in that centre on which the home banker must base his buying price for such instruments. Further, an exchange banker must always cover his commitments so as to avoid an "open position," and he will normally cover a purchase of foreign currency in any form by an immediate sale of approximately the same amount of the foreign currency in the same or in some other form, and *vice versa*. The T.T. rate being the basic rate for exchange dealings in any currency, the banker will base his prices for other forms of remittance on the supposition that he will sell or buy a T.T. as cover for a purchase or sale, respectively, of another T.T. or of any other kind of instrument. Consequently, when buying

a sight draft, for example, the banker will assume that he at once sells T.T. as cover. This means that he must order funds to be paid out at once in the foreign centre, whereas his account there will be credited with the proceeds of the draft purchased only after the lapse of a certain time. As a result his account in the foreign centre will, in theory, be overdrawn for such intervening period, and he therefore bases his purchase price for the draft on the cost to him of such an overdraft. On the other hand, where the banker *sells* a sight draft, or any other "undue" instrument, to a customer, he assumes that he will cover the sale by an immediate purchase of T.T. This operation would use up the home currency received from the sale and would leave the banker with foreign currency to his credit until the instrument sold was presented and paid to the debit of his account. Where money is plentiful in the foreign money market, it will be correspondingly cheap, and the credit rate of interest which he will receive on his account will be low. In such a case, the banker cannot pass on much to the buyer of the "undue" instrument by way of compensation for the loss of the use of the purchase money.

Returning to our examples, we must note that, in calculating their buying rate for sight drafts, the South African banks in London must consider that they will be handing over U.K. pounds at once, but will receive the equivalent in South African pounds only after the draft has been sent by post to South Africa, presented to the drawee for payment and actually paid. There may also be a *perte de place*, or a special cost of collection for drafts on special places, such as up-country villages and stations. The banks recoup themselves for these items by demanding *more* South African pounds for every £100 U.K. which they pay out. In the table given, the "margin" between the buying rate for T.T.'s and that for sight drafts is 10s. S.Af. The actual time for a draft to be mailed from London to South Africa by the usual shipping route is about 20 days, but there is not a daily sailing and a draft may have to be purchased and paid for some days before it can actually catch a mail, while drafts on up-country places naturally take some time to collect even after their arrival at a principal port. Further, most such drafts have documents attached and a charge is always levied for the extra trouble incurred in handling documents and for the responsibility for their safe transit. This charge is usually at the

rate of $1 \text{ } \frac{1}{1000}$ (one per mille) or one-tenth of 1 per cent on the face value of the instrument, so that from the full "margin" between T.T. and "sight" of 10s. S.Af. must be deducted this allowance of 2s. per cent, leaving a net margin to cover loss of interest of 8s. S.Af. per cent. To allow for delays in sailings and for further delays in up-country collections, the banks strike an average and take the normal period from the date of purchase of a sight draft to the date of credit of proceeds as being 30 days. Taking this as roughly one-twelfth of a year, the net margin of 8s. S.Af. represents interest at the rate of £4 16s. S.Af. for a full year on an expenditure of £100 U.K., which is equivalent to interest at about $4\frac{3}{4}$ per cent per annum. The principle thus disclosed will be found to apply to the purchase by banks of all forms of remittances on foreign centres other than T.T.'s and should be carefully studied.

Passing on to the other buying rates, we must note that a bank purchasing a 30 days' sight draft for ready cash will obviously be out of the use of its money for 30 days longer than if it purchased a sight draft (there are no days of grace in South Africa), and must compensate itself by receiving eventually a larger number of South African pounds for each £100 U.K. paid out. Also, a rather greater risk is involved in the purchase of a longer dated instrument, since either acceptor or drawer or both may become insolvent during the currency of the draft and an extra allowance for this extra risk is demanded by the purchaser. Consequently, the "margin" of 10s. S.Af. between the sight rate and the 30 days' sight rate may be regarded as not wholly composed of loss of interest but, as to one per mille, of a premium of insurance against risk of loss and only the balance as compensation for loss of interest. This again gives an interest yield of about $4\frac{3}{4}$ per cent per annum per £100 U.K., and the rates for 60 and 90 days' drafts show the same successively higher margins based on the same principles.

Turning to the selling rates, these quotations show the number of South African pounds which the London offices would sell in return for £100 U.K. In the case of T.T.'s, the banks offer £100 2s. 6d. S.Af. for immediate transfer by cable to South Africa, per £100 U.K. The margin of 15s. S.Af. between the buying and selling rates for T.T.'s is the margin of profit or "banker's turn" in dealings in these exchanges. This margin may be narrowed or widened by the trend and volume of business or by the force of competition against the

banking "ring" from outside sources or by the lack of such competition. This margin is also used to encourage or discourage remittances in either direction. If, for instance, the sterling funds of the South African banks are running low, they may try to stimulate private purchases of South African pounds against payments in U.K. pounds by offering a more attractive rate for remittances to South Africa, and *vice versa*. In such a case, the buying rate might be raised to discourage sales and the selling rate raised more than proportionately to encourage purchases, or, conversely, the buying rate can be lowered to encourage sales while the selling rate is lowered more than proportionately to discourage purchases of South African pounds.

As regards the selling rate for sight drafts, contrary to expectation the banks offered at that time no advantage in price to the person buying such instruments from them. Where the banks were *buyers* of sight drafts, we saw that they paid out only £100 U.K. in exchange for a larger sum in South African pounds than they would have demanded for a T.T., and that this difference was due to the fact that they paid out sterling funds at once but had to wait until the draft purchased had been presented and paid before they regained the use of their money, so that the "margin" was largely compensation for the loss of interest so incurred. Why, then, is no similar compensation allowed, in the quotations under discussion, by the banks to the person who buys from them a sight draft, pays cash in sterling for it, but receives the equivalent in South African currency only when the draft has been mailed out, presented to the drawee office and paid? The answer is to be found in the glut of short-term money in the London Money Market which has existed for some time and in the correspondingly low rates of interest which such money commands, together with the similar state of affairs existing in South Africa. Not only has short-term money in London been difficult to place at better than $\frac{1}{2}$ per cent per annum, but the "lines" with even first-class borrowers must necessarily have a limit and conservative bankers have literally not known what to do with their money. As the banks, in consequence, would really rather be without the sterling and can make no profitable use of the funds in South Africa, even if they cover sales of sight drafts by purchases of T.T. to use up the sterling, they offer no particular inducement to a buyer of a sight draft to take this in preference to

a T.T. Any material alteration in short-term money rates, either in London or in South Africa, would, of course, be quickly reflected in the "sight" selling rate, and a "margin" between this rate and the T.T. rate would be established proportionate to the utility of short-term funds.

With a short-term rate of interest of only $\frac{1}{2}$ per cent per annum, the benefit to a banker of holding funds either in London or South Africa for 30 days would be only $\frac{1}{24}$ th of 1 per cent, and this small fraction would be swallowed up by the expenses of issuing and advising the draft. Were money rates to rise to, say, 1 per cent per annum, the purchaser of a sight draft might expect to receive an allowance over the T.T. rate of something under this. If he received $\frac{1}{16}$ th in the rate of exchange for a period of roughly 30 days, this would represent interest at about $\frac{3}{4}$ per cent per annum and the published selling rates would then show "T.T.'s, £100 2s. 6d. S.Af. per £100 U.K.; sight drafts £100 3s. 9d. S.Af. per £100 U.K."

Finally, it should be noted that all stamp charges on "undue" instruments are passed on to the seller by the buying bank and any exceptional charges, such as an unusually long cable of instructions as to the payment over of funds, are also passed on to the customer.

It should also be noted that, on the rare occasions on which banks *sell* tenor drafts drawn by themselves on their branches or agents abroad, no allowance is ever made in the rate of exchange for the cost of the stamp which may have to be affixed in some other centre or for any charges, such as a *perte de place*, which the eventual collection of the instrument may entail. These costs or expenses must be borne by the buyer or a subsequent transferee in addition to the initial cost of the instrument. On the other hand, a bank purchasing any "undue" instrument will allow in the rate of exchange at which it buys for every likely charge or expense in connection with the handling and eventual collection of the instrument, so that all such charges and expenses are really borne by the customer.

The rates for buying and selling Rhodesian pounds are made up on exactly the same principles. It will be noted that the buying margin between T.T.'s and sight drafts is 12s. 6d. Rhod. as against that of only 10s. S.Af., but there is no explanation of this other than that the banks operating in Rhodesia evidently have a surplus

of funds here and do not wish to cover purchases of sight drafts by sales of T.T. so as to have the use of U.K. funds instead of Rhodesian funds; they therefore offer to buy sight drafts on comparatively expensive terms. The remaining rates follow those for South Africa and the previous remarks apply in their entirety.

The Australian and New Zealand rates are also built up in exactly the same way. The basic T.T. rate is fixed periodically by consultation between the Government, the Central Bank and the commercial banks, and the other rates are calculated from this in accordance with the principles enunciated above. The first thing which is likely to catch the eye in the table above in connection with these rates is that no *buying* rate for T.T.'s is shown in either case and, secondly, that the apparent margin or "bankers' turn" between the buying and selling rates for sight drafts shows a profit of £1 6s. 3d. Aust. or £1 8s. 9d. N.Z. The explanation of the first applies to the second and is as follows. The "pool" of foreign exchange of any country ebbs and flows with favourable and unfavourable trade and financial movements. If a country is selling more than it is buying or is borrowing abroad for internal development, its own currency will be in demand on the exchange markets of the world and will appreciate in terms of other currencies until either gold flows into the country to make up for the deficiency of available exchange or the currency has become so dear as to cause a falling off in the export trade and a consequent lessening of the demand for the currency. Conversely, if a country is forced to buy certain goods from abroad, it can pay for them only out of the proceeds of the sales of its own goods or out of borrowings abroad, but in this latter case a time must come when the borrowings must be repaid, and this can be done only if the country possesses a favourable balance of payments on international account. In the case of Australia and New Zealand, they are both producers of primary products and importers of manufactured goods, while both have borrowed extensively in the past from other countries, chiefly the Mother Country. The general trade depression which began in 1929 and increased in force during the ensuing years, caused a falling off in the demand for primary products and a consequent drop in their price. Admittedly, the cost of manufactured articles also fell, but the diminution in trade was so great that the volume of sales of primary products over purchases of manufactured goods

at ever lower prices was insufficient to provide a "pool" of exchange out of which the governments could meet their requirements. The grave state of the national economy and finances in each case caused an increasing export of capital from these countries, which had the effect of still further increasing the offerings of local currencies without bringing any compensating demand. All this is dealt with in more detail in a subsequent paragraph, but the ultimate result was that the available sterling exchange was "pooled" by the Commonwealth Bank and the commercial banks and rationed out amongst those who wished to sell Australian pounds and buy U.K. pounds, while a similar agreement was made between the various banks in New Zealand. For some time, every application to turn Commonwealth or New Zealand pounds into sterling was closely scrutinized and often it was a matter of days, or even weeks, before a genuine commercial seller of the Dominion currency could be provided with U.K. pounds thereagainst by the banking "ring." An "outside" market was started in these currencies in the hope that the quotation of unofficial rates would establish the true value of each currency and that by showing the real depreciation of each in terms of sterling, natural buyers and sellers would be attracted and the wants of each supplied. Even this, however, failed to ease the situation, since there were no really big requirements for the local currencies and the only effect of showing the full depreciation of each was to slow down materially the export of capital, as owners would not face such heavy losses. The position for some years past therefore has been that purchases of T.T.'s on Australia and New Zealand by the exchange banks have been subject to authority from the other side and to the availability of the necessary sterling, so that no quotation for such operations has been published, but the situation is now much easier and quotations for the sale to the banks of T.T.'s are made readily on request. Although the "pooling" system applied to all requests from the public for sterling against local currency, the publication of buying rates for sight and after sight drafts has been continued, because such instruments are the main forms of commercial remittance and because the period between their purchase and maturity is taken up by the movement of goods and their eventual sale while other goods do not, as a rule, go forward to the same quarters until the first consignment is out of hand, which gives time for the accumulation of further sterling

funds with which to finance the next shipment. At the same time, in order to encourage the sale to them of sterling remittances and to discourage the purchase from them of such remittances, the banks in the Dominions widen the "spread" between buying and selling prices, which is, of course, reflected in the margin between the prices at which their London offices will sell and buy, respectively, the Dominion currencies. Thus the Australian banks in London offer to sell £125 1s. 3d. Aust. in the shape of a sight draft in exchange for £100 U.K., but they demand £126 7s. 6d. Aust. per £100 U.K. if they are asked to buy a sight draft on Australia. The margin in the case of New Zealand is even wider, but it is done with the object of adjusting the demand for the supply of exchange rather than with the desire to make exorbitant profits.

Taking next the margins between the buying rates for various types of remittances, that between the known but unpublished buying rate for T.T.'s represents, as with South Africa, an allowance for loss of interest, possible delays in up-country collections and a documentary commission. The time of mailing is normally 28 days, but delays may arise to bring the total up to 36 days. An average of about 33 days is therefore taken and loss of interest for this period is allowed for, plus the documentary commission. The margin of 10s. Aust. or N.Z. for each succeeding period of 30 days represents a gain to the London buyer of about 8s. sterling, which is at the rate of $4\frac{3}{4}$ per cent per annum. The lower rate of interest in these cases as compared with South Africa is due to the fact that the respective governments introduced legislation in 1931 and 1932 to set limits to the rates of interest which could be charged on various transactions in order to lighten the burden of those who were faced with the payment of interest on and capital repayments of borrowed funds out of greatly reduced incomes due to the fall in commodity prices.

On the selling side, a very slight inducement is offered to buyers of sight drafts—as compared with T.T.'s, showing that a cover of such sales by a purchase of T.T. would show a small margin of profit to the banks, as short-term funds are evidently more usable in Australia or New Zealand than in London. The margin offered of $\frac{1}{16}$ th in the rate represents a gain to the buyer of roughly $\frac{3}{4}$ in the rate for a full year. Turned into sterling, this is equivalent to 12s. per £100, or interest at just under $\frac{3}{8}$ per cent per annum. Rates for

the sale to customers of drafts at longer tenor would probably show a rather higher rate of interest but, as was previously stated, such sales are comparatively rare and the quotations are a matter of negotiation between bank and customer.

The method of calculation of rates for "undue" instruments is of great importance in foreign exchange work and the underlying principles should be clearly grasped, and the reasons for the various allowances thoroughly understood, at the outset. Remember that the basic rate and the true value of one currency in terms of another is the T.T. rate and that any instrument which involves a loss of interest to the purchaser or carries any risk of dishonour, requires a special rate of exchange in which allowance is made for such items on the basic T.T. rate. The fact that these Dominion rates are quoted in currencies similar to our own should make it easy to understand how instruments other than T.T.'s are, as it were, "discounted," so as to arrive at their "present value" by means of a percentage allowance on the T.T. rate and that the worse the instrument from the point of view of immediate cash, the lower will be its exchange rate, or price, as against the purchasing currency.

Fluctuations in Empire Exchanges.

These Dominion exchanges are, of course, subject to fluctuations as are other exchanges and are affected by the usual exchange factors of trade, banking and financial operations, stock exchange operations, and currency and credit conditions. With all young and developing countries, large amounts of capital from abroad are needed for development purposes and, in consequence, it is usual for the trade figures for such countries to show heavy adverse balances during their early years, but the excess of imports thus shown represents the proceeds of foreign borrowings, and the apparent adverse balance is offset by invisible exports of paper promises to pay. As such countries establish themselves and their export trade expands, they should, by wise national financing, place themselves in the position of being able to supply steadily increasing amounts of capital for further development out of their own resources so as to decrease steadily further borrowings from abroad. At the same time, they should utilize a part of their favourable trade income in the redemption of part of their existing

foreign debts so as to reduce steadily the annual burden of interest and capital repayments due to other countries.

Special Features of the Australian Exchange.

For many years prior to the War, the commercial development of Australia, with its vast area, necessitated continuous borrowing abroad, mainly in this country. The early excess of imports of manufactures over exports of primary products was offset by this means and, had this development been allowed to progress unhindered, the adverse margin would have been narrowed down steadily until Australia as a nation arrived at the present position of Canada in being able not only herself to finance her internal needs, but to have funds to spare for investment abroad. Unfortunately, the dislocation of world conditions caused by the War had the worst effect on such a young and largely pastoral community. Her sparse population was depleted of its young manhood for War service, while the world demands for her primary products caused prices to rise unprecedentedly, and such labour as remained took advantage of the opportunity to force up wages correspondingly. In common with other countries, she enjoyed a short "boom" with the return of her young men from the War, and the consequent temporary influx of spending power, and as world prices for her products still ruled high, the level of wages all round was also high. Favourable trade conditions enhanced the already high credit reputation of the country, but instead of seizing the opportunity offered by the prosperity of her people and the favourable rate of exchange (even in 1924 Australian pounds were at a premium of 3 per cent in terms of sterling) to redeem some of her existing indebtedness, the Government was content to impose only comparatively light taxation and to meet its needs by renewing old loans or by contracting new obligations.

The return of this country to a gold standard in 1925 practically forced Australia to take the same step, and she then began to suffer from the effects of a currency over-valued externally, coupled with high internal costs of production and falling world prices for primary products. The spread of political ideas inimical to capital amongst her people, and the great power attained by the various trade unions gradually impaired her credit abroad. Capital already invested there began to be withdrawn, and new capital became

increasingly difficult to obtain. Unwise national financing during succeeding years further worsened the position, and with the rapid slump in world prices during 1929 and 1930 her problem of honouring her foreign obligations became extremely grave. Her exchange with this country was for some time regulated by agreement between the Commonwealth Bank and the commercial banks. Sterling resources were "pooled" and rationed out among the banks as far as possible, but the funds available in London fell far short of her national requirements. Between them, the various banks shipped over £20,000,000 in gold out of their own reserves, as there was no central stock in the country, in an endeavour to provide the sterling funds required. Continued capital withdrawals, the meagre flow of new capital into the country, and the heavy adverse trade balance due to the low prices obtained for her exports, all continued, however, to make a demand for sterling continuously far in excess of supply.

Eventually the reserves of the Australian banks became so depleted that further gold shipments were abandoned, and the banking "ring" lost its control of the exchanges. The Australian pound became inconvertible, and its exchange value depreciated rapidly until it stood at a heavy discount, the rate quoted for T.T.s early in 1931 being £130 to £131 Australian per £100 English. As conditions improved, the official rate was gradually lowered and by 3rd December, 1931, was reduced to £125 5s. Aust. per £100 U.K.

The seriousness of the situation called forth a great national effort and a sinking of political differences, and drastic measures of State and Central Government economy were imposed, together with increased taxation and compulsory reductions in interest rates. By the middle of 1933 a definite improvement had taken place and the credit of the country had so far improved as to permit of large conversion operations being carried out in existing Government debt on much more favourable terms, which resulted in a further saving of interest to the Australian Government. At the time of writing, the position has materially improved, but only a lifting of the general depression of trade can bring prosperity to Australia in common with the rest of the world.

In December, 1931, following the suspension of gold payments in this country, the Commonwealth Bank of Australia was legally empowered to control the Australian exchange and to fix rates weekly. Legal provision was also made that the Bank's reserve

might be kept partly in sterling balances with British banks or in sterling bills, or in British Government securities, either to mature within three months.

New Zealand

On 1st August, 1934, the Reserve Bank of New Zealand commenced business and took over the gold stocks of the commercial banks only at their face value, i.e. at the old parity and with no allowance for the rise in the price of gold as expressed in sterling or in N.Z. pounds. It is legally bound to pay or receive sterling against local notes in amounts of not less than £1000 N.Z. at its published rates. The provisions for its reserve are similar to those ruling in Australia.

South Africa

A South African Reserve Bank had already been established for some years but had played only a small part in the monetary affairs of the country. Owing to the importance of its gold mining industry, South Africa was reluctant to abandon her former gold standard, as she wished to take advantage of the rise in the price of gold in terms of the currencies of those countries which had suspended gold payments. The heavy premium on exports which was thus caused resulted in a marked falling off in her export trade, and in December, 1932, she was forced also to declare her gold standard temporarily suspended. The South African Reserve Bank was at the same time authorized to make investments to prevent undue fluctuation of the value of the currency of the Union of South Africa in relation to the currency of the United Kingdom, which, in effect, puts South Africa on a sterling exchange standard.

The Rhodesias.

Both North and South Rhodesia are self-governing colonies, but both are so closely linked commercially to the Union of South Africa that only the notes of the two chief South African banks circulate there and the exchange is controlled by these two banks.

Canada.

This Dominion is divided between dependence on the United Kingdom and the U.S.A. for trade and finance. During the vicissitudes which have befallen the currencies of these two nations over

the past few years, she has endeavoured to steer a middle course between the exchange values of their respective currencies and has never allowed the Canadian dollar to become so dear or so cheap as the U.S.A. dollar in terms of sterling. Canada actually suspended free shipments of gold in November, 1929, when all such imports or exports were made subject to licence by the Ministry of Finance. This Ministry, with the help of the chartered banks, really controlled the exchange for nearly five years and the restrictions on the movement of gold are still in force. The Bank of Canada was established by law, though its capital was subscribed publicly, and commenced business on 11th March, 1935. It carries out the accepted functions of a central bank and took over the gold holdings of the chartered banks as to 60 per cent at its face value and as to 40 per cent at its current market price, thereby giving itself a useful hidden reserve should it ever decide to write up the value of its total gold stocks to *their current value and incidentally giving the chartered banks a reasonable portion of the profit which had accrued on stocks of gold which they had held for many years.* The chief innovation for Canadian banking practice was the provision that the Bank should re-discount for the chartered banks approved paper at a rate to be fixed and published from time to time which is at present (November, 1936) fixed at $2\frac{1}{2}$ per cent per annum.

The Crown Colonies and Mandated Territories.

Almost without exception, these are all on a sterling exchange standard. In many cases, the exchange is controlled by a Currency Board, such as the East African, West African and Palestine Currency Boards, which are under a legal obligation to pay out local currency against sterling deposited in London, and *vice versa*, a charge under or over parity, respectively, being levied to cover the cost of moving funds. A seigniorage charge is also extracted from local issues of silver, copper or bronze coins.

Irish Free State.

The I.F.S. Currency Act, 1927, gave this Dominion a currency standard of gold bullion or sterling exchange at its option under varying circumstances. The Currency Commission *must* issue legal tender against deposits with it of gold coin or bullion, but it only *may* redeem its notes in gold at its option. It *must* issue in Dublin legal tender notes of the same nominal value as an amount of British

money delivered to it but it only *may* make such an issue in London. It *must* redeem in Dublin its own notes for unlimited amounts in money in any form which for the time being is legal tender in Great Britain, but it only *may* effect such redemption in London. The Legal Tender Note Fund must be held in the form of gold bullion, I.F.S. gold coin, British legal tender, sterling balances with any bank in Great Britain or Northern Ireland, or in British Government securities. These last were originally to be only those maturing within twelve months, but an Act passed in 1930 removed this limit entirely and also authorized investment in all forms of British trustee securities.

Seasonal Fluctuations in Exchanges.

Where the imports and exports of a country vary with such factors as climate, harvesting of crops, tourist traffic, etc., the exchange value of the currency will necessarily vary with the resulting seasonal variations in its supply and demand. In the case of Australia, the grain and wool harvest is gathered from December to February, and sales of these products abroad cause a demand for Australian currency against other currencies. Similarly, South African wool, fruits, ostrich feathers, etc., are harvested in the late summer months, and at such times the value of the currency tends to rise owing to the demand for it with which to pay for these exports. The U.S.A., Canadian, Argentine, and other exchanges are subject to similar seasonal influences, while India is affected by the monsoon, Siberia by the long winter, etc. In most such cases, the banks of the country concerned endeavour to smooth out violent variations in the exchange value of the currency by offering supplies of other currencies which are in demand during the months other than the exporting season (which they can do either by building up balances in advance or by arranging finance credits in other centres), which places them in a position to cover their earlier sales by buying up the offerings of other currencies which come forward when the export season is in full swing.¹ Needless to say, the rates of exchange are allowed to move to a sufficient extent in either direction to afford a profit to the operating banks both on their sales of other currencies (which are made at rates adverse to

¹ Such operations are at present left to the Central Bank or Exchange Fund to conduct if deemed necessary.

the home buyers), and on their subsequent purchases (which are made at rates which show a profit on the original sale as well as covering all the expenses involved in maintaining balances abroad or in arranging credit facilities).

Gold Exports of Gold Producing Countries.

There is no relation between the shipment of gold abroad to adjust a temporary adverse balance of indebtedness, and a shipment of gold abroad by a gold producing country for sale in another country. In the first case, the gold shipped represents savings, and is a payment of part of the accumulated wealth of a country in discharge of debts already incurred, for which full value has been received by the country exporting the gold. In the second case, the gold is shipped as an ordinary export of a commodity which has been produced internally in excess of the country's own needs. When a consignment of wool is shipped and sold abroad, the major part of the proceeds has already been paid out in the home country in the shape of wages, interest on capital, and other costs of production. The same is the case with the gold exported by a gold producing country. In order to produce it and to prepare it for export, heavy costs have been incurred in the shape of interest on the capital sunk in the mining company, machinery, wages, transport costs, etc., and only a small proportion of the market value of the gold represents a profit to the producers. It is only this profit which, when brought home, increases the wealth of the exporting country, but the total value goes to swell the favourable items in the trade balance. Thus, exports of gold from such countries as South Africa and Australia must be considered in a totally different light to exports from the gold stock of a country which has to adopt this method of discharging an amount of debt equal to the full eventual "outturn" of the gold in the other centre.

The Silver Exchanges.

Rates of exchange between gold-using and silver-using countries are known as the "silver" exchanges. Until quite recently, several important countries in the Near and Far East had currency systems based on silver, and the silver exchanges played a fairly prominent part in the world's markets. To-day, however, Persia has abandoned her silver standard and introduced a new currency based on gold; India is in a transitory stage between a gold exchange standard and

a gold bullion standard, and her large population is being slowly but steadily educated away from its age-long adherence to silver as a measure of value; French Cochin-China has also abandoned silver as the basis of the currency, and is in course of adopting a gold exchange standard; China, the principal silver standard country from earliest times, may be even more reluctant than India to abandon silver as an internal measure of value and unit of currency, but her new rulers have practically decided on a re-organization of the currency for external purposes, and propose to establish a new unit based on gold, following the recommendations of what was known as the Kemmerer Commission (which was an advisory body under the leadership of an American economist of that name and which, at the request of the Chinese government, undertook an investigation of the financial and monetary position and outlook in China in 1929). When this change in the currency of China for external purposes is carried out, no part of the world of any importance will still be in possession of a silver standard currency, so that the silver exchanges are steadily losing importance and may even eventually cease to exist as separate exchange entities.

In the meantime, the stocks of silver in China are in process of being "nationalized," i.e. owners (whether banks, companies or individuals) are compelled by law to hand over their holdings of silver to the Government at a legally fixed valuation, against the issue of paper money, with the object of concentrating the metallic reserves of the country in official hands so that exchange control, as well as control of the internal monetary circulation, may be undertaken. This policy is undoubtedly the natural result of the effects of the silver-buying policy of the U.S.A. from June, 1934, onwards (which is referred to in the last chapter of this book), which were to drive up the price of silver in terms of gold, thus rendering Chinese goods dearer to foreign buyers and forcing an involuntary deflationary movement on that country with its concomitants of falling prices and dwindling trade.

The effects of the *internal* use of silver as a medium of exchange must be clearly distinguished from the effects of a silver standard on *external* exchanges. For many years, India has had an internal currency of notes and silver coins, and her domestic exchanges have been based entirely on silver, but the external value of her currency for exchange purposes has been maintained on a gold basis by

government action, as is described below in the paragraph on the gold exchange standard. In such a case, fluctuations in the price of silver in terms of gold may have disturbing effects on the trade of the country, both external and internal, but as long as the government retains control of the exchanges, the external value of the currency need not fluctuate in proportion to the changes in the gold price of silver. Where, however, a country has a silver standard only, the exchange value of the currency must fluctuate exactly with every fluctuation in the gold price of silver. The main factors relating to the supply of and demand for silver, and the resulting effects on the value of the metal in terms of gold have already been set out in an earlier chapter, but, under present conditions and especially if China adopts a gold basis of currency for external purposes, they are chiefly of importance in considering the effects on the economic life of silver-using countries and not on their exchanges where these are linked in some way to gold.

The silver exchanges, then, are those between countries with a true silver standard of currency, i.e. in which silver is the only measure of value for both internal and external purposes, and other countries. They are affected not only by the normal factors affecting exchange rates but also by variations in the gold price of silver and in the costs of moving silver from place to place. No Mint Par can be calculated between a gold-using and a silver-using country, and the theoretical par can be ascertained at any given moment only by taking the weight of pure silver in the silver coin at the current market price for silver and comparing the result with that given by taking the pure gold content of the gold coin at the current market price for gold. A fixed arithmetical expression, known as a "Silver Exchange Constant,"¹ is used to find the current value of a silver unit of currency in terms of a gold unit. This is obtained by expressing the amount of silver in the silver unit in relation to the quoted unit of silver in the bullion market in the gold country. For example, the Hong Kong dollar contains 415·985 grains of silver $\frac{9}{10}$ ths fine, while silver is quoted in the London Bullion Market in terms of shillings and pence per ounce Troy ·925 fine. An ordinary arithmetical calculation will show that the Hong Kong dollar therefore contains ·843213 times the amount of pure silver that there is in one ounce Troy ·925 fine, and if the London market

¹ See Deutsch's *Foreign Exchanges*, 1914, p. 62.

price for one ounce of standard silver is multiplied by $\cdot 843213$, the result gives the sterling value of the Hong Kong dollar as silver bullion, and this will be the theoretical par of exchange at that moment. The *actual* rate of exchange will depend on the relation between the supply of and demand for the currency existing at that moment, but will be kept near this par by the possibility of discharging debts by movements of silver should the market price of credit instruments make this the cheaper method. Where there is a marked discrepancy between the demand for and supply of a silver currency, the resulting movement in the market price of credit instruments will tend to cause silver to be shipped either to or from the silver-using country. The consequent efflux or influx of silver from or into the gold-using country will affect the market price of silver there accordingly, and the par of exchange will tend to approach the current market price of credit remittances, while the cost of laying down silver in one centre or the other is proportionately altered. For example, if the rate of exchange for Hong Kong dollars should be $rs. 9d.$ when the market price of silver in London is $2s.$ per ounce, and the cost of moving silver either from London to Hong Kong or from Hong Kong to London is taken at $\frac{3}{4}d.$, then, should there be a temporary excess of demand for over the supply of Hong Kong dollars in London until the market price of T.T.'s. is forced up to $rs. 9\frac{1}{8}d.$, silver will be purchased in London and shipped to Hong Kong to be turned into dollars or sold as silver bullion there for dollars. The demand for silver in London will send up the price to, say, $2s. 4d.$ per ounce, which, in turn, will raise the intrinsic value of the Hong Kong dollar to, say, $2s. 0\frac{1}{2}d.$, while the increased cost of silver bullion will decrease the "outturn" of a shipment of silver bullion for a given sterling outlay. The import of silver into Hong Kong will have the same effect as an import of gold into a gold-using country; the basis of currency and credit is increased and prices tend to rise, while the margin between the supply of and demand for debts payable in Hong Kong is narrowed down by the satisfaction of an amount of debt equal to the "outturn" of the bullion shipment.¹

The frequent and wide fluctuations in the gold price of silver introduce a decided element of speculation into trade and financial relations between gold and silver-using countries, and the majority

¹ This, of course, does not hold good while the silver standard in Hong Kong is suspended.

of such transactions are carried out in terms of the gold currency, leaving the exchange risk to the silver country. Most of the loans raised abroad by silver countries are expressed in terms of a gold currency or currencies, and the interest coupons, as well as the eventual capital repayments, are made payable in terms of the gold currency or currencies concerned. Trade between merchants in gold and silver countries is nearly always carried on in terms of the currency of the gold country. Importers in the silver country can always purchase from the local banks sufficient of the gold currency to meet the debts due to the gold country exporter in his own currency, as exporters from the silver country usually sell in terms of a gold currency and sell the rights to such currencies to the local banks. Were this not so, traders may have to face heavy losses through adverse movements in the gold price of silver, even though there is also the possibility of an unlooked-for profit arising from a favourable movement. Merchants, however, are averse from having a strong element of speculation enter into their normal business affairs, and exporters and importers in silver countries each prefer to conduct their external transactions in terms of a gold currency. Merchants in the silver countries, however, usually cover their engagements in gold currencies by means of "forward" dealings, either in the exchange or in silver, as they cannot otherwise fix the current value of the goods in terms of either silver or gold.

China.

The vast extent of this country, the lack, hitherto, of adequate internal communications, the almost continuous internecine warfare, and the illiteracy of the great bulk of the population have combined to produce a most complicated system of currency which is only now beginning to take coherent shape. Writing in 1914, Mr. Henry Deutsch in his *Transactions in Foreign Exchanges* said: "China has no gold coins, no silver coins—the comparatively few dollars minted during the last three years do not count—and only one small copper coin of the value of one-fiftieth of a penny. That coin, the so-called 'cash,' has a hole in the middle, so that it can be put on a string, and 1000 of these 'cash' form nominally one *tael*. The number of 'cash' which is given for one *tael* fluctuates; at the present moment 1300 'cash' form the *tael* equivalent. It is obvious that the 'cash' cannot serve as a suitable medium of exchange

in case of payments of larger amounts. Such payments are made by pieces of silver which have the form of Chinese shoes (and are therefore called 'shoes'), and show, next to the mark of an official, the weight and fineness of the metal.

"With regard to weight, it must be stated that not only every province of China has its own weight, but every town and village, too; even every butcher and every baker has his own weight. Wherever we go we find 1 kilo weighs 1000 gr. and 1 oz. Imperial weight weighs 1 oz. But in China there exist a thousand kinds of different weights or taels. Important only are the weights (taels) in the treaty ports which are fixed by treaty. If a treaty fixes the weight of 1 tael at, for instance, 1 oz., then the tael of that special harbour must weigh 1 oz. and a piece of silver weighing 1 oz. represents 1 money tael of that harbour. With regard to the fineness of the Chinese silver, there are as well all degrees of it in circulation and the reader can see that China must be a country of constant calculation. In fact, the Chinese are excellent calculators.

"The most important *money taels* are the following—

"(1) *The Shanghai Tael*, which might be taken as equal to $1\frac{1}{8}$ oz. standard silver. (At a silver price of 30d., the Shanghai tael would be $30 + \frac{3.0}{8} = 35d. = 2s. 11d.$)

"(2) *The Haikwan Tael*, which is the heaviest of all taels (38.264 gr. = 1.23 oz.), is the tael used for payments of customs;¹ it is converted into Shanghai taels at the rate of 100 Haikwan taels = 111.4 Shanghai money taels.

"(3) *The Kuping Tael*, tael of the Treasury and some other Government departments.

100 Kuping taels = 109.6 Shanghai money taels.

100 Kuping taels = $\left\{ \begin{array}{l} 105 \text{ Tientsin taels} \\ 108.75 \text{ Hankau taels} \\ 106.4 \text{ Chefoo money taels.} \end{array} \right.$

". . . Mexican dollars are great favourites with the Chinese.

". . . Silver of a fineness from 0.935 up to 0.986 is called 'sycee.'"

Since these words were written, many changes have taken place, but they are still true in substance. The "shoes" of silver usually bear the "chop" or mark of the authority originally responsible for their issue, though this may only be a money-changer or firm

¹ The chief of these is the "likin" or internal transport tax.

of merchants, but should it not bear any such mark, it is known as a "clean shoe." The main currency in the coastal provinces for many years has been the notes issued by the British banks operating in the Far East, but there have also been innumerable internal note issues on the part of Chinese banks, local authorities, or even merchants, over which no control has hitherto been exercised.

On 1st March, 1933, the Chinese Government adopted the *Shanghai Dollar* (theoretically containing 26·6971 grammes of silver 880 fine), of 100 cents and equal to ·715 tael of silver, as the official unit of currency and exchange.

For all exchange purposes, the foreign banks operating in China were essential before the "nationalization" of silver stocks by the Chinese Government and its assumption of exchange control. They maintained stocks of silver there and balances in the foreign gold centres, so that they are always in a position to buy up rights to wealth in gold centres for silver or to pay out funds in gold centres against payment in silver in China. It should be remembered that each metal is merely a commodity in the other country, and that a bar of gold can be sold as bullion in China only in the same way as can a bar of silver in London. Chinese exporters therefore sell their goods abroad in terms of a gold currency, and then sell that currency to a local bank in exchange for a book credit in terms of silver taels or dollars or against the actual payment of a weight of silver by the purchasing bank. Similarly, a Chinese importer having bought from abroad in terms of a gold currency, can have his debt paid abroad for him by his local bank by being debited in account with the equivalent in silver taels or dollars, or by paying over the necessary weight of silver.

The price of silver in terms of gold in the various bullion markets of the world is, therefore, of prime importance in connection with the silver exchanges. The Eastern banker who is asked to sell a gold currency in exchange for payment in silver will consider how much it would cost him to buy the silver in the other centre, where he has funds, and ship it home, and he will not sell more foreign units per tael or dollar than the equivalent rate produced by bringing home silver. Conversely, if he is asked to buy a remittance on a gold centre, he will consider how many foreign units would be produced by shipping the silver he will have to pay out to the foreign centre and selling it there, and he will not accept fewer foreign units per

tael or dollar than the equivalent rate produced by such an operation. Silver will only actually move when the discrepancy between the demand for and supply of debts on a gold centre forces the market price of credit remittances to a point where such shipments are the cheapest method of discharging debts. Where, for instance, a good harvest of rice and silk has made China a creditor on balance for the time being, the offerings of sterling to local banks will force them to demand more and more pence for each tael or dollar which they pay out in silver locally. Eventually, their local stocks of silver will become so depleted and the number of pence per tael which they demand from sellers of sterling will become so high, that the pence bought can be used for the purchase of silver at the market price in London, and for the payment of all the costs of transmission and still leave a profit for the banker. Silver will then move from London (or more probably direct from the producers in America or Mexico) to China until the imports of the metal are sufficient to absorb the offerings of sterling, and to build up again the silver reserves of the local banks. Silver would move from China to be sold abroad when the balance of indebtedness was temporarily against her to such an extent that the demand for sterling from the banks forced them to offer fewer and fewer pence per tael or dollar, until the silver received in payment could be shipped to London and sold there at a price which would yield more pence per silver unit, even after paying expenses, than the number of pence sold locally in exchange for each silver unit. Should the expenses of transmission vary either way, the limit to the movement of the exchange rate will be amended accordingly but the most important factor is, of course, the price at which silver can be bought or sold in the other centre. Owing to the physical distance between the Far East and European or American centres, the forward market in silver was developed in order to allow of a price being fixed at once at which silver could be delivered and paid for at a future date, which became fixed at two months from the date of sale. This permits the Eastern banks to fix at once the eventual price and "outturn" of silver which they are shipping immediately as a result of heavy sales of sterling, or to arrange for the purchase of silver at a future date out of the proceeds of sterling tenor drafts bought locally, at a price fixed at once. The current exchange rate will then be based on the forward

price of silver, and the risk of loss through fluctuation in the market price of the metal is eliminated.

Prices for other forms of credit instruments in addition to the T.T. are calculated on the usual basis of loss of interest to the purchaser, plus any expenses when the purchaser is a bank. Thus, if the rate in Shanghai for T.T.'s. on London is rs. 4d. per tael, and the time of mailing is taken as 27 days, a bank in that centre would purchase a sight draft on London from a local seller at a price of, say, rs. $4\frac{3}{2}$ d. per tael. This represents about 8 per cent per annum for the mailing period, and the bank requires *more* pence per tael, as it is paying out silver at once and will only receive its sterling payment on the arrival of the draft in London, and so takes more pence per home unit to compensate it for the loss of interest involved. A local purchaser of a sight draft on London would receive more pence per tael than was offered by the T.T. rate, but the interest allowance would only be at the rate allowed by the bank on short deposits, say, $2\frac{1}{2}$ per cent per annum, so that he would receive from the bank about rs. $4\frac{3}{2}$ d. in the shape of a sight draft on London for each silver tael paid over to the bank. Rates for drafts at longer tenor are similarly calculated, an additional allowance for interest, stamps, and expenses being made by a purchasing bank for the extra time which must elapse before credit is eventually received, while a selling bank would only allow for interest for the extra period at the lower rate. These rates for instruments other than T.T.'s. will fluctuate not only with the fluctuations in the basic T.T. rate, but also with variations in the rates of interest allowed for in the calculation. A rise in interest rates will mean that the silver unit will command more pence per unit in the shape of sight or tenor drafts on the gold centre, while a fall in interest rates will mean that fewer pence per unit will be obtainable for such instruments.

The Paper Exchanges.

The exchanges of those countries which have only an inconvertible paper currency not linked in any way to gold or any gold standard currency, are known as the "paper exchanges." The principal examples of such currencies used to be those of the Argentine Republic, Brazil, and Spain. In each case, the unit of currency had a nominal gold basis, but the various governments temporarily suspended the convertibility of the respective

internal note issues into gold, as well as prohibiting the export of gold except by the government concerned, so that the paper currency of each of these three countries was at times purely inconvertible. During the past few years most of the countries have suspended gold payments, abrogated the right to demand gold for paper, and prohibited, or at least supervised, the private ownership of and dealings in gold. Such currencies thereupon become "inconvertible paper" currencies, but in nearly every case government action has been taken to maintain a certain stability of exchange value by linking the currency to one of the remaining gold currencies, by imposing restrictions on exchange dealings, and by operating in exchange as and when necessary to preserve the exchange value of the unit. Such methods are denounced as purely artificial and it is held that the only sure method of preserving a sound currency and exchange stability is to link the unit directly to some universally recognized common denominator of value, such as gold.

The currency of the Argentine Republic has been rendered inconvertible on several occasions. After many vicissitudes during early days, in the course of which considerable inflation of the paper currency took place, the currency was eventually re-organized, and the existing notes were de-valued in terms of the gold unit by establishing a fixed ratio of 100 pesos paper to 44 pesos gold. This legal ratio is still in force, but the gold peso is only the official unit, while the paper peso is the commercial unit in general use. Consequently, for the gold rate to be used in respect of a transaction in paper pesos it must be multiplied by 44 and the result divided by 100 to arrive at a paper rate, or the amount expressed in paper pesos must be multiplied by 44 and the result divided by 100 to reduce the amount to its equivalent in gold pesos. A Conversion Office exists at which notes may be exchanged for gold, and *vice versa*, at the legal ratio of 44 gold to 100 paper, though this Office has had to be closed down for a time on several occasions owing to unwise national finance or political disturbances. On the suspension of gold payments by this country in September, 1931, the Argentine currency was linked to the U.S. dollar at a fixed ratio, which was maintained by government action coupled with drastic control of and restrictions on dealings in foreign exchange. When America suspended gold payments in April, 1933, the Argentine peso was linked to the French franc for some months, but in January, 1934,

it was once more linked to sterling at a ratio of 15 paper pesos per pound. The original method of quoting the London-Argentine exchange was in terms of pence per gold peso and this continued for very many years, but on 14th January, 1935, it was agreed in the London Foreign Exchange Market to follow the new method introduced in the Argentine the previous year and the exchange is now quoted in terms of paper pesos per pound. The currency of Brazil is also on a nominal gold basis, but owing to internal financial and political troubles the notes have been inconvertible for many years, and the currency has depreciated severely in value through inflation and loss of confidence.

Spain really needs a special chapter, but it is only possible here to remark that she benefited during the War to an extent which made it quite easy for her to establish a full gold bullion standard of currency, or even a full gold specie standard. Successive governments, however, saw fit to allow the currency to remain inconvertible, although the central gold holding showed a proportion of over 60 per cent of the note issue, and with steady inflation and the gradual building up of serious political unrest, the currency depreciated in value continuously in spite of half-hearted efforts on the part of those in authority to hold its value stable. Following the Revolution of 1931, the Republican Government made genuine efforts to place the finances of the country on a sound basis and to prevent further depreciation of the currency. Restrictions on exchange dealings were imposed and government control was instituted to maintain a kind of gold exchange standard, based on the French franc, at a new exchange level for the peseta, representing a gold depreciation in the peseta of about 50 per cent.

With the silver exchanges, the purchasing power of a silver unit is linked to the purchasing power of gold through the market price of silver in terms of gold. If a silver unit will purchase internally more than will the gold equivalent of the same weight of pure silver, abroad, then gold-using countries will purchase silver with which to buy goods in the silver-using country until the rise in the gold price of silver thus induced offsets the comparative cheapness of goods in the silver-using country. Conversely, where silver can be sold for gold outside a silver-using country at a price which will produce more goods than would the same quantity of silver expended internally,

i.e. when silver has a higher purchasing power outside the silver country, then silver will be exported until the resulting sales of silver lower its gold value to the point at which its purchasing power in gold countries is no greater than at home.

With an inconvertible paper currency, however, the notes have no intrinsic value whatever, and, although the authority responsible for their issue may be able to enforce their use internally, they will be accepted by foreigners in discharge of debts due to them only for their value in terms of goods and services in the country of issue, i.e. their internal purchasing power. The exchange value of such currencies therefore tends to fluctuate with the internal price level, but this price level must be at or near the world level for similar commodities if the country is to continue to trade internationally. Any artificial attempts to maintain a certain price level within a country without regard to the prevailing level of prices elsewhere either increases or decreases its international trade, according as to whether the price level is fixed below or above world level. The government of Brazil for some years attempted to hold the price of coffee (one of the staple exports of the country) at an uneconomic price above world level, by withholding part of each year's crop in the hope of forcing purchases of the balance left over from previous years and, by curtailing supplies, to force buyers into paying the controlled price. Other similar attempts at price fixation for a primary product have been made, notably in the cases of rubber, tin, copper, Canadian wheat, and American cotton, but such attempts to evade the working of economic laws have met with almost complete failure and have all, in the end, been abandoned by their originators.

The exchange value of an inconvertible note issue depends, therefore, on the degree of confidence held in the issuing authority both at home and abroad, and on the use which foreign holders can make of it within the country of issue. As long as a given quantity of inconvertible paper will purchase an amount of goods and services approximately equal to the amount obtainable elsewhere in exchange for the commodities which produced that amount of paper money, it will have a certain command over other currencies, i.e. an exchange value, proportionate to its relative purchasing power at home and abroad. It is essential, however, that the volume of such money in circulation should be strictly controlled and kept well

within the requirements of the community, or its internal exchange value (or purchasing power) will fluctuate continually, its external exchange value will be, in consequence, unstable and foreign trade will be hampered by the varying value of the currency and by the loss of confidence engendered, or will have to be carried on in terms of some stable currency.

From an economic viewpoint, an inconvertible currency of which the volume is precisely adapted to the fluctuating needs of the community for a medium of domestic exchange should prove an infallible index to the economic life of the country by a consideration of its exchange value in terms of other currencies. If prices are too high within the paper-using country, its exports will fall off, its trade balance will become unfavourable, and the excess of supply of over demand for its currency will cause the exchange value to fall. The cheapening of the exchange cost of the unit will tend to bring internal prices, combined with exchange rate, to a point at which foreign buying of home goods is stimulated and, in the meantime, the falling off in foreign demand will have tended to cause a fall in the internal price level. The revival of the export trade will lead to a demand for the currency, causing it to appreciate in value, while the demand for goods will tend to cause a rising price level. There is no unsettling factor in the shape of gold exports or imports to prevent the rise and fall in internal prices, and so in the exchange value of the currency, from operating to depress or stimulate trade and, always providing that the control of the currency is highly efficient, money is made to be a help to and the servant of international trade instead of trade being expected to respond to a monetary policy, as is the case in many countries in which the currency and gold are insolubly welded in the minds of those responsible for monetary control.

Inefficient control of an inconvertible paper issue is, of course, disastrous for the commercial and financial sections of the community alike. No one knows how long the purchasing power of the currency will remain at any given level, and money ceases to perform its primary function of a measure and a store of value. At the same time, inflation may work its own cure if stopped in time or if controlled, since the fall in the exchange value of the currency is usually quicker than the internal rise in prices, making the country a cheap market to buy in, while the redundancy of money

makes it cheap and stimulates borrowing for extension of enterprise, and the trade of the country receives a sharp impetus which, if carefully fostered, may bring lasting prosperity to the country, provided that efficient control of the currency is reimposed.

The attachment of the principal currencies of the world to gold, however, and the inherent dangers of an inconvertible paper currency and the fluctuating value of silver as a metal, in the case of silver-using countries, have led to certain measures being taken, in many instances, by the responsible authority to give a reasonably stable external exchange value to the currency by linking it to another currency which is on some form of gold standard.

The Gold Exchange Standard.

The type of monetary standard under which the external exchange value of a currency of silver or of paper or of any form other than gold is placed on an indirect gold basis, by associating the currency with a currency on some form of gold standard, is known as a Gold Exchange Standard.

This method enables the country adopting it to use a silver or paper currency for internal purposes while enjoying all the external advantages of a gold bullion standard. The essentials are that—

(a) The currency unit must be given a definite value in terms of a gold standard unit by the home government ;

(b) The home government must possess and maintain balances at home and in the foreign centre or centres to the currency of which the home unit is linked, and must be prepared to sell or buy such currencies in exchange for the home currency in unlimited amounts at prices which would represent the outgoing or incoming gold points, respectively, were the country on a gold bullion standard ;

(c) Amicable relations must be maintained with the governments of the foreign country or countries on whose currency the standard is based ;

(d) The internal volume of currency must be strictly controlled and, as far as possible, varied in accordance with the fluctuating monetary needs of the home country, and

(e) In the case of a metallic currency, the face value of the coins must be fixed well above their intrinsic value (or value as metal), as otherwise the internal volume of currency will be

affected by exports of coins whenever their value as metal exceeds their value as token money.

The outstanding example of the successful working of this system is that of India from 1893 to 1919. The internal currency consisted of silver rupees and paper money, and the rupee was given an arbitrary ratio with sterling of 15 to the pound, which made the rupee equal to rs. 4d. The government of India assumed control of the internal currency and accumulated stocks of silver as a backing for the paper issue and, at the same time, built up balances in London in sterling. When the rate of exchange moved against the rupee and it cheapened to under rs. $3\frac{2}{3}\frac{0}{2}$ d., the government sold in India remittances in sterling on London, which lowered the value of the pound (or raised the value of the rupee), while the rupees paid over for the purchase of such remittances were withdrawn from circulation, thus reducing the volume of currency and so increasing its value. When the value of the rupee rose to over rs. $4\frac{1}{2}$ d., the India Council in London sold remittances on India in rupees for sterling, and the sterling paid for such remittances went to swell the balances in London of the government of India, while the eventual payment out in India of the rupees, from the silver stocks of the government there, increased the volume of currency in circulation, and so lowered its value simultaneously with the lowering of the exchange value due to the sales of rupees in London.

Remittances sold in London on India were known as "Council Bills" or "Councils," and were at first only in the form of 90 days bills. Subsequently, T.T.s on the principal centres in India were sold and, later, "Deferred" T.T.s, for payment in India 18 days after payment in London, were introduced. All sales were made by tender from prospective purchasers through the Bank of England, and were made weekly, purchasers having the option of tendering for delivery on any stated day during the ensuing week.

Remittances sold in India on London were known as "Reverse Councils" and were in the form of 90 days bills or, after some time, in the form of T.T.s, and these sales were also made by tender and could be completed on any day of the ensuing week at the option of the purchaser.

Owing to the wide fluctuations in the price of silver after 1918, and to the consequent sharp rise in the value of the rupee on account

of its silver content alone, the India government was forced to make several changes in the ratio between the rupee and sterling, in order to maintain the face value of the silver coin above its value as metal. Then, with the slump in the gold price of silver, the position was reversed and the ratio was successively reduced to keep pace with the purchasing power of silver. In both cases, however, outside forces were too strong for currency control, and the gold exchange standard functioned erratically and with difficulty. The subsequent events concerning the currency of India are dealt with in a following paragraph.

In the course of the rehabilitation of several of the European currencies after the War, the gold exchange standard was used first for stabilization purposes and, in some cases, to provide, subsequently, a currency on a gold basis without the expense of accumulating and keeping idle a large stock of gold as a backing for the internal currency. Belgium, France, Germany, and Italy all adopted this system in the course of restoring their respective currencies to a gold bullion standard. Bulgaria and Greece, at the moment, are maintaining the external value of their currencies by means of a gold exchange standard and, of the post-war States, the Free City of Danzig, and Estonia are examples of the successful use of this system. Against the system it is argued that it leads to an excessive pyramiding of credit on a limited gold basis. The gold holding of a country to whose unit other units are linked may be subjected to a drain, not only by reason of home conditions, but also because of adverse conditions in those countries who have linked themselves to it. Moreover, unwise action on the part of the authority responsible for working a gold exchange standard may result in sales or purchases of the basic currency being carried on too long in the face of a definite world trend against or for the home currency. This may cause a serious "lag" in the adjustment of home prices to world conditions, to the detriment of the overseas trade and finances of the country, whereas the effects of a drain on actual gold holdings are more problematical.

Currency Exchange Standard.

This is the term applied to a system under which one currency is linked to another by methods akin to those used for the practical working of a gold exchange standard but where neither currency is

on a *legislatum* basis. At the present time (November, 1936) a considerable part of the world uses this method of regulating the exchange value of currencies, since many countries, both inside and outside the British Commonwealth of Nations, have linked their currencies to sterling, either *de jure* or at least *de facto*, and so are on a sterling exchange standard. Numerous examples of the introduction and working of this method of giving a certain exchange stability to a currency have been given in the paragraphs above.

Currency Problems in India.

As has already been mentioned, the wide fluctuations in the gold price of silver had serious effects on the monetary position of India as a silver standard country internally, even though her currency was linked to sterling for external purposes, and the temporary abandonment of the gold standard by this country during, and for a few years after, the War led to the exchange between this country and India tending to vary with the relative purchasing power of silver and the paper pound. The rapid rise in the value of the rupee, through the rise in the gold price of silver and the depreciation of the paper pound in terms of gold, caused Indian products to become relatively very dear to other nations, especially in Europe, while the cheapness of many other currencies induced Indian buying abroad. The trade balance, therefore, moved sharply against India, in common with other Far Eastern countries, with a resulting decrease in the capacity to absorb silver until it even became necessary for silver to be exported in discharge of the temporary adverse balance of indebtedness. At the same time, the production of silver, with the cessation of hostilities, had begun to expand, and the demand from other quarters had begun to fall off. During the rise in the value of the rupee, the Indian government had sold Council remittances on India in large quantities until the resulting inflation of the internal currency had given rise to no little anxiety, and had then endeavoured to prevent the abnormal demand for rupees from continuing by raising the ratio to sterling. When the fall in the price of silver commenced a reverse process was necessary, and the excess currency in India was steadily absorbed by sales of sterling until it became necessary to reduce the ratio. The pressure against the rupee was so great, however, that its value fell continuously in spite of all the efforts of the government in reducing

the ratio and in selling enormous quantities of Reverse Council remittances. Eventually, the sterling balances of the India government ran down to a dangerously low level, and control of the exchange was abandoned in September, 1920, the exchange value of the rupee being left to find its economic level.

The original ratio of 1s. 4d. per rupee was tenable as long as the market price of silver fluctuated only between about 2s. and 3s. 6d. per ounce, and, in fact, from 1893 to 1917 these prices were the extreme limits of movements. By the beginning of 1920, the market price of silver had risen steadily to 89d. per ounce, and the ratio was officially moved in stages as high as 2s. 7d. per rupee. In February, 1920, as the price of silver showed signs of having reached its highest point, an Act was passed fixing a new legal ratio of 10 rupees to the pound, or 2s. per rupee. No sooner had this been done than conditions became completely reversed, and silver fell rapidly in price, accompanied by a fall in the exchange value of the rupee which brought it down to 1s. 3½d., after the abandonment of official control measures in September, 1920. Early in 1921, silver had declined to 30d. per ounce, but the effects of an externally cheap currency had resulted in an increase in exports and a decrease in imports, and the rupee gradually rose in value to about 1s. 6d., at which level the government endeavoured to maintain it.

In the meantime, political unrest had become allied with an agitation by the commercial community for complete autonomy for India, and loud demands were made that the rupee should be divorced from its association with sterling and the currency put on an individual gold basis. Eventually, and following the return of this country to a gold bullion standard in 1925, a Commission was set up under the chairmanship of Sir Hilton Young to report on the currency system of India, and to suggest any reforms which might be advisable and beneficial under the changed conditions. This Commission issued its report in 1926 and most of its recommendations were carried into effect by the Indian Currency Act, 1927.

This Act provided that the rupee should be given a theoretical gold content of 8·47512 grains of pure gold, but that silver and paper currency should continue to be used internally, and that the gold value of the rupee should be maintained externally by purchase and sales of gold bullion as and when the condition of the exchange required. The Commission recommended that a new Central Bank

should be established to take complete control of the currency, and to be ready to buy and sell gold bullion in exchange for rupees in unlimited amounts at a fixed price. Owing to a fundamental difference of opinion between the Government and the Indian members of the Assembly, the former insisting on a State-owned institution and the latter on a privately-owned concern, the establishment of a Central Bank was delayed for some years. Finally, the Government was out-voted and the capital of the new bank was raised by public subscription. The Reserve Bank of India opened for business on 1st April, 1934, and was in full operation by 1st July of that year. The theoretical gold content of the rupee gave it a Mint Parity of 1s. 6d. per rupee and the original intention was that the Reserve Bank should be legally compelled to buy all bar gold offered to it at a fixed price but should have the option of selling either bar gold or gold exchange at another legally fixed price, or it could enter the market as a seller of exchange at a lower price should it see fit to take such action. The suspension of gold payments in this country led to the eventual abrogation of some of these provisions and at present the rupee is on a sterling exchange standard. The Reserve Bank, as with the Bank of England, has a legally fixed *buying* price for gold, but its obligation to sell gold or gold exchange at a fixed price has been temporarily suspended. The link between the rupee and the pound, however has been strengthened by the inclusion of a section in the Act which provides that the Reserve Bank shall buy or sell rupees in exchange for sterling, in unlimited amounts, at the extreme limits of 1s. 5 $\frac{1}{4}$ d. per rupee for buying and 1s. 6 $\frac{3}{8}$ d. per rupee for selling.

100,000 rupees is written Rs. 1,00,000 and is known as a "lac," or "lak," or "lakh" of rupees, and in exchange dealing the term "lak" is used to denote 100,000 units of any currency. A hundred lacs of rupees are known as a "crore," and this is therefore 10,000,000 rupees, and is written Rs. 1,00,00,000. The decimal system does not obtain in India and answers to examination questions should be shown in rupees, annas, and pies. An amount of Rs. 7,24,69,500 10a. 4p. would be, in words, seven crores, twenty-four lacs, sixty-nine thousand five hundred rupees, ten annas, four pies.

CHAPTER IX

FOREIGN EXCHANGE DEALINGS, TERMINOLOGY, AND QUOTATIONS

THE buying and selling of foreign currencies, or dealing in foreign exchange, is a highly specialized business for the professional, but the main principles involved can be quite easily understood by anyone. The professional dealers, who are the officials of the banks and financial houses entrusted with the buying and selling of foreign currencies on behalf of their institutions, have the responsibility of so adjusting their purchases and sales of any currencies that their balances in foreign centres are neither too large nor too heavily overdrawn. These dealers are in constant touch with the sources, both financial and commercial, from which the demand for, or supply of, any currency originates. If, for example, a sudden rise in interest rates should take place in New York above the level of interest prevailing elsewhere, there will be a general movement of funds to that centre for temporary investment, and exchange dealers all over the world will be met with a demand for dollars.¹ They will sell their available balances in dollars, and the proceeds of any dollar remittances which they may be able to purchase, at a steadily rising price for dollars in terms of their home currency as the strength of the demand makes itself felt. When the price of dollars has risen high enough, any credit facilities in America which the dealers may have will be utilized and, finally, should the price rise sufficiently high in any country with a free gold market, leading dealers there will arrange to ship gold to New York so as to use the "outturn" in dollars to meet the requirements of buyers.

Conversely, any exceptional offering of any currency, either on financial or commercial account, must be absorbed eventually by the exchange dealers. As the supply begins to overrun the normal demand, dealers will buy the currency only at successively lower prices, and it may eventually become so cheap that, in the case of a country with a free gold market, dealers will use the proceeds of the

¹ This assumes that reasonable conditions of world stability prevail, that the chief countries are operating on a gold standard and that no exchange restrictions are in force.

remittances they have purchased to buy gold in that country and pay the expenses of bringing it home.

This again makes clear the control over the exchange value of a currency given by the existence of a free gold market within the country, and explains why, in the case of countries which will not or cannot either permit the free import and export of gold or exercise official control over the currency such as by means of a gold exchange standard, the exchange value of the currency can fluctuate very widely.

It has already been stated that exchange dealers act as clearing houses for international debts, buying rights to wealth in terms of other currencies from those who have them to sell and selling rights to wealth in terms of other currencies to those who wish to buy them. The usual forms of these rights to wealth, in the shape of credit remittances, have already been described, and the use of gold as a final means of discharging indebtedness, or of laying down funds in another centre, has also been dealt with. The operations of an exchange dealer are chiefly concerned with the buying and selling of such credit instruments and in arranging for the shipment of bullion in bulk when this is both possible and profitable. An exchange dealer will be asked to buy—

(a) T.T.S OR CABLE TRANSFERS. These form the principal banking means of transferring funds in large amounts and are only offered in other cases by the largest commercial firms. As the buying dealer must pay out his home currency to the seller before he can be sure that the money has been paid over in the centre, and as he has no tangible security but must rely on the good faith of the seller, he will only take such instruments from a "good name" even if the seller is another bank or financial house.

(b) M.T.S AND G.M.T.S. These instruments again are chiefly used only by banks, financial houses, and the largest commercial firms, and as cash is paid at once to the seller while payment in the other centre takes place only some days later, the purchase is equivalent to a clean loan to the seller for the time being, and the question of "name," i.e. the standing of the seller, is of the utmost importance.

(c) CHEQUES AND SIGHT DRAFTS. These are usually tendered for purchase by commercial or private customers of the bank who have received them from debtors abroad, or who have drawn such

instruments on their foreign debtors or on balances which they possess with banks abroad. The dealer will only purchase such articles "with recourse" to the seller and may refuse to purchase them if he has any reason to doubt the standing of the customer (see below).

(d) ENCASHMENTS UNDER CREDITS. Letters of credit issued by foreign connections of the bank in terms of a foreign currency are frequently presented by foreigners travelling in this country, who wish to draw the sterling equivalent of all or part of the letter of credit to meet their expenses or disbursements in this country. The holder signs a form of receipt or a form of sight draft on the foreign issuer for the amount of foreign currency which he wishes to convert into sterling. The dealer purchases this as if it were a cheque in foreign currency and allows in his buying rate for the cost of the service rendered by his bank in making the encashment, as well as for the loss of interest through making the sterling payments at once, but only receiving credit in the foreign currency on the arrival of the instrument in the foreign centre, and for the cost of any necessary foreign stamp, etc.

(e) STOCK CHEQUE OR DRAFT. This is the term applied to a cheque or sight draft drawn on another centre in respect of a sale of stock and having the stock or share certificates attached to the cheque. International dealings in securities are mainly carried out between stockbroking firms in the various centres between whom business relations have been firmly established for some time, and payment by the buying firm in one centre to the selling firm in the other centre is usually made by a Telegraphic Transfer on the appointed day, while the stock or share certificates are sent direct by the seller to the buyer. In some cases, however, the selling firm may not be prepared to part with the stock or shares except against payment in cash, while the buyer is not prepared to pay over his cash except against delivery of the security, or the seller may be unable to finance the operation himself and needs temporary accommodation. In such cases, the buyer may instruct his bank to honour the cheque drawn on it by the seller for a stated amount, if certain specified securities accompany the cheque and are found to be in order. A seller here, under such circumstances, will draw a cheque on a bank in the foreign centre designated by the buyer, or on the broker in the foreign centre through whom the sale was carried

out, will attach to or deliver with this the parcel of stock or share certificates to which it refers, and will tender the whole for purchase to the exchange dealer at his own bank. The banker obtains a lien on the securities through his purchase, in addition to preserving recourse against the customer as drawer of the cheque, but he must allow in his buying rate for the instrument for the interest lost while the cheque is in transit as well as for the cost of packing, posting, and insuring the parcel of securities, and should also take a margin to cover a possible drop in the market value of the securities.

(f) REVERSE STOCK CHEQUE. The home buyer of stock or shares in a foreign centre may be asked by the seller to arrange for cash to be paid out there against delivery of the securities. The buyer must then arrange with his home banker for such payment to be made in the foreign currency by the banker's local agent on presentation by the seller of the stated securities attached to a draft drawn by the seller on the buyer in terms of the *home* currency. The home banker will therefore be selling to his customer foreign currency for immediate payment abroad but for which he will receive reimbursement in the home currency only when the stock draft has arrived from the foreign centre and can be presented to and paid by his customer. The banker must therefore allow in the rate at which he sells the foreign currency for the loss of interest he will suffer, for any charges made by his agent, and for the cost of packing, posting, and insuring the parcel.

(g) LONG BILLS. While it is still true that London draws few bills but accepts many, there is always a certain number of long bills which are drawn by firms and persons in this country on other centres on financial or trade account, and these are frequently offered for sale to exchange dealers.

Bills drawn in sterling on foreign centres usually bear special clauses which are dealt with in a later chapter and such bills, except those clauséd "exchange as per endorsement," do not affect the foreign currency balances of the dealer, but are treated as an investment of sterling funds as in the case of an ordinary discount operation.

Bills drawn in or which may be converted into a foreign currency (as with the clause mentioned above) will be purchased by the dealer with recourse to the seller, and under the usual conditions as given below. The dealer will allow in his buying rate for loss of

interest on the cash invested, cost of any foreign stamps, agents' charges, etc. The loss of interest in the case of an *after sight* draft will be for the time taken in transit plus the *full currency* of the bill, as it cannot be "sighted" until it arrives on the other side, while in the case of an *after date* draft, interest is lost only from the date of purchase until the date of maturity, since the bill commences to run from the date of drawing and no "sighting" is needed to fix the date of maturity.

(h) FOREIGN COUPONS AND DRAWN BONDS. It has already been explained how such articles as these now form part of the credit instruments used for expressing international debts, and a British holder of coupons or drawn bonds payable abroad in a foreign currency will offer them for sale to his bank in the same way as with any other credit instrument payable in another centre.

The exchange dealer must allow in his buying rate for interest lost during the time of mailing and for the estimated period which must elapse after arrival before the proceeds are eventually collected and credited to his account with his foreign agent, for the cost of packing, posting, and insuring the parcel, and for the comparatively heavy charge which will be made by his agent for the service of collection of such items.

(i) FOREIGN COIN AND NOTES. In most of the big banks a special department exists, known as the "Foreign Money Department," for dealing in actual foreign money in the shape of the notes and coins of other countries. The amounts handled are usually small and arise through travellers from abroad wishing to convert what small change in their own currency they may have left after the journey, into small change in sterling, or through persons journeying from this country to places abroad wishing to purchase a certain amount in small change in the currency of the country to which they are going so as to be able to meet the usual expenses incurred on arrival.

In the ordinary way, the amounts involved are so small that the stocks maintained by the department represent only a trivial amount and overhead expenses are paid by taking a fairly wide margin between the buying and selling prices. Occasionally, however, stocks of the notes of a certain currency may mount up unduly (as in the case of U.S.A. notes during the American tourist season), or a specially large parcel may be offered for sale to the bank. In

such cases the exchange dealer will have to buy the notes and remit them abroad for credit to his account, allowing in his buying rate for loss of interest during transit, packing, postage, and insurance.

Sanctions or "Limits."

As mentioned above, the "name" of the seller of any exchange instrument is of the first importance to the buyer. Even as between the big banks themselves, each has a "limit" to the total of obligations of the others which may be allowed to remain outstanding at any one time and, as the grade of the other party descends, so the amount of the "limit" on that "name" decreases. The purchase of T.T.'s involves the least risk, as any default in paying over the funds in the foreign centre is known in a few hours, and immediate steps are taken against the seller either to obtain payment of the foreign currency or a refund of the sterling paid to him.

In the case of cheques, demand drafts, longer dated articles, coupons, drawn bonds, etc., the operation of purchase is similar to the discounting of a bill, and while attention is paid to the standing of the drawee or payer, even more is devoted to the standing of the customer from whom the articles are being purchased. With the exception of encashments under credits, for which the purchasing bank must assume responsibility, and so must take every precaution against fraud when effecting such payments, *banks will purchase exchange instruments only with recourse to the seller and only from regular customers*. In order to make the responsibility of the customer quite definite and relieve the bank from liability in respect of any acts of its agents or of any expenses incurred in connection with instruments purchased, it is customary to take from the customer a General Form of Authority for Collection or Negotiation of Foreign Bills. By his signature to this form, the customer agrees that any such operations shall be at his entire risk and responsibility and that, in addition to any rights which the bank may acquire as holder of any such articles, the bank shall have the right to debit the customer's account immediately with the value of any such articles which may be unpaid, together with any charges which may have been incurred.

The granting of "Sanctions" or the fixing of "Limits" is carried out by the Managerial Department of the Head Office of the bank, and limits will be fixed by this department as to the total amount

in respect of each of the classes of transaction which the customer may desire to carry out, which may be outstanding at any given time. The exchange dealer is responsible for seeing that the outstanding amount of foreign exchange transactions with any customer never exceeds the total of the sanction granted by the Head Office.

Sales by the Dealer.

The exchange dealer will be asked to sell principally T.T.s to either banks at home and abroad, or large financial or commercial houses; G.M.T.s and M.T.s to other banks and to financial and commercial houses; bank drafts to commercial firms and private persons; letters of credit, either personal or commercial, for payments to be effected abroad in terms of a foreign currency by the bank's agents; and the Foreign Money Department will be asked to sell small amounts in actual foreign coin and notes to persons proceeding abroad.

In all of these cases the dealer will endeavour to sell at a better price for himself than that at which he has purchased similar instruments, the margin of difference constituting his profit. He will make no allowance to a buyer for any expenses, such as stamps, etc., which the latter must incur before he can obtain payment, and it may be accepted that a bank will always pass on to the customer any expenses which it must itself incur, but will make no allowance for such expenses when incurred by the customer except as regards any usual interest allowance at a comparatively low rate. In the case of sales of T.T.s for small amounts, the dealer will either quote a rate in which he makes allowance for the cost of the telegram, or will quote a rate "plus cost of cable," since the exchange profit on a small amount of foreign currency does not show a sufficient margin to cover telegraphic expenses.

The exchange dealer endeavours to carry out his operations in such a manner as will show a reasonable profit for his bank by buying at one rate and selling at another. It is by no means essential that he should cover a purchase or sale of one class of instrument by a sale or purchase of another instrument of the same type, and, in fact, much of the dealer's profit is derived from covering one class of transaction by means of a different class of transaction, e.g. he may cover a purchase of "cheque" by a sale of T.T., or a purchase of long bills by a sale of forward T.T., depending upon the funds

which he may have available at home and in the foreign centre and the relative rates of interest which he can obtain.

It is not the practice of London banks to permit their exchange dealers to "run a position." This means that the dealer is expected to set off within a little the totals of his purchases and sales of any currency each day, and is not allowed to leave any substantial amount of currency "uncovered," i.e. he must not show either an unduly heavy over-bought or over-sold position at the end of the day.

The Position Sheet.

In order to keep in exact touch with the state of his accounts in other centres, the exchange dealer keeps a "position" sheet or book which is started each morning with the approximate total credit balance or overdraft in each foreign centre (most banks maintain accounts with several banks in each principal foreign centre), as agreed at the close of the previous day by the book-keeping department.

As he transacts each operation of purchase or sale, the exchange dealer will either debit or credit the amount of currency to the balance in the relative centre, making a note at the side of the class of instrument dealt in. He can thus see at a glance whether he is becoming over-bought or over-sold and effect adjusting operations accordingly. Space does not permit of an examination of the entire book-keeping system of a foreign branch, but brief reference is made in the chapter on the London Foreign Exchange Market to the process of dealing with a T.T., and this may be taken as typical of the entries needed. It may be mentioned that in international banking, certain terms are employed to distinguish accounts kept by the banks with each other. The accounts which a bank keeps with other banks are termed by it "Nostro" accounts. The accounts kept with it by other banks are termed by it "Vostro" accounts. Entries passed to the account of a third party are said to be for "Loro" account, e.g. a remittance made by one bank to another for account of a third bank may be sent by the remitter "for credit of Loro a/c (— bank)" meaning "their account with you."

Foreign Currency Accounts for Account of Customers.

A bank is frequently asked to accept deposits from customers in the form of foreign currency. It will accept such deposits only at

the entire risk and responsibility of the customer and assumes no liability for the solvency or acts of its agent, for the time being, in the foreign centre. The customer must sign a form admitting these points and the deposit is then accepted and *held in the foreign centre* as part of the bank's own balance there. Interest is allowed by the bank at a rate under that allowed to it by its agent, so as to show a margin of profit, and advances in sterling are sometimes made to the customer against the security of the funds held abroad, but only up to about 75 or 80 per cent of the current value of the amount of foreign currency in sterling and this margin must be maintained by the customer should the foreign currency depreciate in value.

The exchange dealer will be able to use such deposits in the same way as a bank uses the sterling deposits of its customers.

Most of such sums will be placed on deposit for a fixed period and the dealer will have a fairly accurate idea of the times at which the remainder is likely to be withdrawn. He can, therefore, use the funds so provided in the course of his operations in exchange, as long as he always retains a sufficient margin of available credit on his account in the foreign centre to meet any withdrawals made by the depositors. All such deposits are, of course, registered in separate accounts in the name of each customer in the books of the home bank. The foreign agent, however, cannot distinguish between funds paid in to the credit of the account of the home bank in its books, and so shows merely a total debit or credit balance in the home bank's "Vostro" account. It is, therefore, necessary to reconcile the balance abroad as shown by the statement of account received from the agent, by arriving at the aggregate of the bank's own balance and the balances in foreign currency of its depositors, and by allowing in the usual way for items in transit which will eventually be credited or debited to the account by the agent, as entries to a "Nostro" account abroad must be passed by the home bank as and when transactions take place, and adjusted as to any charges and as to the date for interest purposes (known as the "value date") on receipt of the advice from the agent.

Loans in Foreign Currencies.

Another important exchange operation is the utilization of funds in other centres either by way of investment in first-class bills or securities or by direct loan to approved borrowers, who will usually

be only foreign banks or financial houses of the highest standing. As long as the country in which the funds are used remains on a gold standard and allows the reasonably free import and export of gold, there is very little more risk to the lender than is the case with similar investments at home as he can, in the last resort, reconvert the foreign currency into home funds by shipping gold. Foreign banks operate largely in this way, but the leading British banks confine the amount of their funds which they use in other centres to very modest proportions, and it is chiefly foreign currency placed on deposit with them by their customers which is so used, except for certain cases where sterling is converted into a foreign currency and the currency loaned to a bank abroad to encourage reciprocal business. The method employed in these operations is dealt with in the chapter on forward exchange.

Exchange Maxims and the Making of Prices.

Exchange dealers throughout the world are the persons immediately responsible for making the prices at which they will buy and sell various classes of remittances in different currencies, and it is the competition between these dealers, based on the offerings and demands for currencies received from their customers or on their own account, which eventually hammers out the current rate of exchange. The method of building up from the basic T.T. rate prices for instruments involving a loss of interest or expenses has already been referred to and will be dealt with again in a later chapter.

The maxim to be applied to all remittances is—

“The Better the Bill, the Better the Rate.”

This means that an instrument involving little expense in collection and small loss of interest to the buyer will be more valuable, i.e. will command a better price for the seller, than will an instrument costing more to collect and involving a greater loss of interest. It also means that an instrument issued by and/or on a first-class name will yield a better price to the seller than will an instrument of similar tenor or usance issued by and/or on a name of lesser standing. Thus a cheque on New York would have a greater “present value,” i.e. would command a better rate of exchange for the seller, than could a 60 days draft on New York, both drawn on a bank by a bank, while a 60 days commercial draft on New York

would not command such a good rate of exchange for the seller as would the 60 days bank draft.

Currency and Pence Rates.

The method of quoting the prices or rates of exchange for different currencies takes one of two forms. In the case of the exchanges between this country and others, the rates are quoted either in terms of a variable number of foreign units to the fixed unit of £1, or in terms of a variable number of pence sterling per fixed foreign unit. Rates quoted in terms of foreign units per £1 are known as "**currency**" rates while those quoted in terms of pence per foreign unit are known as "**pence**" rates. "Currency" rates are also known as "*indirect*," or "*uncertain*," since the sterling cost of a single foreign unit can be obtained only by a division sum, i.e. indirectly, and the number of foreign units to the £1 can vary, i.e. is uncertain and movable. "Pence" rates are also known as "*direct*," or "*certain*," for the opposite reasons to those given above.¹

Most of the rates quoted in London are currency rates owing to the early predominance of the £1 in international finance, and to the fact that it is the largest standard unit in the world. Other centres necessarily quote "direct" rates on London, except those quoted in pence here who quote London as an "indirect" rate, and their quotations on each other are nearly always of the "direct" type, e.g. Paris quotes New York in terms of francs per fixed unit of \$1, while New York quotes Paris in cents per unit of 1 fr.

Occasionally the value of one currency is said to be at a "premium" or at a "discount" in terms of another. Remembering that "premium" is synonymous with "dearer" and "discount" with "cheaper," it can be seen that such expressions mean that the first currency is dearer or cheaper in terms of the second currency than the ratio established between them by the Mint Par, e.g. if the Mint Par between London and New York is \$4.8665 to £1, a rate in London on New York of \$4.85½ to £1 would mean that dollars were at a premium in London since the pound will purchase fewer dollars than the Mint Par ratio, while a rate of \$4.87½ would show that

¹ W. F. Spalding in *Foreign Exchange and Foreign Bills*, pp. 58 and 59, also defines "currency" rates as "movable" rates (since the number of foreign units moves in terms of the pound) and the "pence" rates as "fixed" rates (since the number of foreign units is fixed in the quotation).

more dollars than the fixed ratio could be obtained per pound, and that dollars were at a discount in London.

Buying and Selling Prices, or the "Two-way Price."

An exchange dealer quotes what is known as a "two-way" price, which means that he quotes two rates always, at one of which he will buy and at the other of which he will sell the foreign currency. In all *currency* rates, the dealer will obviously endeavour to *sell as few foreign units per pound* as he can persuade the buyer to accept, and will endeavour to *buy as many foreign units for each pound* he parts with as he can force the seller to give him. The principle is the same as that by which a retail greengrocer endeavours to obtain oranges from a wholesaler at the rate of fifteen a shilling, and to re-sell them to a confiding public at the rate of ten a shilling.

For *currency rates* then, the maxim is—

"Buy high, Sell low"

and this basic principle can be summed up in a piece of doggerel (for those who like that sort of thing) thus—

"When buying foreign units at so many to the pound,
You need a rate that's very high—the highest to be found.
But when engaged in selling, in voice sepulchral say,
'I can't give you many units, the rate is down to-day'!"

It is, of course, much simpler to memorize the brief admonition to "Buy high, sell low," but there are many who like their educational pastry made with a very light hand!

When rates are quoted in pence per foreign unit, however, the maxim is reversed. For "*pence*" rates the dealer must—

"Buy low, Sell high,"

in the same way as with buying and selling any commodity in terms of pounds, shillings, and pence. No aid to memory should be needed in this connection.

A distinction must be drawn between rates quoted by a dealer to his customers and the so-called "*market*" rates. If a dealer makes a price of 124.26.-28 in French francs to a customer, it means that he is prepared to sell a T.T. on Paris (or other principal centre), to the customer giving 124.26 fcs. for each pound paid by the latter, and that he will buy a T.T. from the customer, taking 124.28 fcs. for each pound he pays to the latter. The margin of 2

centimes per pound is the "*Dealer's Turn*" and constitutes his profit as long as he can sell at one rate and buy at the other. Similarly, if he quotes a rate for Japanese yen of 2s. 1¼d.—2s. 1½d., it means that he will sell yen to his customer at a charge of 2s. 1½d. per yen or will buy yen from the latter, paying over only 2s. 1¼d. per yen.

The "market" rates are those ruling between the dealers themselves as members of the market, and consist of offerings by dealers who wish to sell at one price and bids by dealers who wish to buy at another price. Thus, a "market" rate on Berlin of 20.41½—42 would mean that certain dealers were prepared to sell marks at the rate of 20.41½ per pound, while others were prepared to buy if they could obtain 20.42 marks per pound. The actual rate at which a deal is effected in the market is a matter of negotiation and depends on the relative keenness of buyer and seller, and on their respective bargaining powers. Failing any giving way on the part of the other party, a dealer who was forced to cover in the market an operation carried out with a customer, would have to buy marks at the market's selling price of 20.41½ or sell them at the market's buying price of 20.42. In the case of a pence rate, if the market quoted Bombay as 1s. 5¾d.—1½d. a dealer might only be able eventually to sell to the market at 1s. 5¾d. per rupee, or to buy from it by paying 1s. 5½d. per rupee.

It is usual to regard movements in exchange rates from a *national* point of view. The old Mercantile Theory held that the inflow of gold to a country showed that it was trading at a profit while an out-flow of gold showed that it was trading at a loss or was sending abroad more than its surplus income. Consequently it is customary to regard a movement in exchange rates towards the point at which gold is likely to flow into this country as being good from the national point of view, and to regard as adverse to the country as a whole, movements in rates towards the point at which gold is likely to be exported. From a national viewpoint, in the case of *currency* rates—

" High rates are for us "

" Low rates are against us,"

and in the case of *pence* rates—

" Low rates are for us "

" High rates are against us."

From the point of view of the individual, whether a rate is favourable or adverse will depend upon whether the individual is a buyer or a seller. A rate on Paris of 124.40 fcs. is *favourable* from the national viewpoint with a Mint Par of 124.2134 fcs., as the rate then would be moving *towards our Import Gold Point*. Such a rate is also favourable to an individual who has a debt to discharge in francs and who is, therefore, a buyer of that currency and wishes to obtain as many francs as possible for each pound he spends. But such a rate is unfavourable to an individual who has to receive francs in payment of a debt, since he is, therefore, a seller of francs and will wish to "Sell low," i.e. give as few francs as possible for each pound he receives. A high pence rate would be *adverse* to this country generally, as it would show that the cost of the foreign unit had grown so dear that *gold might shortly be exported*, and would be adverse to an individual who had to buy some of the currency in question, but would be favourable to a creditor who had the foreign currency for sale, since he would receive a larger number of pence per foreign unit than the ratio set up by the normal parity.

Other Exchange Expressions.

The terms "Favourable" and "Unfavourable" are most often used to describe, from the *national* point of view, movements in exchange rates, but other more indefinite terms are occasionally to be found in articles on the foreign exchanges in the Press. Those who are not well versed in exchange terminology would do well to confine themselves to the use of the expressions "favourable" and "unfavourable" when describing movements in exchange from the point of view of this country, or to the use of "appreciate" and "depreciate" when describing a movement in the value of any particular currency. For example, if the rate of exchange in London on Brussels moves from Belgas 34.97 to Belgas 34.95 per pound, belgas have "appreciated" in value, since fewer are obtainable per pound, while if the rate in London on Rio de Janeiro moves from 4 $\frac{3}{4}$ d. to 4 $\frac{1}{2}$ d. per milreis, the milreis has "depreciated" in value, since it will cost less in terms of sterling.

All other technical expressions are variations of the above terms. The depreciation or appreciation of a currency may be expressed as—

(a) That the currency has become "cheaper" or "dearer."

(b) That there has been a "rise" or "fall" in the exchange rate, when this is quoted as a currency rate, though unfortunately, financial writers often refer to a "rise" or "fall" in a currency when they mean that the *value* and not the rate, has risen or fallen.

(c) That the currency is "weaker" (or "easier"), or "firmer" (or "harder"), though here again it is sometimes stated that the dollar rate was "weaker" when it is not intended to convey that dollars had depreciated in value but that the rate had "weakened" so that fewer dollars were obtainable per pound.

(d) The use of the terms "premium" and "discount" has already been explained, but it is sometimes said by financial writers that the premium or discount has "run off" (particularly with reference to the margins quoted for "forward" rates against "spot" rates), when it is meant to convey that a movement towards parity in either case has taken place.

The student should now be able to read with understanding both the Foreign Exchange Table and the letterpress accompanying it in the daily and weekly Press, but some additional words of explanation follow the text given below.

The London Course of Exchange.

This was a list of exchange rates fixed at the meetings of foreign exchange dealers and brokers held in the Royal Exchange in London each Tuesday and Thursday afternoon.

This practice obtained for many years but was abandoned in January, 1921, owing to the enormous increase in business, the wide fluctuations in rates during every hour of every business day, and the network of private telephone lines connecting dealers and brokers which had been established and which rendered actual meetings of operators unnecessary. At these former meetings, rates were fixed which more or less held good until the next meeting. The rates were those ruling in London on foreign centres and, although two rates were quoted for each centre named, they were not "two-way" prices, or selling or buying rates, but were quotations for bank and trade paper respectively. For some centres only a T.T. rate was quoted, for others only a "cheque" rate, while for others again both a T.T. and 3 months rate appeared.

This list was reproduced in the daily Press on Wednesdays and Fridays, and the rates were regarded as official.

At that time the newspapers published daily a Foreign Exchange Table compiled from rates cabled to London dealers by their foreign agents on the previous day. This table therefore gave rates *ruling in foreign centres on London*, and it is important that this old form of table should not be confused with the modern table dealt with in the following paragraph.

The Foreign Exchange Table.

Even before the end of the War the volume of foreign exchange business had begun to increase very rapidly and, with the resumption of commercial intercourse between nations after the conclusion of hostilities, the volume of exchange business reached colossal proportions, while fluctuations in rates were so rapid and so wide as to make the state of the foreign exchanges a matter of universal interest. At the same time, this country was forced to abandon, to a large extent, her former practice of buying and selling in terms of sterling, and so leaving any exchange risk to the foreign customer, as the foreigner refused to accept this risk while the values of currencies fluctuated so wildly. Also the geographical position and financial prestige of London made her a natural centre as a clearing house for international debts, and London banks were forced to establish highly organized foreign exchange departments to meet the demands of their customers at home and abroad.

The Press also found it necessary to devote more space and attention to the exchanges, and lists of the *quotations ruling in London on foreign centres* began to be published daily under the heading of "Foreign Exchanges," together with a series of comments by the Financial Editor on the movements which had taken place during the previous day. This table quickly grew in size as the number of centres on which dealings took place increased, while the loss of confidence which followed the War, and the rapid movements in rates led to most dealings being carried out by means of T.T's., and quotations for cheques and 3 months bills were gradually dropped until only one or two remained. The evolution of the Foreign Exchange Table is still proceeding, and on page 183 is given a specimen of its modern method of presentation taken from the *Financial Times* of 18th November, 1936.

The manner of presentment of the table differs with various papers but the confusing discrepancies are less than formerly. At one time some papers quoted a two-way price for each centre which was actually the buying and selling rates ruling in the market at or towards the close of business; others quoted one rate only which was sometimes the closing "middle" rate, i.e. a rate midway between the buying and selling rates ruling in the market at the close, or was a "mean" or average rate for the day; others again quoted a two-way price which was the highest and lowest rates quoted during the day. Following the suspension of gold payments in this country in September, 1931, the London Foreign Exchange Bankers' Committee endeavoured to secure a uniform method of compiling these tables, and the old-established banking house of Samuel Montagu & Co. undertook the task of collecting daily a record of the highest and lowest quotations ruling in the market during the day, and this record is available to Press representatives. Many of the leading newspapers have since adopted this list, but others still adhere to their own methods of collection of quotations and their subsequent presentation. This list cannot be described as "official" in the sense of the "official" rates quoted on some of the foreign Bourses but, as presented in *The Times*, for instance, it would undoubtedly be good evidence in a court of law. It is compiled by Messrs. Montagu from the daily records of dealings and quotations in the books of the leading banks and foreign exchange brokers, and a wide range of these is taken, whereas those rates obtained independently by some newspapers are gathered from a few sources only. Messrs. Montagu also supply a list of carefully compiled "closing" rates, and this list is utilized by some of the leading financial "dailies" such as the *Financial Times* and the *Financial News*.

Reverting to the table on pages 183-184 it will be noted that the centres are placed in groups. Owing to its paramount importance, the New York rate is shown first, followed by the Montreal rate owing to the close connection between the Canadian and the American dollar. Then follows a group of the leading European currencies in alphabetical order, chosen because of the number of dealings which take place in their currencies. Next comes the Scandinavian group, which is of lesser importance, and then a group of miscellaneous European currencies, technically

LONDON QUOTATIONS

—	Quoted	Par prior to 29/9/31	30th March, 1938, Close	29th March, 1938, Close
New York T.T. (1%)	Dol. to £	4.86 $\frac{3}{4}$	4.96 $\frac{1}{2}$ -96 $\frac{3}{4}$	4.97 $\frac{1}{2}$ -4.97 $\frac{1}{2}$
Montreal (T.T.)	Dol. to £	4.86 $\frac{3}{4}$	4.99 $\frac{1}{2}$ -4.99 $\frac{1}{2}$	4.99 $\frac{1}{2}$ -4.99 $\frac{1}{2}$
Amsterdam (2%)	Fl. to £	12.107	8.96 $\frac{3}{4}$ -8.97	8.96 $\frac{1}{2}$ -97 $\frac{1}{4}$
Berlin (4%)	Mks. to £	20.43	12.37-37 $\frac{1}{2}$	12.37 $\frac{1}{2}$ -38 $\frac{1}{2}$
Berlin (4%)	Reg. Mks.	—	50 $\frac{1}{2}$ % dis.	51 $\frac{1}{2}$ % dis.
Brussels (2%)	Belga to £	35	29.37-29.38	29.39 $\frac{1}{2}$ -40 $\frac{1}{2}$
Madrid (5%)	Ptas. to £	25.22 $\frac{1}{2}$	80-140††	80-140††
Milan (4 $\frac{1}{2}$ %)	Lire to £	92.46	94 $\frac{3}{4}$ -94 $\frac{7}{16}$	94 $\frac{7}{16}$ -94 $\frac{7}{16}$
Paris (3%)	Fr. to £	124.21	163 $\frac{1}{2}$ -163 $\frac{1}{2}$	162 $\frac{1}{2}$ -163
Zurich (1 $\frac{1}{2}$ %)	Fr. to £	25.2215	21.66-.66 $\frac{1}{2}$	21.66-21.67
Copenhagen (4%)	Kr. to £	18.159	22.38-22.42	22.38-22.42
Danzig (4%)	Gul. to £	25.00	26-26 $\frac{1}{2}$	26-26 $\frac{1}{2}$
Helsingfors (4%)	Mks. to £	193.23	225 $\frac{1}{2}$ -226 $\frac{1}{2}$	225 $\frac{1}{2}$ -226 $\frac{1}{2}$
Kovno (5 $\frac{1}{2}$ %)	Litas to £	48.66	29-30	29-30
Oslo (3 $\frac{1}{2}$ %)	Kr. to £	18.159	19.88-19.92	19.88-19.92
Riga (5%)	Lats to £	25.22 $\frac{1}{2}$	24 $\frac{1}{2}$ -25 $\frac{1}{2}$	24 $\frac{1}{2}$ -25 $\frac{1}{2}$
Stockholm (2 $\frac{1}{2}$ %)	Kr. to £	18.159	19.38-19.42	19.38-19.42
Tallinn (4 $\frac{1}{2}$ %)	E. Kr. to £	18.159	17 $\frac{1}{2}$ -18 $\frac{1}{2}$	17 $\frac{1}{2}$ -18 $\frac{1}{2}$
Alexandria	Pstrs. to £	97 $\frac{1}{2}$	97 $\frac{3}{4}$ -97 $\frac{3}{4}$	97 $\frac{3}{4}$ -97 $\frac{3}{4}$
Athens (6%)	Drch. to £	375	540-555	540-555
Belgrade (5%)	Din. to £	276.316	212-222	212-222
Bucharest (4 $\frac{1}{2}$ %)	Lei to £	813.6	665-690	665-690
Budapest (4%)	Pen. to £	27.8	24 $\frac{1}{2}$ -25 $\frac{1}{2}$ f	24 $\frac{1}{2}$ -25 $\frac{1}{2}$ f
*Constantinople	Pstrs. to £	110	621¶	621¶
Lisbon (4%)	Esc. to £	110	110-110 $\frac{3}{4}$	110-110 $\frac{3}{4}$
bMoscow	Rbls. to £	9.458	26.36-36 $\frac{1}{2}$	26.32-26.32 $\frac{1}{2}$
Prague (3%)	Kr. to £	164.25	142-142 $\frac{1}{2}$	142 $\frac{1}{2}$ -142 $\frac{1}{2}$
Sofia (6%)	Levas to £	673.659	390-420	390-420
Vienna (3 $\frac{1}{2}$ %)	Sch. to £	34.58	††	††
Warsaw (4 $\frac{1}{2}$ %)	Zloty to £	43.38	26 $\frac{1}{2}$ -26 $\frac{1}{2}$	26 $\frac{1}{2}$ -26 $\frac{1}{2}$
*Bangkok	d. to baht	21.82d.	22-22 $\frac{1}{2}$ d.	22-22 $\frac{1}{2}$ d.
*Batavia (3%)	Fl. to £	12.107	8.93-8.96	8.93-8.96
Bombay (3%)	d. to rupee	18d.	18 $\frac{3}{8}$ -18 $\frac{3}{8}$ d.	18 $\frac{3}{8}$ -18 $\frac{3}{8}$ d.
Calcutta (3%)	d. to rupee	18d.	18 $\frac{3}{8}$ -18 $\frac{3}{8}$ d.	18 $\frac{3}{8}$ -18 $\frac{3}{8}$ d.
*Hong Kong	d. to doll.	—	1/2 $\frac{1}{2}$ -1/2 $\frac{1}{2}$	1/2 $\frac{1}{2}$ -1/2 $\frac{1}{2}$
Kobe (3.285%)	d. to yen	24.57d.	1/1 $\frac{3}{8}$ -1/2 $\frac{3}{8}$	1/1 $\frac{3}{8}$ -1/2 $\frac{3}{8}$
*Manila	d. to peso	24.66d.	1/11 $\frac{1}{8}$ -2/0 $\frac{1}{8}$	1/11 $\frac{1}{8}$ -2/0 $\frac{1}{8}$
*Saigon	d. to pstre.	—	1/2 $\frac{1}{2}$ -1/3	1/2 $\frac{1}{2}$ -1/3
*Shanghai	d. to doll.	—	1/0 $\frac{1}{2}$ -1/1	1/11 $\frac{1}{8}$ -1/0 $\frac{1}{2}$
*Singapore	d. to doll.	—	2/3 $\frac{1}{8}$ -2/4 $\frac{1}{8}$	2/3 $\frac{1}{8}$ -2/4 $\frac{1}{8}$
Teheran	Rials to £	—	80 $\frac{1}{2}$ ††	80 $\frac{1}{2}$ ††
aB. Aires (3 $\frac{1}{2}$ %)	—	11.46	15.00†	15.00†
fB. Aires	paper	—	20.05-20.10	20.00-20.05
gB. Aires	peso to £	—	16.12‡	16.12‡
Bogota	peso to £	—	8 $\frac{1}{2}$ -9	8 $\frac{1}{2}$ -9
Rio de Janeiro	d. to mil.	5.89	2 $\frac{1}{4}$ $\frac{1}{2}$ a¶	2 $\frac{1}{4}$ $\frac{1}{2}$ a¶
†Lima (6%)	Sols. to £	17.38d.	20††	20††
eMontevideo	d. to dol.	51d.	31 $\frac{1}{2}$ d.	31 $\frac{1}{2}$ d.
iMontevideo	—	—	27 $\frac{3}{4}$ $\frac{1}{2}$ d.	27 $\frac{3}{4}$ $\frac{1}{2}$ d.
fMontevideo	—	—	20 $\frac{1}{2}$ -20 $\frac{1}{2}$ d.	20 $\frac{1}{2}$ -21d.
Mexico	Peso to £	—	n.q.	n.q.
kValparaiso	Dol. to £	—	124.37††	124.37††

* Rate quoted on London. ‡ Official rate. † 90 days. § Sight. †† Nominal ¶ Seller. n.q. No quotation.

a Official rate for export bills. b Approximate. c Exporters' rate. f Free market rate. g Central Bank selling rate, including commission of $\frac{1}{4}$ per cent. i Importers' rate. k Latest export rate.

N.B.—Following are the rates applicable for payment to the Bank of England for the Clearing Offices: Italy, 94.54 lire; Spain, 77 pesetas; Turkey, 625 piastres.

CENTRAL AND SOUTH AMERICAN EXCHANGES

The Bank of London and South America issues the following details relative to quotations for certain of the South and Central American exchanges. All these exchanges, with the exception of that of Bolivia, are related to the United States dollar, and the approximate sterling rates may be obtained by applying the dollar-sterling exchange rate—

Bolivia*	Official commercial rate was 50.17½ bolivianos per £ on 25th September, 1936.
Colombia .	Sight rate 175¾ pesos per 100 U.S. dollars on 7th October 1936. This rate applies to holders of permits buying in the "open" market.
Ecuador*	Sight selling rate was maintained in September at 10.50 sucres per U.S. dollar.
Guatemala	Sight rate on New York is maintained at one quetzal per U.S. dollar, but a commission of 1 per cent is charged by the Banco Central for the sale of drafts.
Nicaragua*	Official selling rate 110 cordobas per 100 U.S. dollars on 15th October, 1936.
Salvador .	Sight rate on 11th November 2.50 colones per U.S. dollar.
Venezuela.	Sight rate on New York 3.91½ bolivares per U.S. dollar on 26th September, 1936.

* Exchange controls are operative in these countries.

known as the "Exotics" owing to the fact that most of them came into existence after the War and fluctuated wildly for some time. Then follows the group of Far Eastern currencies, most of which were at one time on a silver basis and constituted the "Silver Exchanges," and finally those of the South American currencies in which dealings regularly take place in London. The supplementary table of Central and South American Exchanges gives rates for such of those currencies as are not usually quoted in London, but these latter rates are all *rates ruling in the foreign centres on London*, having been cabled overnight from abroad, as are some few quoted in the main table.

The percentages shown in brackets against many centres are the official Bank Rates ruling in those centres and are given as a guide to the relative values of money. In the next column is given the method of quoting the exchange, whether in foreign units per pound or in pence per foreign unit, then follows a column giving the approximate Mint Pars of exchange, then a column giving the market buying and selling rates ruling very near the close of business, and finally, a column giving the rates of the previous business day for purposes of comparison. Practically all the quotations are for

T.T.s as these are the usual banking form of remittance; the exceptions are clearly shown. Most of the special notations at the foot of the table are dealt with later in this book in the sections on exchange restrictions and the financial events of 1931 and onwards. A regular study of the exchange table in one of the leading newspapers is of the utmost assistance to those desiring a better acquaintance with the inter-relation of economic and political conditions and currency values.

The Foreign Exchange Article.

Accompanying the Foreign Exchange Table is usually a paragraph or two commenting on any special movements which may have taken place in rates during the day, and a few remarks regarding the general position. The following paragraphs might have been written to accompany the table above, but they are actually concocted to contain as much "Journalese" as possible.

FOREIGN EXCHANGES

17th November, 1936.

The foreign exchanges displayed more animation to-day and, had it not been for the operations of the "tripartite controls," wide fluctuations in the principal rates might have been seen. An early commercial and speculative demand for U.S. dollars caused this exchange to firm up to $4.88\frac{3}{8}$ during the morning but, at this level, official support for sterling was introduced and, without much resistance, the market was artificially weakened to near the overnight close of $4.88\frac{1}{8}-\frac{7}{8}$. A further natural demand for dollars in the afternoon was countered by what was believed to be inspired selling from New York at $4.88\frac{3}{8}$ and this, as usual, prevented the movement from developing, the market closing at $4.88\frac{5}{8}-\frac{3}{4}$. The strength of the early demand for dollars evidently caused some competition for the gold on offer in the Bullion Market as the "fixing" price of 142s. 2d. showed a premium of $\frac{1}{2}$ d. over the dollar-sterling exchange at that time. The subsequent firmness of the dollar of course more than neutralized this temporary firmness of gold. In the forward dollar market, the premiums tended to weaken with the firmness of the spot rate, though this tendency was again slightly reversed by the official offerings of spot. After running off to $\frac{5}{32}$ c. and $\frac{9}{32}$ c. offered for the one and three months positions respectively, the margins hardened to $\frac{3}{16}$ c. for one and $\frac{5}{8}$ for three months. Canadian dollars not only moved in sympathy with the U.S. dollar, but were subject to a genuine commercial demand on their own account. After improving to $4.87\frac{1}{4}-.88$, the support given to the U.S. dollar caused a reaction in the afternoon to $4.88-\frac{1}{4}$.

During the morning, fairly heavy offerings of French francs were in evidence, presumably due to the recent disclosures of budgetary difficulties, and the rate weakened to $105\frac{3}{18}-\frac{7}{12}$. Vigorous official action,

both in London and Paris, was then taken and the rate was brought back to its former level of $105\frac{1}{8}-\frac{5}{8}$. During the afternoon, the comparative quietness of trading seemed to cause a relaxation on the part of the controls and the rate was permitted to weaken to $105\frac{5}{8}-\frac{3}{8}$. Forward francs, after showing firmness, were rather offered, the discount on the one month position being finally wider at $\frac{3}{4}$ fc. while that for the three months was $1\frac{7}{8}$ fcs. sellers, which represents interest at nearly $7\frac{1}{2}\%$ p.a. Belgas rallied, the Brussels rate closing at $28.89\frac{1}{2}$ b. against 28.92 b. overnight. Little change was shown in the premiums on forward belgas, the three months remaining at about $5c.$ premium. The rate for Dutch guilders sagged slightly to $9.04-\frac{1}{2}$ on a moderate demand and Swiss francs were appreciably better at $21.25\frac{1}{4}$ as compared with $21.26-\frac{1}{4}$ yesterday. Forward guilders were rather weaker at $5\frac{1}{4}c.$ discount, but Swiss francs three months ahead were unchanged at $2\frac{1}{4}c.$ premium. The rate for free German marks was steady at $12.14\frac{1}{2}m.$, but the discount on registered marks widened out slightly to $48\frac{1}{4}\%$. There was little interest in Italian lire and the rate closed unchanged from yesterday. Scandinavian and Central European exchanges showed no change, save for a minor hardening of the rate on Prague.

The price of silver remaining steady, no change was shown in the exchange rates on the Far East, though the Hong Kong rate was somewhat easier at $1s. 3d.$ South American exchanges were quietly steady, and the market for "free" pesos on Buenos Aires seems to have settled down at the new level of $17.50-60$ after the recent flurry which carried it up to nearly 18.00 .

This may be translated briefly as follows—

More business appeared to be passing in the London Foreign Exchange Market than on the previous day and considerable changes in the values of the principal currencies of the world, in terms of each other, might have taken place had it not been that the Exchange Equalization Accounts of this country, France, the U.S.A. and their associates were used by the authorities in each country to prevent more than minor changes taking place in the respective exchange rates. At the commencement of business buyers of U.S. dollars predominated, some requiring dollars in connection with genuine trading transactions and others as a speculation for an improvement in their exchange value, and, as a result of this dual demand, the value of the U.S. dollar in terms of sterling appreciated until only $\$4.88\frac{3}{8}$ per \pounds could be obtained. At this price, one or other of the Exchange Equalization Accounts was used to support sterling by offering U.S. dollars against pounds and, the early demand apparently having been satisfied for the time being, the dollar was made to depreciate until it was nearly as cheap as it had been at the close of business on the previous day when there had been sellers of dollars at $\$4.88\frac{3}{8}$ per \pounds and buyers only at $\$4.88\frac{7}{8}$ per \pounds . The demand for U.S. dollars was renewed in the afternoon and again the dollar was prevented from appreciating unduly as a result by what was thought to be offerings of dollars against pounds by the U.S. authorities operating their Exchange Equalization Account in New York. In consequence, the market tendency as shown up to then

disappeared, which is a usual sequel to evidence of official operations in exchange working in an opposite direction to the current market trend, and the exchange was quoted at the close of business as \$4.88½ per £ sellers to \$4.88¼ per £ buyers.

As the U.S. Mint would buy gold at a legally fixed price for dollars, it was always possible to provide dollars by buying gold in London or elsewhere and sending it to New York for sale against dollars. The apparent strong demand for dollars on the morning under review caused arbitrage dealers to cast round for methods of obtaining dollars with which to meet this demand. There being some gold on offer in the London Bullion Market, gold and exchange arbitrage operators were anxious to obtain it and so bid against each other, through the bullion brokers attending the daily meeting at which the price of gold is fixed for all dealings in the metal which may take place at that meeting. This keenness on the part of buyers enabled the sellers of gold to obtain a price in sterling which represented a premium of ½d. over the return they would have received by selling dollars in the exchange market at the then current rate and shipping their gold to New York for sale there against dollars at the legal price. As the exchange rate for dollars moved in favour of that currency later in the day, the increased dearness of the dollar then more than offset the comparatively high price of gold at the time the price of that metal was fixed. In the market for U.S. dollars for future delivery, forward dollars were not quite so dear, compared with those for immediate delivery, as they had been, and the dearer dollars for immediate delivery became, those for future delivery became less and less dear in comparison. When dollars for immediate delivery were forced to a cheaper level again, those for future delivery tended to become somewhat dearer in comparison. The initial of these two movements caused the margin between forward and spot deliveries of U.S. dollars to approach nearer to par (or level terms) until dollars for delivery in one or three months time were only ⅓c. and ⅔c. dearer than spot respectively, but the subsequent reversal of this trend caused the forward to become dearer than spot by ⅓c. and ½c. for these respective periods. Canadian dollars usually fluctuate in value in accordance with fluctuations in the value of the U.S. dollar owing to the close trading and financial relationships between the two countries. On this occasion, in addition to tending to become dearer in sympathy with the U.S. dollar, the Canadian dollar was also in demand on its own account for commercial requirements. This caused it to improve in value to \$4.87½ per £ sellers and \$4.88 per £ buyers, but the official cheapening of the U.S. dollar caused the Canadian dollar to cheapen also until sellers were offering \$4.88 and buyers demanding \$4.88¼ per £.

Fears that recent disclosures of the difficulties of balancing the French budget might lead at least to increased taxation and possibly to further devaluation of the currency, led to a movement to withdraw capital from France and during the morning fairly large amounts of French francs were offered for sale against sterling, causing their exchange value to cheapen until sellers were offering 105½ fcs. and buyers were asking 105¾ fcs. per £. The British and French Exchange Control Funds were then brought into operation by the authorities in London and Paris and francs were officially bid for against sterling

until the value of the franc had been improved to its former level of $105\frac{1}{2}$ fcs. sellers, $105\frac{5}{8}$ fcs. buyers, per £. This official action, as usual, caused a considerable diminution in the volume of business and, later on, the authorities allowed a small natural selling of francs to cause that currency to cheapen to $105\frac{5}{8}$ fcs. sellers, $105\frac{3}{16}$ fcs. buyers, per £. Francs for future delivery were at first slightly dearer than those for immediate delivery, as compared with the previous day, but later on became even cheaper than before, francs for delivery in one and three months time being about $\frac{3}{4}$ fc. and $1\frac{1}{8}$ fc. definite sellers, respectively, cheaper than francs for immediate delivery. The latter margin of $1\frac{1}{8}$ fc. for 3 months represented a loss of interest to the seller and a gain to the buyer at the rate of nearly $7\frac{1}{2}$ per cent per annum. Belgian belgas improved in value during the day, the exchange between Brussels and London showing that only $28.89\frac{1}{2}$ belgas per £ could be obtained at the close of business as against 28.92 belgas per £ overnight. There was little change in the price of belgas for future delivery as compared with spot, belgas for delivery in three months time being about 5c. per £ dearer than those for immediate delivery. The rate of exchange for Dutch guilders was lower, showing an appreciation of the guilder in terms of sterling, as a result of a slight demand for this currency and sellers offered 9.04 guilders per £ as against the $9.04\frac{1}{2}$ asked by buyers; Swiss francs also appreciated materially in value as only about $21.25\frac{1}{2}$ Sw. fcs. per £ could be obtained as against 21.26 Sw. fcs. sellers and $21.26\frac{1}{2}$ Sw. fcs. buyers, on the previous day. Dutch guilders for future delivery were somewhat cheaper than previously, being $5\frac{3}{4}$ c. cheaper than guilders for immediate delivery, but Swiss francs for delivery in three months time were still $2\frac{1}{2}$ c. dearer than for delivery on the spot. German marks on "free" or "unblocked" accounts remained unchanged in value at $12.14\frac{1}{2}$ m. per £ but "registered" marks, which can only be used for certain transactions and are by no means "free," were cheaper than before, being at a discount of $48\frac{1}{4}$ per cent so that the sterling cost of a given quantity of such marks would be $48\frac{1}{4}$ per cent less than the cost of the same amount in "free" marks. The market for Italian lire was not active and no change was shown from the previous day in the value of this currency against sterling. The exchange rates between London and the Scandinavian and Central European countries showed no change from the previous day, except that the Czechoslovakian crown was slightly dearer than before.

As the sterling price of silver in London did not fluctuate, the rates of exchange between London and the silver-using countries of the Far East also showed no change, except that the Hong Kong dollar was slightly cheaper than before at 1s. 3d. per \$. The values of the currencies of the South American countries, in terms of sterling, showed no change owing to there being little business and the market for "free," i.e. freely transferable, Argentine pesos was once more steady at 17.50 p. sellers, to 17.60 p. buyers per £, after evidently having fluctuated rather wildly on previous days when pesos cheapened to nearly 18.00 p. per £.

The final footnote to the main foreign exchange table, giving the rates applicable to payments to the Bank of England for the "Clearing Offices," refers to the various bi-lateral agreements made

by this country with certain others under which payments due by our nationals in respect of imports of goods and services from nationals of the other countries concerned must be paid into a "Clearing Office" run by the Bank of England, thus forming a "pool" of sterling out of which current debts due to our nationals by such other countries can be paid, a proportion being allotted to the redemption of past outstanding similar debts and any balance eventually being placed at the disposal of the Central Bank of the other country concerned. The rates quoted are those at which debts

FOREIGN EXCHANGE RATES
NEW YORK, 30TH MARCH

	Mint Parity	30th Mar.	29th Mar.
Call Money	—	1%	1%
	\$	\$	\$
Montreal on London (cables)	—	4.99 $\frac{7}{8}$	5.00 $\frac{3}{8}$
New York on London—			
(Sight)	—	4.96 $\frac{3}{4}$	4.97 $\frac{1}{4}$
(Cables)	—	4.96 $\frac{7}{8}$	4.97 $\frac{1}{4}$
(Sixty days' sight)	—	4.96 $\frac{1}{2}$	4.97 $\frac{7}{8}$
Grain bills (sight)	—	4.96 $\frac{3}{4}$	4.97 $\frac{1}{4}$
Grain bills (7 days)	—	4.96 $\frac{3}{4}$	4.97 $\frac{1}{4}$
Bankers (60 days' sight)	—	4.96 $\frac{1}{2}$	4.97 $\frac{7}{8}$
Commercial (60 days' sight)	—	4.96 $\frac{1}{2}$	4.97 $\frac{7}{8}$
Montreal	—	99.430	99.500
Paris, cables	6.63 $\frac{3}{4}$	3.04 $\frac{1}{2}$	3.06
Italy, cables	8.91	5.26 $\frac{1}{4}$	5.26 $\frac{1}{4}$
Holland, cables	68.06	55.40	55.52
Norway, cables	26.30	24.97 $\frac{1}{2}$	25.00
Sweden, cables	26.80	25.60	25.65
Denmark, cables	26.80	22.20	22.22 $\frac{1}{2}$
Czechoslovakia, cables	3.51 $\frac{3}{4}$	3.49 $\frac{5}{8}$	3.49 $\frac{1}{4}$
Berlin, cables	40.35	40.16	40.18
Belgium, cables	16.94	16.91	16.93
Switzerland, cables	32.67	22.95	22.97 $\frac{1}{2}$
Spain, cables Madrid	19.30	—	—
Austria, cables	14.07	—	—
Hungary, cables	29.61	19.90	19.90
Yugoslavia, cables	1.76	2.34 $\frac{1}{2}$	2.34 $\frac{1}{2}$
Greece, cables	1.29 $\frac{1}{2}$	0.91 $\frac{1}{4}$	0.91 $\frac{1}{4}$
Buenos Aires, market	—	a24.77c	a24.79c
Buenos Aires, paper	—	a30.84	a30.88
Brazil, cables	a11.96	d5.90	d5.90
Japan, cables	a49.83	a28.98	a29.00
Bulgaria, cables	—	01.25	01.25
Finland, cables	—	2.20 $\frac{1}{4}$	2.20 $\frac{1}{4}$
Shanghai, cables (dollar)	—	a26.25	a25.25
Poland, cables	—	18.88	18.88
Rumania, cables	—	0.74 $\frac{1}{2}$	0.74 $\frac{1}{2}$
Hong Kong dollars on New York	—	a30.70	a30.66

a Cents. b Nominal. c Open market rate. d Now quoting official rate.

due by our nationals in terms of the foreign currency must be converted into sterling for payment to the relative "Clearing Office."

In another section of the Press will be found tables of rates ruling in other centres, but these are only of interest to the professional dealer and are not of much practical use as they are merely approximate quotations cabled over-night from the centre in question. On page 189 is a specimen of the table of rates on other centres ruling in New York.

In all cases the quotations are in terms of dollars for 100 foreign units or cents for one such unit, except for those of the pound sterling, which is in dollars, cents, and fractions of a cent per pound. It is interesting to note that the quotations on London for cheques, 7 days' and 60 days' drafts differ from the T.T. rate owing to the allowance which must be made to the buyer for loss of interest, and this is done by offering fewer dollars per pound for the longer that the buyer is out of his money, and fewer still for a commercial bill as against a bank draft, while drafts drawn at sight or 7 days' sight in respect of grain shipments receive special quotations.

Finally, the following table is a list of the currencies of the principal countries of the world, showing the nomenclature of the standard unit and subsidiary coin, the type of monetary standard in force in March, 1938, and the Mint Par or official ratio between the foreign currency and the pound sterling, as in 1931.

Country	Standard and Subsidiary Coins	Type of Monetary Standard	Mint Par or Ratio
ALBANIA .	Franc = 100 centimes	Gold specie	25·2215
ALGERIA .	Franc = 100 centimes	Cur. exchange	124·2134
(a) ARGENTINE	Peso = 100 centavos (44 pesos gold = 100 pesos paper)	Gold bullion (Temporarily suspended)	—
AUSTRIA .	Schilling = 100 groschen	Mark ex.	
(b) BELGIUM .	Belga = 5 francs (1 franc = 100 centimes)	Gold bullion	35.00
(c) BOLIVIA .	Boliviano = 100 centavas	Gold bullion (Temporarily suspended)	13.33
BRAZIL .	Milreis = 1,000 reis (1 conto = 1,000 milreis)	Gold bullion (Temporarily suspended)	60 \$000
BULGARIA .	Lev (<i>plur.</i> Levas) = 100 stotinki	Cur. exchange	673·659
CANADA .	Dollar = 100 cents	Gold bullion (government managed)	4·8665
CEYLON .	Rupce = 100 cents	Gold bullion	1s. 6d.
(d) CHILE .	Peso = 100 centavos	Gold bullion (At option of Central Bank)	40.00
(e) CHINA .	Tael = 10 mace = 10 candareens (or 800 to 1,800 cash) also (for external use) the dollar (silver) of 100 cents = 715 tael	Silver	—
COLUMBIA .	Peso = 100 centavos	Gold bullion (At option of Central Bank)	5.00
CUBA .	Peso = 100 cents (1 peso = 1 U.S.A. doll.)	Gold exchange	4·8665
(f) CZECHO-SLOVAKIA	Krone or crown = 100 heller	Gold bullion (At option of Central Bank)	197.103
DANZIG .	Gulden = 100 pfennige	Gold exchange	25.00
DENMARK .	Krone = 100 ore	Sterling exchange	18·1595

(a) The official rate is 15 pesos paper, sellers, per pound.

(b) On 31st March, 1935, the belga was devalued a second time and given a new gold content of 150632 grammes fine. This gives a theoretical Mint Parity with the old gold pound of 48·61.

(c) Single rate of exchange of 100 bolivianos per £ established 5th January, 1938.

(d) At present controlled by Central Bank on basis of 19.37 pesos per U.S. dollar.

(e) The Shanghai silver dollar has a theoretical silver content of 26·6971 grammes, 880 fine.

(f) On 15th February, 1934, the Crown was legally devalued by one-sixth and given a new gold content of 37·15 milligrammes fine. On 8th October, 1936, the Crown was further devalued and given a variable gold content of from 32·21 to 30·21 milligrammes fine, allowing the internal price of gold to be varied by the Central Bank within these limits.

Country	Standard and Subsidiary Coins	Type of Monetary Standard	Mint Par or Ratio
DUTCH EAST INDIES	Florin = 100 cents	Cur. exchange	12·107
ECUADOR	Sucre = 100 centavos	Gold bullion (At option of Central Bank)	24·33
EGYPT	Pound Egyptian = 100 piastres, or 1,000 millièmes	Sterling exchange	97½ pia.
ESTONIA	Estonian Kron or Krone = 100 cents	Gold bullion	18·1595
FINLAND	Markka = 100 penni	Gold bullion or gold exchange (Temporarily suspended)	193·23
(a) FRANCE	Franc = 100 centimes	Managed	124·2134
GERMANY	Mark (or Reichsmark) = 100 pfennige	Gold bullion (government managed)	20·429
GREECE	Drachma = 100 leptae	Gold exchange (in suspense)	375
(b) HOLLAND	Guilder or florin = 100 cents	Managed	12·107
HONG KONG	Dollar = 100 cents	Silver	—
HUNGARY	Pengo = 100 filler	Gold exchange	27·82½
ICELAND	Krona = 100 aurar	Gold exchange	18·1595
INDIA	Rupee = 16 annas = 64 pice = 192 pies	Sterling exchange standard	1s. 6d.
INDO-CHINA	Piastre = 10 francs	Cur. exchange	Par with French franc
IRAQ	Dinar = 1,000 fils	Sterling exchange standard	Par
(c) ITALY	Lira = 100 centesimi	Gold bullion and gold exchange	92·46
(d) JAPAN & KOREA	Yen = 100 sen = 1,000 rin	Gold bullion (in suspense)	2s. 0·582d.
LATVIA	Lat = 100 santims	Gold bullion	25·2215
LITHUANIA	Litas = 100 centas	Gold exchange	48·66
MADAGASCAR	Franc = 100 centimes	Gold exchange	124·2134
MANCHUKUO	Yuan = 23·91 grammes pure silver	Yen exchange standard	—
(e) MEXICO	Peso or dollar = 100 centavos	Managed silver	2·433
(f) NICARAGUA	Cordoba = 100 centavos	Inconvertible paper	4·8665

(a) See pages 347-350.

(b) On 26th September, 1936, Holland suspended gold payments and introduced an Exchange Control Fund to manage the exchange value of the guilder.

(c) On 5th October, 1936, Italy again devalued the lire to a gold content of 46·77 milligrammes fine.

(d) In July, 1937, the gold stocks of the Bank of Japan were revalued at 3·50 yen per gramme.

(e) In August, 1931, Mexico demonetized gold for internal purposes and announced that silver would become the national standard but, up to the present, the currency and its exchange value have been "managed" by the government. As from January, 1938, by agreement between the two governments, the exchange was to be held at 3·60 Mex. dollars per U.S. dollar, but later events caused this to be altered to about 4·15 in March, 1938.

(f) Sight selling rate on New York, including tax and commission, 2·16 cordobas per U.S. dollar since 22nd October, 1937.

Country	Standard and Subsidiary Coins	Type of Monetary Standard	Mint Par or Ratio
NORWAY	Krone = 100 ore	Sterling exchange	18.1595
PALESTINE	Pal. pound = 100 piastres = 1,000 mils.	Sterling exchange	£P.1 = £E.1
PANAMA	Balbao = 100 centesimos	Gold exchange	2.433
PARAGUAY	Peso = 100 centavos	Inconvertible paper	5.113
PERSIA	Riyal = 100 dinars (20 Riyals = 1 Pahlavi)	Gold bullion	20.00
PERU	Sol = 100 centavos	Gold bullion (at option of Central Bank)	12.166
POLAND	Zloty = 100 grosz	Gold bullion or gold exchange	43.38
(a) PORTUGAL	Escudo = 100 centavos	Inconvertible paper	4s. 5½d. (nominal)
RUMANIA	Leu (<i>plur.</i> Lei) = 100 bani	Gold bullion or gold exchange	813.6
(b) RUSSIA	Chervonetz = 10 roubles = 1,000 kopecks	Inconvertible paper	945.8 ch. per £1,000
SALVADOR	Colon = 100 centavos	Gold exchange	9.73
SIAM	Baht = 100 satang	Gold bullion or gold exchange	11.00 or 21.82d. per baht.
SPAIN	Peseta = 100 centimos	Inconvertible paper	25.2215 (nominal)
STRAITS SETTLEMENTS	S.S. dollar = 100 cents	"managed" Gold exchange	—
SWEDEN	Krona = 100 ore	Sterling exchange	18.1595
(c) SWITZERLAND	Franc = 100 centimes	Managed	25.2215
SYRIA	Syr. pound = 100 piastres	Cur. exchange	£Sy.1 = £E.1
TRIPOLI	Lira = 100 centesimi	Cur. exchange	92.46
TUNIS	Franc = 100 centimes	Cur. exchange	124.2134
TURKEY	Piastre = 40 paras (100 piastres = 1 Turkish pound)	Inconvertible paper	110.71 pia.
(d) U.S.A.	Dollar = 100 cents	Gold bullion "managed"	4.865
(e) URUGUAY	Peso or dollar = 100 centimos	Inconvertible paper	51⅙d.
(f) VENEZUELA	Bolivar = 100 centimos	Inconvertible paper	25.2215
YUGOSLAVIA or JUGOSLAVIA	Dinar = 100 paras (Stabilized <i>de facto</i> at 11 dinars paper = 1 dinar gold)	Inconvertible paper (exchange under State control)	25.2215 gold dinars

(a) Linked to sterling at 110 escudos per pound.

(b) Linked to the French franc at 4½ fc. per rouble.

(c) On 28th September, 1936, the Swiss franc was devalued and given a variable gold content of between 190 and 215 milligrammes, nine-tenths fine.

(d) From 31st January, 1934, the U.S. Mint was legally empowered to buy fine gold at \$35.00 per ounce fine. As the sovereign theoretically contains .23542 of an ounce of fine gold, the theoretical Mint Par is \$8.2397 = £1.

(e) Linked to sterling at 39⅞d. per peso, temporarily. The peso has now been given a legal gold content of 9.585018 grammes fine.

(f) Sight selling rate on New York has been maintained at 3.19 bolivares per U.S. dollar since 27th April, 1937.

CHAPTER X

THE ARITHMETIC OF THE EXCHANGES; DEMAND, LONG, AND "TEL QUEL" RATES

No advanced or abstruse arithmetical processes whatever are used in the performance of foreign exchange calculations. All that is necessary is ordinary ability to add, subtract, multiply, and divide, but the author, in the course of marking many thousands of test and examination papers, has found a lamentable failure on the part of students generally in carrying out even these simple and elementary processes. The actual method used is not of prime importance. Educational methods vary, and what one learns at school in the way of arithmetic usually accompanies one in later life. The "standard" method of contracted multiplication and the "Italian" method of contracted division are admirable for those who are thoroughly accustomed to their use, but they are not indispensable aids to exchange calculations. The author must confess that he still uses, when unobserved, the "farmer's" methods both of multiplication and of division, that is, he sets down every figure of multiplier and multiplicand, or divisor and dividend (even when these run into eight, ten, or more digits), and does not juggle with decimal points but treats them with the respect they deserve. Examples of both methods are given below.

The point which is of the utmost importance is that *all foreign exchange calculations must be worked with extreme accuracy*. Any result should always be obtained correct to five places of decimals at least, and methods of prediction and approximation should be used with great caution, if not entirely avoided. The constant use of a rough check is also strongly advised to minimize the risk of mistakes in the correct place for the decimal point.

A thorough, almost an automatic, knowledge of the decimal system is also essential, as is an ability quickly and accurately to convert fractions into decimals, and *vice versa*, and shillings and pence into decimals of one pound, and *vice versa*. At one time, there seemed a possibility that this country would adopt the metric system but, pending that step, everyone should be able to decimalize sterling at sight.

As regards fractions, it must be noted that *all the fractions used in Foreign Exchange are multiples of $\frac{1}{4}$* , i.e. $\frac{1}{4}$, $\frac{1}{2}$, $\frac{1}{8}$, $\frac{3}{8}$, $\frac{5}{8}$, $\frac{11}{16}$, $\frac{3}{4}$, etc., and no other fractions, such as $\frac{3}{11}$, $\frac{2}{3}$, $\frac{5}{7}$, etc., are ever used. The student is advised to practise turning fractions into decimals mentally, to facilitate calculations, and this can be done by memorizing the "eighths" fractions in decimals, and then adding the decimals for $\frac{1}{16}$, $\frac{1}{8}$, or $\frac{1}{4}$ as required. Thus—

$$\begin{array}{l|l} \frac{1}{8} = \cdot 125 & \frac{5}{8} = \cdot 625 \\ \frac{1}{4} = \cdot 25 & \frac{3}{4} = \cdot 75 \\ \frac{3}{8} = \cdot 375 & \frac{7}{8} = \cdot 875 \\ \frac{1}{2} = \cdot 5 & \end{array}$$

while $\frac{1}{16}$ is $\cdot 0625$, $\frac{3}{16}$ is $\cdot 03125$, and $\frac{1}{4}$ is $\cdot 015625$, so that to decimalize, say $\frac{11}{16}$, take the "eighth" below it which is $\frac{3}{8}$, which is $\cdot 625$, and add $\frac{1}{16}$, which is $\cdot 0625$, making $\cdot 6875$ as the decimal equivalent of $\frac{11}{16}$. Or to decimalize, say, $\frac{59}{64}$, divide the numerator by 8, which gives 7 as the nearest "eighth" below, so that $\frac{7}{8}$ is the basis; this leaves $\frac{3}{64}$, which is $\frac{1}{8}$ plus $\frac{1}{64}$, which is $\cdot 03125$ plus $\cdot 015625$, therefore add $\cdot 875$, $\cdot 03125$, and $\cdot 015625$, which gives $\cdot 921875$ as the decimal equivalent of $\frac{59}{64}$.

Decimalization of Sterling.

The basis of the easy conversion of shillings and pence into decimals, and *vice versa*, is that the florin is $\frac{1}{10}$ of a pound, and is therefore $\cdot 1$ of a pound. A shilling is therefore $\cdot 05$, sixpence $\cdot 025$, and a penny $\cdot 004$ plus a very small balance. To convert any amount in shillings and pence into decimals of one pound, divide the shillings by 2, which gives the first digit behind the decimal point, an odd shilling gives $\cdot 05$, to which is added the number of pence multiplied by 4, making the units figure of this result occupy the third decimal place, and then an allowance of $\cdot 0005$, where the number of pence is between 3d. and 5d., $\cdot 001$ for 6d. to 8d., $\cdot 0015$ for 9d. to 11d., or up to $5\frac{3}{4}$ d., $8\frac{3}{4}$ d., and $11\frac{3}{4}$ d., respectively. Thus, to decimalize £142 13s. 8d.—

Divide the shillings by 2, which gives . . . . .	.6
One shilling over gives . . . . .	.05
Multiply number of pence by 4, which gives . . . . .	.032
Add allowance . . . . .	.001
	.683

Giving an answer of £142.683.

The reverse process applies for the conversion of decimals of a pound into shillings and pence. Thus, to show £227.597 in £ s. d.—

	s.	d.
Multiply the first decimal figure by 2, giving . . .	10	—
Add one shilling for .05, leaving .047 . . .	1	—
Divide remainder by four to give pence, but deduct allowance before dividing, i.e. deduct .0005 for each complete 12, in this case .0015, giving .0455 to divide by 4, giving		11½
		11 11½
		11 11½

Making an answer of £227 11s. 11½d.

Frequent practice will make these operations automatic but, in any case, a few rough figures will help in arriving at the result. Another method is to regard any number over 5 in the second decimal place, and the whole number in the third decimal place, as farthings, after deducting the allowance. This can also be used for converting shillings and pence into decimals. In the first example, take first the number of florins, which is 6, and which gives the first decimal place of .6; this leaves 1s. 8d., which is 80 farthings, to which must be added .001 for each 25 farthings, i.e. .003 in this case, making a total of 83 which gives .083, or a total answer of .683. In the second example, each unit of the first place of decimals is one florin, therefore .5 is 10s.; this leaves 97 farthings, less the allowance of 1 in each 25, i.e. 3 in this case, making a net total of 94 farthings, or as it is nearer 100, deduct 4, making 93 net, which is 23½d., or 1s. 11½d., and this again gives a total of 11s. 11½d.

For exchange calculations, when working decimals into sterling remember that a dealer always works against the customer in that he pays out to the lower penny when buying and charges to the higher penny when selling, so that, in the above instance, .597 would be reckoned as 11s. 11d. with the bank as a buyer, or as 12s. exactly, with the bank as a seller of a foreign currency or bill.

Interest Calculations.

The rapid calculation of interest is also a matter of importance to the exchange dealer. In practice, all allowances in respect of interest lost on different types of remittance are made in the rate of exchange and not by adjusting the principal. Therefore, the rate of exchange is always regarded as the amount of principal on which interest is to be found. The interest formula of

$I = \frac{P \times R \times N}{100}$, where P is the principal, R the rate per cent per annum, and N the number of years, is in constant use. When a number of days is in question, the formula becomes, $I = \frac{P \times N \times R}{100 \times 365}$ and a somewhat clumsy division sum is often involved.

The Third, Tenth, and Tenth Rule.

In order to minimize the arithmetical working in interest calculations with the above formula, the following short method is of considerable use. First multiply both numerator and denominator by 2, thus giving a divisor of 73,000. To effect the division without dividing, take the amount of the numerator and divide it by 100,000, i.e. move the decimal point *five* places to the left, then add to the resulting figure one-third of itself, then one-tenth of that figure, then one-tenth of that figure, and add the whole together. Finally, deduct from the total so obtained one-tenthousandth of itself, and the result is the required amount of interest.

For example, if it is required to find the interest margin between T.T. and "cheque" New York, the T.T. rate being \$4.86 per £, the time of mailing being 8 days, and the rate of interest 3 per cent per annum, set out the problem thus—

$$I = \frac{4.86 \times 8 \times 3 \times 2}{100 \times 365 \times 2}$$

$$= \frac{233.28}{73000}$$

Therefore, take the numerator divided by 100,000	.0023328
Add $\frac{1}{3}$ rd of this	.0007776
" $\frac{1}{10}$ th of this	.00007776
" $\frac{1}{10}$ th of this	.000007776
	.003195936
Deduct $\frac{1}{10000}$ th of this	.000000319
Result	\$.003195617

Therefore the interest margin would be .003196 of a dollar, which is .3196 of a cent, or $\frac{5}{16}$ nearest in the rate.

The use of this method is further exemplified in the working of Long rates later in this chapter.

Chain Rule.¹

This is another contracted method greatly used in foreign exchange calculations, and was once described in an examination paper by a cynical candidate as "a method of working Compound Proportion invented by Mr. Δ to make a simple problem more difficult!" It is generally considered, however, that this method is simplicity itself once the basic principle has been mastered. It is used in attaining a comparison or ratio between two quantities which are linked together through another or other quantities, and consists of a series of equations, commencing with a statement of the problem in the form of a query and continuing the equations in the form of a "chain" in that each equation must start in terms of the same quantity as that which concluded the previous equation. Mint Parities and Gold Points are invariably calculated by this method as is shown by the following examples—

(a) To find the Mint Par between this country and the U.S.A. if £1 contains 123·27447 grains of gold $\frac{11}{12}$ fine and 10 U.S. dollars are minted from 258 grains gold $\frac{9}{10}$ fine.

Chain Rule. ? \$ = £1.

If £1 = 123·27447 grains British standard.

and if Br. st. grs. 12 = 11 grains fine.

and if 9 grs. fine = 10 grains U.S. standard.

and if U.S. grs. st. 258 = 10 \$.

Note that the "chain" starts with the problem put in the form of a query, that each equation starts with the same kind of quantity as concluded the previous equation, and that the "chain" is completed by the concluding quantity in the final equation being the same as the commencing quantity in the first equation.

Now multiply the figures of each of the two sides and divide the total product of the right-hand side by the total product of the left-hand side, thus—

$$X = \frac{1 \times 123 \cdot 27447 \times 11 \times 10 \times 10}{1 \times 12 \times 9 \times 258}$$

Divide 123·27447 and 258 by 3 as a common factor and multiply out the remainder, which gives—

$$X = \frac{45200 \cdot 639}{9288}$$

¹ See Clare's *A.B.C. of the Foreign Exchanges* (1892), Spalding's *Foreign Exchange and Foreign Bills*, p. 28, and others.

which, on being divided out gives, 4.8665 dollars per pound. Therefore the Mint Par between the U.K. and the U.S.A. is—

$$\$4.8665 = \text{£}1.$$

(b) To find the Mint Par between the U.S.A. and Belgium if the U.S. dollar contains 15 $\frac{5}{21}$ grains of gold nine-tenths fine and the belga contains 0.150632 gramme of fine gold.

? belgas	= \$1
if \$21	= 320 grains
and if 10 grains std.	= 9 grains fine
and if 480 grains	= 1 ounce
and if 1 ounce	= 31.1035 grammes
and if 0.150632 gramme	= 1 belga

$$\begin{aligned} \text{Then } X &= \frac{1 \times 320 \times 9 \times 1 \times 31.1035 \times 1}{21 \times 10 \times 480 \times 1 \times .150632} \\ &= \frac{89578.08}{15183.7056} \\ &= 5.89962 \text{ (nearly).} \end{aligned}$$

Therefore the Mint Par between the U.S.A. and Belgium is

$$\text{b. } 5.89962 = \$1$$

(c) To find the equivalent rate produced by buying gold in the London Market at 142s. 3d. per fine ounce and selling it to the U.S. Mint at \$35 per fine ounce.

? \$	= 20 shillings
if 142.25 shillings	= 1 ounce fine
and if 1 ounce fine	= \$35

$$\begin{aligned} \text{Then } X &= \frac{20 \times 1 \times 35}{142.25 \times 1} \\ &= \frac{700}{142.25} \\ &= 4.920914 \text{ (nearly).} \end{aligned}$$

Therefore the equivalent rate is \$4.920914 (or \$4.92— nearest) = £1.

Contracted Multiplication.

While there is always a certain danger in too contracted methods,

some labour-saving processes are quite permissible, though many of them afford scope for additional errors. In the "standard form" of contracted multiplication, the multiplier is set down so that the first significant figure becomes the units figure, the decimal point being moved to permit this, and the decimal point in the multiplicand being moved a similar number of places in the reverse direction. Multiplication is then carried out to one more decimal place than the number required correct by applying the units figure of the multiplier to that said figure in the multiplicand, which will give the necessary number of decimal places, the next figure in the multiplier being applied to the next figure in the multiplicand, and so on. The decimal point remains behind the units figure of the multiplier.

For example, to find the number of dollars produced in exchange for £142 5s. at \$4.920914 per £, decimalize the sterling into £142.25 and, as this forms the easier multiplier, set down thus—

$$\begin{array}{r}
 492.0914 \\
 1.4225 \\
 \hline
 492.0914 \\
 196.8365 \\
 9.8418 \\
 .9842 \\
 .2460 \\
 \hline
 699.9999
 \end{array}$$

To obtain answer correct to 3 decimal places, multiply through by 1 from the last figure of the multiplicand, then by 4 from the figure 1 onwards, by 2 from the figure 9 onwards, and so on. Allow for any figures to be carried from the figure before that on which multiplying is commenced and keep the decimal point below that in the multiplier.

Therefore the dollar equivalent of £142 5s. at \$4.920914 per £, is
\$699.9999.

As it can be seen from the previous example that the exact equivalent is 700, there is a very small margin of error which would have been eliminated by working correct to five places. Therefore, *always work foreign exchange calculations correct to five places of decimals at least.*

Other contracted methods may be used with advantage, but with care, and the student is advised to use the methods which come most easily to him, and in which he feels he is least likely to fall into error.

Italian Method of Division.

This method merely consists in making the multiplication of the

divisor by the series of figures in the quotient at the same time as the subtraction of the product from the dividend, the two operations being performed mentally, and only the result written down. When working correct to five places of decimals, it is not advisable to strike off any of the figures of the divisor until after the third place of decimals has been obtained in the quotient.

For example, to find the sterling equivalent of 4,853,808.60 fcs. at 124.25 $\frac{3}{4}$ fcs. per £, set out thus—

$$\begin{aligned}
 \text{Fcs. } 4,853,808.60 \text{ at } 124.2575 &= \frac{48538086000}{1242575} \\
 &= 1242575 \overline{)48538086000(39062.50001} \\
 &\quad \underline{11260836} \\
 &\quad \quad \underline{7766100} \\
 &\quad \quad \quad \underline{3106500} \\
 &\quad \quad \quad \quad \underline{6213500} \\
 &\quad \quad \quad \quad \quad \underline{1125000}
 \end{aligned}$$

Therefore, the required sterling equivalent is £39,062.50001, which is £39,062 10s.

Calculations involving the conversion of a foreign currency into sterling at a *pence* rate can nearly always be carried out by "Practice," i.e. by factorizing the pence amount and adding together the products of multiplying the foreign currency amount by these factors.

For example, to find the cost of 100,000 yen at 2s. 1 $\frac{1}{2}$ d. per yen, take—

	<i>£</i>	<i>s.</i>	<i>d.</i>
100,000 yen at 2s.	10,000	—	—
100,000 yen at 1d. ($\frac{3}{4}$ th of the above)	416	13	6
100,000 yen at $\frac{1}{2}$ d. ($\frac{1}{2}$ of the above)	208	6	9
Total cost	£10,625	—	3

Therefore, the required cost is £10,625 os. 3d.

Percentages and Per Milleages.

The meaning of these expressions should be clearly understood as they are greatly used in exchange operations. A percentage is a proportion per hundred, e.g. 1 per cent is one part in every hundred parts, such as £1 per £100, while *pér mille* means per thousand, e.g. 1 per mille is one part in every thousand, such as £1 per £1,000. Care should also be taken to distinguish between a

percentage and a fraction of a cent U.S. currency, e.g. $\frac{1}{4}$ per cent of a dollar rate of \$4.86 per £ is $\frac{1}{4}$ of .0486, or .01215, which is nearly $1\frac{1}{4}$ cent, whereas a proportion of $\frac{1}{4}$ c. in the rate is actually one quarter of a cent, which is .25 of a cent or .0025 of a dollar. Percentages or per milleages can also be used to advantage in checking roughly any calculations, such as interest when allowed for in a rate of exchange.

For example, 61 days at 3 per cent per annum is $\frac{61 \times 3}{100 \times 365}$

which is roughly $\frac{1}{100 \times 2}$ which is $\frac{1}{2}$ per cent of the principal.

Consequently, 61 days interest at 3 per cent per annum on a rate for French francs of 124.25 per £ must be about $\frac{1}{2}$ per cent of

124.25, or $\frac{124.25}{100 \times 2}$ which gives $\frac{1.2425}{2}$ or .62125 of a franc, which

is $62\frac{1}{2}$ centimes.¹ An answer to the exact calculation of this interest, therefore, which was not within a little of this figure would obviously be wrong, as where an answer of 21 centimes was obtained. Practice in the conversion of amounts into percentages or per milleages of a rate or of another amount is always useful, if only for the purpose of rough-checking exact calculations. For example, an exchange dealer may have made a profit of $\frac{1}{4}$ c. on \$100,000, and wishes to give a rough estimate of the sterling profit immediately. He takes a round rate of \$5 per £ which gives a sterling equivalent of the principal of £20,000. The profit of $\frac{1}{4}$ c. on each £ dealt in is equal to .0025 on each \$5, which is at the rate of \$25 on \$50,000, which is \$1 on \$2,000, which is $\frac{1}{2}$ on \$1,000, or a proportion of $\frac{1}{2}$ per mille.

On £20,000, $\frac{1}{2}$ per mille is $\frac{1 \times 20000}{2 \times 1000}$ or 10, so that the profit in

sterling is approximately £10. These calculations are mental, but have been set out here in their entirety to show the methods by which the results are obtained.

Selection of Rates and Allowance for Profit.

It has already been explained how a dealer endeavours to buy as

¹ Also, that 1 day at 9% p.a. is $\frac{1}{360}$ of the principal, taking a 360 day year, can be used as a rough check.

many foreign units per pound as possible, and to sell as few per pound as possible (buy high and sell low in currency rates) or to give as few pence per foreign unit as possible when buying, and to take as many pence per foreign unit as possible when selling (buy low, sell high in pence rates). It has also been mentioned that when a dealer has to cover any of his operations in the market, he must buy at the market's selling price, or sell at the market's buying price, unless he can bargain successfully with other members of the market. The members of the general public who have occasion to deal in foreign exchange are mostly so well advised nowadays of the prevailing rates, and have, in many cases, acquired such an expert knowledge of exchange dealing, that they are able to put dealers into competition with each other so as to extort the best rate possible from one bank or another. As a result, the margins of profit left to dealers have been greatly reduced during recent years, and at the present time a dealer must allow his customer the actual market rate with only a very small proportion of profit, or may even have to quote between the market rate, in order to secure business and trust to his powers of bargaining, or to a favourable movement in the rate, to show him a profit on the operation.

Where a dealer can allow himself a margin of profit, he takes it in the rate by—

- (a) When buying, taking more foreign units per pound or giving fewer pence per foreign unit, or
- (b) When selling, giving fewer foreign units per pound, or taking more pence per foreign unit.

For example, if the market price for T.T.s on New York is \$4.86 $\frac{1}{2}$ to \$4.86 $\frac{1}{4}$ per £, and a dealer can take a margin of profit of $\frac{1}{16}$ c. (which is only about $\frac{1}{8}$ per mille), he would actually buy from a customer at 4.86 $\frac{1}{4}$ plus $\frac{1}{16}$, making 4.86 $\frac{5}{16}$, or would sell to the customer at 4.86 $\frac{1}{2}$ less $\frac{1}{16}$, making 4.86 $\frac{1}{16}$, so that his dealing prices with the customer would be 4.86 $\frac{1}{16}$ to 4.86 $\frac{5}{16}$. Similarly, if the T.T.s rate on Calcutta was rs. 6 $\frac{1}{8}$ d. to rs. 6 $\frac{3}{16}$ d. in the market, and the dealer could take a margin of profit of $\frac{1}{32}$ d. (which is about $\frac{1}{4}$ per mille), he would offer to buy from the customer at rs. 6 $\frac{3}{32}$ d. rupee, or to sell to him at rs. 6 $\frac{7}{32}$ d. per rupee. Exchange profits are actually shown, for the time being, in the "Nostro" account with the foreign agent, either in the shape of a disproportionate

sterling value of the currency balance held (where similar amounts of currency have been bought and sold at a profit in sterling) or in the shape of more currency bought with the sterling received for a sale, in which case the profit is eventually turned into sterling by means of an excess of sales of the currency over purchases, to the extent of the accumulated profit.

Demand Rates.

It has already been explained how the rate for Telegraphic Transfers between two centres must be regarded as the basic rate of exchange of the two currencies, since there is no loss of interest, practically no risk, no stamp duties, and only a very small proportionate charge for cable expenses. In the case of the Empire Exchange rates, it was shown how the rate for sight or demand drafts (or cheques) varied from the basic T.T. rate to the extent of the interest lost by the buyer from the time he paid out cash at home for the instrument until he eventually received credit in the books of his agent in the other centre, plus, on occasion, an extra margin for any assumed risk owing to the lesser standing of the drawer and for any exceptional stamp duties. The same principle applies to all instruments, the purchase of which involves loss of interest, extra risk, or appreciable stamp duties. Where a rate is quoted in terms of pounds for another kind of pounds, the operation shows itself as a form of discounting, in that fewer home pounds are given or more foreign pounds demanded for any such instruments payable in other pounds in the same way as fewer present pounds are given for a bill payable at some future date in the same currency, i.e. in discounting an undue instrument. Where the rate of exchange is for a different unit of currency, however, the working is not so easily perceived, though the principle remains exactly the same and the maxim "the better the bill, the better the rate," invariably applies. Consequently, such allowances must always be made by the bank in the same way as it takes its exchange profit in the rate, and the following rules should be clearly understood—

(a) *In currency rates*, the buyer must receive an allowance for loss of interest, and this is done by giving him more foreign units per pound; therefore always **ADD** interest to currency rates, allowing the higher rate of interest when the bank is buying, and the lower rate of interest when the bank is selling;

(b) *In pence rates*, the buyer receives compensation for loss of interest by paying fewer pence per foreign unit; therefore, always DEDUCT interest from pence rates, at the higher rate when the bank is buying, and at the lower rate when it is selling;

(c) The allowance for profit is made in the usual way by adding to the currency rate or by deducting from the pence rate when buying, and by deducting from the currency rate, or by adding to the pence rate when selling.

These rules are made clear by the following examples.¹ Where the T.T. rate on New York is $\$4.86\frac{1}{2} - \frac{1}{2}$ per £, and the margin for cheque over cable is $\frac{3}{8} - \frac{7}{16}$ c., the bank will—

SELL T.T. at $\$4.86\frac{1}{2}$ per £, less its profit of, say, $\frac{3}{8}$ c., making a net rate of $\$4.86\frac{3}{8}$ per £;

SELL Cheque at $\$4.86\frac{1}{2}$ per £, plus its selling margin of interest of $\frac{3}{8}$ c., making $\$4.86\frac{1}{2}$, less its profit of $\frac{3}{8}$ c., making a net rate of $\$4.86\frac{1}{2}$ per £;

BUY T.T. at $\$4.86\frac{1}{2}$ per £, plus its profit of $\frac{3}{8}$ c., making a net rate of $\$4.86\frac{3}{8}$ per £;

BUY Cheque at $\$4.86\frac{1}{2}$ per £, plus its buying margin for cheque of $\frac{7}{16}$ c., making $\$4.86\frac{1}{8}$, plus its profit of $\frac{3}{8}$ c., making a net rate of $\$4.86\frac{3}{8}$ per £.

Where the T.T. rate on Singapore is 2s. $4\frac{1}{8} - \frac{1}{4}$ d. and the margin for cheque against cable is $\frac{1}{8} - \frac{1}{16}$ d., the bank will—

SELL T.T. at 2s. $4\frac{1}{8}$ d. per S.S. dollar, plus its profit of, say, $\frac{1}{16}$ d., making a net rate of 2s. $4\frac{3}{16}$ d. per S.S. dollar;

SELL Cheque at 2s. $4\frac{1}{8}$ d. per S.S. dollar, less its selling margin of interest of $\frac{1}{16}$ d., making 2s. $4\frac{1}{16}$ d., plus its profit of $\frac{1}{16}$ d., making a net rate of 2s. $4\frac{3}{16}$ d. per S.S. dollar;

BUY T.T. at 2s. $4\frac{1}{8}$ d. per S.S. dollar, less its profit of $\frac{1}{16}$ d., making a net rate of 2s. $4\frac{3}{16}$ d. per S.S. dollar;

BUY Cheque at 2s. $4\frac{1}{8}$ d. per S.S. dollar, less its buying margin of interest of $\frac{1}{16}$ d., making 2s. 4d., less its profit of $\frac{1}{16}$ d., making a net rate of 2s. $3\frac{15}{16}$ d. per S.S. dollar.

It is highly important that the rules for making these allowances should be thoroughly understood, and the student is advised to study them at length, and perfect his knowledge by taking the published rates in the newspapers and working out buying and selling rates for himself, afterwards comparing his results with those which would have been obtained by following out the rules given above. All the above rates are assumed to be "market" rates, so that the eventual net rates obtained would be the dealer's actual dealing rates as quoted to customers in cases where he felt justified in taking such a margin of profit.

¹ Allowances for expenses, such as brokerage, cables, etc., have been ignored in these simple examples.

Basis of Interest for Demand Rates.

The rates of interest commonly allowed for by a dealer in quoting Demand rates to customers are, for *buying*, the rate of interest at which he would be charged for an overdraft in the foreign centre, since he is assumed to cover his purchase of cheque by a sale of T.T., and so overdraw his account abroad until the arrival and credit of the cheque; for *selling*, the rate of interest which he receives on current account in the foreign centre, since he is assumed to cover his sale of cheque by a purchase of T.T. on which he will be allowed interest by his agent abroad at the usual rate for current account balances until the cheque is presented and paid to his debit.

The "spread" between T.T. and cheque quoted in the market is based on the rate for Call Money ruling in the foreign centre, since holders of funds there will not sell T.T. and buy cheque unless they receive an allowance which represents at least the same rate of interest as could be earned by the foreign funds if loaned in the Money Market in the foreign centre, while sellers of cheque must be prepared to allow at least this rate of interest, and may be prepared to allow more if a sale of cheque against T.T. is necessary for them to avoid an expensive overdraft, or if they can employ the T.T. so obtained at a better rate of interest until the payment of the cheque, as by loaning the funds on the Stock Exchange in the foreign centre.

It must be remembered that in the case of a purchase and sale of cheque against T.T., the sterling payments for the cheque and for the T.T. are almost always "compensated," i.e. payment for the cheque is made by the buyer on the same day as he receives payment for the T.T. which he has sold, or, in other words, the purchase of the cheque and the sale of the T.T. are made "value same day." Thus, there is no gain or loss of interest on the sterling side of such transactions, and it is simply a case of the seller of the T.T. being deprived of the use of his foreign funds for a certain time, this use being enjoyed by the seller of the cheque, and the "cheque spread" (or margin between T.T. and cheque) merely gives compensation to the buyer of the cheque for the loss of the use of his immediately available funds, which he disposes of by his sale of T.T.

The advantage of the Guaranteed Mail Transfer (G.M.T.) is now apparent. Any owner of immediately available funds can, as it were, loan them to another party for an exact period of time by

selling T.T. and buying a G.M.T. for payment on a stated date, and can, at the same time, be assured of a rate of interest at least as high as that which he could himself obtain by using the funds in the other centre, otherwise he would not undertake the operation. The utility of such transactions to both parties and the method of arriving at the "cheque spread" can be illustrated by the following example.

If the Call Money rate in New York is $1\frac{1}{2}$ per cent per annum, the overdraft rate there is 4 per cent per annum, one exchange operator has funds lying to his credit there as cover for drafts sold to customers on a low interest basis or against a forward sale of dollars, and another exchange operator is short of immediate funds owing to sale of T.T.s as cover for purchases of cheques on a high interest basis from customers, or against forward purchases, the former operator can only obtain $1\frac{1}{2}$ per cent per annum if he uses his balance for a few days in the New York Money Market, while the latter would have to pay 4 per cent for an overdraft with his agent until the proceeds of his purchases were credited to his account there. There will probably be several operators in the market here in each of these positions, and force of competition between owners of funds and borrowers will eventually hammer out a dealing rate for cheque against T.T. based on a rate of interest somewhere between $1\frac{1}{2}$ per cent and 4 per cent per annum, say $2\frac{3}{4}$ - 3 per cent. The actual margin or "spread" in any transaction will then depend on the length of time for which the funds are used, a "run" of 8 days needing an allowance of about .32 of a cent, one of 10 days needing about .40 of a cent, one of 12 days needing about .48 of a cent, and so on. In each case the margin is for cheque *over* T.T., that is to say, the rate for cheque is always cheaper than that for T.T., and the margin will vary with the rate of interest agreed to by the parties, and the estimated time which will elapse between the date of purchase and the date of credit, in the case of cheques, demand drafts, or ordinary M.T.s, or the exact time allowed for in the case of a G.M.T. When these two factors have been decided, the working of the margin is merely a matter of a simple interest calculation as the following examples will show.

(a) At what rate would you sell T.T. and buy G.M.T. if the T.T. rate, London on New York, is \$4.86 per £, if you wish to earn 3 per cent per annum on the dollars used, and if the G.M.T. is

guaranteed for payment in 10 days' time from the date of sale of the T.T., and purchase of the G.M.T.? (New York takes 360 days to the year.)

Answer.

$$\text{Interest} = \frac{4.86 \times 3 \times 10}{100 \times 360} = \frac{.0486}{12} = \$0.00405$$

∴ Margin for the G.M.T. will be $40\frac{1}{2}$ points over T.T., i.e. T.T. will be sold at \$4.86, and G.M.T. purchased at \$4.86405 per £.

(b) At what rate would you purchase a cheque on New York from a customer if the London market quotes \$4.85 $\frac{7}{8}$ - 4.86 per £ for T.T.s. if you estimate that the cheque will not be credited to your account until 9 days after the date of purchase, if your agent in New York allows you 1 $\frac{1}{2}$ per cent per annum on credit balances and charges you 4 per cent per annum on overdrafts, and if you require a profit of $\frac{1}{2}$ per mille on the transaction? (New York allows 360 days to the year.)

Answer.

If the market quotes \$4.85 $\frac{7}{8}$ - 4.86 per £, the operator can only sell to the market at \$4.86, and must therefore base his price on this rate. Also as he must assume that he will sell T.T. as cover for his purchase, and so will be overdrawn on his account in New York until the cheque is collected and credited to him, he must allow for interest at the overdraft rate of 4 per cent per annum.

$$\text{Then, Interest} = \frac{4.86 \times 9 \times 4}{100 \times 360} = \frac{4.86}{1000} = \$0.00486.$$

∴ Margin for cheque over T.T. is .486 of a cent.

∴ Buying rate for cheque is \$4.86 plus .486 c.	\$4.86486
Add profit at $\frac{1}{2}$ per mille (operator must take more dollars per £)	.002432
	\$4.867292

∴ Operator will buy cheque from customer at \$4.867292, or \$4.86 $\frac{3}{4}$ nearest, per £.

(c) At what rate would you sell to a customer a cheque on Kobe for 5,000 yen if the London market quotes T.T.s on Kobe as 1s. 11 $\frac{3}{4}$ d. - 2s. per yen, if the cheque will probably be presented and debited to your account 30 days after sale, and if you are allowed interest on credit balances with your agent at 2 per cent per annum, and if you require a profit of $\frac{1}{8}$ d. per yen?

Answer.

The operator can only buy T.T. Kobe from the market at 2s. per yen, and so must base his rate on this price, while he must assume that he will cover the sale by a purchase of T.T. on which he will receive interest at the rate of only 2 per cent per annum.

$$\text{Then, Interest} = \frac{24 \text{ (pence)} \times 30 \times 2 \times 2}{100 \times 365 \times 2} \quad \text{(Multiply numerator and denominator by 2 for use of } \frac{1}{3}\text{rd, } \frac{1}{10}\text{th, and } \frac{1}{10}\text{th rule.)}$$

$$= \frac{2880}{73000}$$

Take $\frac{1}{100000}$ th of 2,880	.	.	.02880
Add $\frac{1}{3}$ rd of this	.	.	.00960
„ $\frac{1}{10}$ th of this	.	.	.000960
„ $\frac{1}{10}$ th of this	.	.	.000096

Deduct $\frac{1}{100000}$ th of this	.	.	.039456
			<u>.000004</u>

$$= .03945$$

∴ Margin for cheque against T.T. is .03945d., or $\frac{1}{32}$ d. nearest, cheaper than T.T.

∴ Operator will sell cheque to customer at 2s. less $\frac{1}{32}$ d., s. d.
 making $1\ 11\ \frac{31}{32}$ per yen
 Add profit (as customer must pay more pence per yen) $\frac{1}{32}$
 Making 1 11 $\frac{32}{32}$

∴ Operator's net rate for selling cheque, Kobe to his customer, will be 1s. $11\ \frac{32}{32}$ d. per yen.

(d) If cheque against T.T. New York is quoted at a margin of 30 points in the London market, with a T.T. rate of \$4.86 per £, and the time of mailing is taken as 10 days, what rate of interest does this show to an operator who sells T.T. and buys cheque? (New York allows 360 days to the year.)

Answer. Using the usual formula—

$$(1) \$.0030 = \frac{4.86 \times 10 \times R}{100 \times 360}$$

$$\therefore 48.6R = 108$$

$$\therefore R = \frac{1080}{486} = 2.222$$

$$\begin{array}{r} 486 \overline{)1080} \quad (2.222 \\ \underline{972} \\ 1080 \\ \underline{1080} \\ 0 \end{array}$$

∴ Rate of interest represented by a margin of 30 points for a 10 days' run on a T.T. rate of \$4.86 per £ is 2.222 per cent per annum.

The same formula can be used to ascertain the number of days for which a G.M.T. must be fixed to allow of a certain margin over T.T. at a stated rate per cent per annum.

The operation of "swapping" T.T. against G.M.T., or cheque, is now such a usual method of using or obtaining temporary funds either in London or in New York, and is so largely dealt in between the chief centres, that most operators have constructed tables showing the equivalent rate per cent per annum produced by any given margin, within practicable limits, for any given number of days up to 91 (for use in obtaining the equivalent rate per cent of a forward margin, which see later). Operations on cheque or G.M.T. can also be undertaken to provide funds on the home centre. If the margin for "short forwards," i.e. foreign currency for delivery a few days ahead, is at a discount over the T.T. or "spot" rate, the operator can sell cheque or G.M.T. for immediate cash in the home currency and cover himself by buying the foreign currency needed to meet the cheque "forward" for a date to coincide with the probable date of presentation of the cheque or maturity of the G.M.T. He will not have to pay for the "forward" purchase of the foreign currency until the date of delivery and so is left with the use of the home funds in the meantime. For such an operation to be profitable, the discount on the "short forward" must be great enough to reduce the rate of interest represented by the cheque margin to below the rate of interest for short-term loans ruling on the home market.

Long Rates and "Tel Quel" Rates.

Many countries have export trades in which it is so customary to allow a recognized period of credit to a buyer that such a lapse of time before payment has come to be accepted as a matter of course, or even of legal right, as in the case of the "three days grace" in this country. Consequently, bills drawn by or on that country have come to possess a "customary usance," or a certain tenor at which all such bills are drawn. Thus, in most of the South American countries, the "customary usance" is 90 days after sight, in the American cotton trade it is 60 days after sight, in certain French textile trades it is 30 days after date, and so on. Such bills came forward for purchase so regularly before the War that rates were quoted for them as a matter of course, and these rates were known

as "Long" rates since they were for "long bills," or bills at tenor as distinct from demand drafts or cable transfers. The falling off in the use of trade bills and the almost universal use of the T.T., which was the result of the disturbance of commercial confidence and the wide fluctuations in rates of exchange following the War, led to the gradual dropping of the quotations for "long" rates in the London market, especially as the London banks had by then established their own Foreign Departments, and were prepared to purchase and hold against spot or forward sales any long bills in foreign currency which might be offered to them by their customers, instead of re-selling them to the foreign banking houses as was their custom before the War. The use of the commercial bill, however, has been steadily reviving during the past few years, and it is essential that an exchange operator should be able to calculate quickly and accurately a "long" rate for any draft at usance which may be offered to him for purchase.

A "Tel Quel" rate (or a t.q. rate) is literally a rate for a bill "such as it is"; in other words, it is a rate of exchange calculated to apply to a bill having any period of time still to run. The original "long" rates were calculated on fixed usances, e.g. for the purchase of 90 d/d bills, to allow for the necessary loss of interest from the date of purchase until the estimated date of payment, plus expenses, but bills often came forward for purchase of which a certain portion of the usance had already expired. Thus, if a customer drew at 90 d/d on a buyer in Lisbon, sent the draft for acceptance and return, and offered it for sale here only after it had been returned to him duly accepted, the maturity date would be at least ten days nearer than the estimated maturity date allowed for in the quoted long rate for 90 d/d drafts just drawn, and the buyer would have to make an allowance to the seller in respect of the difference in interest lost. This could be done either by making an allowance in the long rate for the time already run or by calculating a new rate from the basic T.T. rate to allow for the loss of interest during the remaining period of the currency of the bill, plus expenses. In either case, the resulting rate was said to be a "tel quel" rate since it was exactly fitted to the particular bill.

In point of fact, most rates other than T.T. rates can be considered as "tel quel" rates. A rate for a demand draft is now calculated from the T.T. rate on the basis of interest lost and any incidental

charges, and nearly every bill offered to a bank for purchase has either rather more or rather less than an exact 60 or 90 days to run, so that an exact allowance for interest must again be calculated. There is, then, no difference in the method of calculation from the basic T.T. rate of a demand, a long, or a "tel quel" rate. In all cases, allowance is made for interest lost (at the bank's rate for advances when buying or at its rate for deposits if selling), any stamps or collecting charges the cost of which must be borne by the buying bank, and an allowance for profit.

It may be repeated that a bank very rarely *sells* a tenor draft of its own drawing, and should it do so, it would make no allowance to the buyer for the cost of any stamps or collecting charges which would have to be borne by him but would, in fact, charge him with the cost of the English stamp on the draft and with an allowance for profit, and would only allow him interest at the lower rate for the exact period between the date of purchase and the estimated date of payment and debit to the bank's account in the foreign centre.

The following examples show the methods of calculating long and "tel quel" rates for buying drafts, in currency and pence rates, and a theoretical example of the sale of a tenor draft by a London bank to a customer. The principles are exactly the same as those set out for the calculation of demand rates, with the addition that costs of stamp and collection charges are allowed against the seller—

(a) At what rate would you purchase from a customer a 90 d/s draft with documents attached, on San Francisco, if the T.T. rate London on New York is $\$4.85\frac{7}{8} - 4.86$ per £, if the time of mailing from London to New York is 10 days, from New York to San Francisco 5 days, and the return journey the same, if market discount rates for commercial paper are 3 per cent in London, and 4 per cent per annum in New York, if the stamp duty in the U.S.A. is $\frac{1}{2}$ per mille *ad valorem*, if your agent makes a charge for collecting documentary drafts of $\frac{1}{2}$ per mille *ad valorem*, and if you require a profit of $\frac{1}{32}$ c. in the rate? (U.S.A. takes 360 days to the year.)

N.B. It is highly important to note that the rate of interest to be applied in the purchase of any tenor draft is the rate of discount at which the bank is prepared to buy such paper. In the case of Inland bills, it is obviously the ruling rate in this country for the class of paper in question. In the case of foreign bills, it is the rate, at least, at which the buying bank could re-sell the draft so as to

provide immediate foreign funds ; in other words, the rate at which it could re-discount the draft should it so wish. Consequently, in all foreign exchange rates in which interest must be allowed for, *the rate of interest to be applied is the rate of interest ruling in the foreign centre.* In the case of cheque, or demand, or short rates, this rate of interest will be the rate for temporary overdrafts, when buying, or for short loans in the foreign Money Market, if selling. For drafts at longer tenor, the rate will be *the rate at which such drafts could be re-discounted in the foreign centre in case of need,* i.e. the foreign market discount rate for that class of paper, when buying, or for a fixed deposit of foreign funds for the period, if selling.

In this example, the rate of interest must, therefore, be the rate for such paper *ruling in New York*, which is given as 4 per cent per annum. The buying bank will be out of its money for 10 days mailing to New York, plus 5 days on to San Francisco, plus 90 days currency of the draft (since it cannot be "sighted" until it arrives in San Francisco, and so does not commence to run until then, while no days of grace obtain in the U.S.A.), plus 5 days for the return remittance from San Francisco to New York, making a total of 110 days from the date of purchase until the estimated date of credit of the proceeds in New York.

Working interest for this period at 4 per cent per annum on the rate at which the bank would buy T.T., viz. \$4.86 per £, without allowing for profit, gives—

$$I = \frac{4.86 \times 110 \times 4}{100 \times 360} = \frac{.5346}{9} = \$.0594$$

The bank must therefore take \$.0594 *more* per £ than the T T. rate to cover loss of interest.

It must also take *more* dollars per £, to cover the cost of U.S. stamp agent's charges, and its own profit.

Therefore, the final buying rate will be—

T.T. rate	\$ 4.86
Plus interest for 110 days at 4 per cent per annum . . . . .	.0594
„ U.S. stamp at $\frac{1}{2}$ per mille on \$4.86 . . . . .	.00243
„ agent's charge of $\frac{1}{2}$ per mille on \$4.86 . . . . .	.00243
„ bank's profit . . . . .	.0003125
	\$4.9245725

∴ The required buying rate would be \$4.9245725, or \$4.92 $\frac{2}{3}$ nearest, per £.

(b) At what rate would you purchase a 90 d/s draft on Montevideo if the London market rate for T.T.s is $36 - \frac{1}{2}$ d., if the market rates of discount for such bills are $2\frac{1}{2}$ per cent in London, and 6 per cent in Montevideo, if the time of mailing is 21 days, and there are no days of grace in Uruguay, if the foreign stamp duty is $\frac{1}{2}$ per mille *ad valorem*, if your agent makes a collecting charge of $\frac{1}{4}$ per mille, and if you require a profit of $\frac{1}{32}$ d.?

The rate of interest applicable is that ruling in the foreign centre, which is 6 per cent per annum, and the total period between the date of purchase and probable date of credit is 21 plus 90 days, making 111 days in all. The bank can only sell T.T. Montevideo to the market, as cover, at 36d. per peso, and so must base its buying rate on this price.

The interest at 6 per cent per annum for 111 days on 36d. will be—

$I = \frac{36 \times 111 \times 6 \times 2}{100 \times 365 \times 2}$	(multiply numerator and denominator by 2 for $\frac{1}{3}$ rd, $\frac{1}{10}$ th, and $\frac{1}{10}$ th rule)
= 47952	Take $\frac{1}{100000}$ th of 47,952 47952
73000	Add $\frac{1}{3}$ rd of this 15984
= 6568767d.	" $\frac{1}{10}$ th of this 015984
	" $\frac{1}{10}$ th of this 0015984
	Deduct $\frac{1}{100000}$ th of this 47952
	<u>6568767</u>

The bank must give *fewer* pence per peso to cover this loss of interest and fewer pence still to cover foreign stamp, agent's charge, and profit.

It will therefore calculate its buying rate thus—

	d.	d.
T.T. rate		36
Deduct interest for 111 days at 6 per cent per annum on 36d.	6568787	
" foreign stamp at $\frac{1}{2}$ per mille	018	
" agent's charge at $\frac{1}{4}$ per mille	009	
" allowance for profit	03125	
	<u>7151267</u>	
	Net	<u>35.2848733d.</u>

∴ The required buying rate would be 35.2848733d., or $35\frac{3}{32}$ d. nearest per peso.

(c) On 8th June, 1931, a customer presents to you for purchase, a bill on Berlin drawn at 5 months date from 30th April, 1931. If

the London market quotes T.T.s on Berlin at $20\cdot43\frac{1}{2} - 44$, if the market discount rates for such paper are 3 per cent in London, and 5 per cent per annum in Berlin, if German stamp duty at $\frac{1}{2}$ per mille *ad valorem* must be paid, and if you require a profit of $\frac{1}{4}$ per mille, what buying rate would you quote to your customer?

A 5 m/d bill drawn on 30th April, 1931, matures on 30th September, 1931, there being no days of grace in Germany. On 8th June, 1931, the bill has therefore 114 days still to run (22 in June, 31 in July, 31 in August, and 30 in September), and the bank will therefore be out of its money for this period. T.T. could only be sold as cover in the London market at $20\cdot44$ per £, and the bill could only be re-discounted in Berlin at 5 per cent per annum.

The interest to be allowed is therefore—

$I = \frac{20\cdot44 \times 114 \times 5 \times 2}{100 \times 365 \times 2}$ $= \frac{23301\cdot6}{73000}$ $= \cdot3192$	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="padding-right: 10px;">Take $\frac{1}{100000}$th of 23,301·6 .</td> <td style="text-align: right;">·233016</td> </tr> <tr> <td style="padding-right: 10px;">$\frac{1}{3}$rd</td> <td style="text-align: right;">·077672</td> </tr> <tr> <td style="padding-right: 10px;">$\frac{1}{10}$th</td> <td style="text-align: right;">·0077672</td> </tr> <tr> <td style="padding-right: 10px;">$\frac{1}{10}$th</td> <td style="text-align: right;">·00077672</td> </tr> <tr> <td></td> <td style="text-align: right; border-top: 1px solid black;">·31923192</td> </tr> <tr> <td style="padding-right: 10px;">Less $\frac{1}{100000}$th</td> <td style="text-align: right;">·00003192</td> </tr> <tr> <td></td> <td style="text-align: right; border-top: 1px solid black; border-bottom: 3px double black;">·3192</td> </tr> </table>	Take $\frac{1}{100000}$ th of 23,301·6 .	·233016	$\frac{1}{3}$ rd	·077672	$\frac{1}{10}$ th	·0077672	$\frac{1}{10}$ th	·00077672		·31923192	Less $\frac{1}{100000}$ th	·00003192		·3192
Take $\frac{1}{100000}$ th of 23,301·6 .	·233016														
$\frac{1}{3}$ rd	·077672														
$\frac{1}{10}$ th	·0077672														
$\frac{1}{10}$ th	·00077672														
	·31923192														
Less $\frac{1}{100000}$ th	·00003192														
	·3192														

The bank will require *more* marks and pfennige per £ to cover loss of interest and expenses so that the final buying rate will be calculated thus—

T.T. rate	20·44
Add interest for 114 days at 5 per cent per annum on 20·44	·3192
,, German stamp duty at $\frac{1}{2}$ per mille on 20·44	·01022
,, bank's profit at $\frac{1}{4}$ per mille on 20·44	·00511
	20·77453

∴ The required quotation is, Rms. 20·77453, or Rms. $20\cdot77\frac{1}{2}$ nearest, per £.

(d) A New York banker has offered to him for purchase a 60 d/s draft on London for £2,389 14s. 4d. The market rates in New York for T. T.s on London are $\$4\cdot86\frac{1}{2} - \frac{1}{4}$ per £, discount rates are 3 per cent in London and 2 per cent per annum in New York, time of mailing is 8 days, English bill stamp may be taken at $\frac{1}{2}$ per mille *ad valorem*, and the banker requires a profit of $\frac{1}{3}\frac{1}{2}$ c. in the rate. At what rate will he purchase the bill from his customer?

The New York banker will have to pay out dollars on the spot and receive sterling in about 2 months' time. He must therefore pay out as few dollars per £ as possible, and so must *deduct* from his buying rate for T.T.s all the necessary allowances. He can only sell sterling T.T. to the New York market as cover at the *lower* quoted rate, as a buyer of sterling would give as few dollars per £ as possible. He must therefore base his rate on \$4.86½ per £, and must take the London discount rate as he could only re-discount the bill there at that rate. He will be out of his money for 8 days mailing, plus 60 days currency of the bill after it has been "sighted," plus 3 days grace, making 71 days in all.

The interest will therefore be (taking London terms of 365 days to the year)—

$$I = \frac{4.86125 \times 71 \times 3 \times 2}{100 \times 365 \times 2}$$

1000000th of 2070.8925	.	.020708925
And ¼th of this	.	.006902975
„ 10th of this	.	.000690297
„ 10th of this	.	.000069030
		.028371227
Less 100000th of this	.	.000002837
		.028368390

$$= \frac{2070.8925}{73000}$$

He will now build up his 60 days rate by deducting from the T.T. rate the allowances for interest and expenses thus—

	\$	\$
T.T. rate		4.86125
<i>Deduct—</i>		
Interest for 71 days at 3% per annum on this rate . . . . .	.0283684	
English stamp duty at ¼%/100 on \$4.86½ . . . . .	.0024306	
Banker's profit of 3½ c. . . . .	.0003125	
	.0311115	
		\$4.8301385

∴ The required rate is \$4.8301385 or \$4.83½ nearest, per £.

Note again that the New York banker pays fewer dollars per £ in the same way that an English banker would pay fewer pence per foreign unit.

(e) Where a banker is prepared to *sell* a tenor draft on a foreign centre in the foreign currency, he would calculate the rate to be applied as follows.

To sell a 90 d/s draft on New York, if the time of mailing is 10 days, if he is prepared to allow interest on 3 months dollar deposits

at 2 per cent per annum, if the market rates in London are \$4.86 - $\frac{1}{4}$ per £ for T.T.s on New York, and the margin for cheque over T.T. is 30 to 33 points, and if he requires $\frac{1}{8}$ c. profit in the rate, the banker must assume that he will cover his sale by a purchase of spot, i.e. T.T., and must regard this as a deposit from the customer on which interest at only 2 per cent per annum is allowable. Also, the market will only sell cheque at 30 points over T.T., and this is, therefore, the allowance to be made for the time of mailing. He must base his rate, then, on the price at which he can buy T.T. from the market, plus the market's margin over T.T. for selling cheque, plus 90 days currency of his draft after arrival on the other side, as the customer will expect to receive as much compensation for the time of mailing as he would receive in the case of buying a cheque from the banker, and a further allowance for loss of interest during the currency of the draft, both of which mean that he will expect *more* dollars per £ than if he had bought T.T. On the other hand, the banker must take his profit by giving *fewer* dollars per £, and this item must therefore be deducted when compiling the rate, as must the cost of the English stamp on the draft which the banker must provide. The banker will calculate thus—

	\$	\$	
Selling rate for T.T.		4.86	
Add cheque margin . . . . .		.0030	
„ interest for 90 days at 2 per cent per annum on 4.86 . . . . .		.0243	
		\$4.8873	
Deduct banker's profit of $\frac{1}{8}$ c. . . . .	.0003125		
„ English stamp at $\frac{1}{2}$ per mille . . . . .	.00243		
	.0027425		
		\$4.8845575	

∴ The rate at which the banker will sell at 90 d/s draft on New York is \$4.8845575, or \$4.88 $\frac{1}{8}$ nearest, per £.

Note that the customer receives no allowance for the cost of U.S. stamp duty or for any expenses of collection which he may incur, but must pay these out of his own pocket, whereas the banker, when buying, charges up to the customer in the rate quoted, all the expenses which are involved by the presentation and collection of the instrument purchased.

In the case of a currency for which a pence rate is quoted, a

banker who was prepared to sell a tenor draft on the foreign centre in the foreign currency would compile his selling rate thus: If the London market rate for T.T.s on Montevideo is $35\frac{7}{8} - 36d.$, if no market cheque margin is quoted, but the time of mailing is taken as 30 days, if the banker can earn interest on 3 months' deposits of pesos at 3 per cent per annum, if he requires a profit of $\frac{1}{8}d.$ in the rate, and he is prepared to sell a 90 d/s draft on Montevideo, he must charge the customer fewer pence per peso for the equivalent of the interest lost by the customer during the time of mailing and the currency of the draft; he cannot afford to allow interest at any higher rate than that which he himself will receive on a fixed deposit of the T.T., which he must assume he will buy as cover; he can only buy T.T. from the market at 36d. per peso, and so must base his selling rate on this price.

Then he will sell at—

	<i>d.</i>
T.T. rate	36
Deduct interest for 120 days at 3 per cent per annum on 36d. . . . .	.36
	35.64
Add banker's profit (as he must charge <i>more</i> pence per peso to cover this) . . . . .	.015625
„ cost of English stamp at $\frac{1}{4}$ per mille . . . . .	.018
	35.673625

∴ The rate at which the banker will sell at 90 d/s draft on Montevideo is 35.673625, or $35\frac{7}{8}\frac{3}{4}$ nearest, pence per peso.

(The interest shown in the above two examples is approximate only.)

Similar results could be obtained in all the above examples by adjusting the interest in the amount of the bill, i.e. by discounting the bill and arriving at its present value in terms of the foreign currency, and then allowing in the rate for the expenses and profit only, converting the reduced amount of the bill at the only partly inclusive rate. In nearly all cases, however, a banker will have to quote a *rate* to a customer, and so must work a long or a "tel quel" rate on the spur of the moment. A careful study of the rules set out above, and of the examples given should enable students to obtain a clear grasp of the principles involved, but only constant practice can bring real facility in working out such calculations in a matter of seconds only, and this the professional exchange operator has to do several times daily.

The whole has been presented in its simplest form, but a thorough grasp of the principles involved and the intelligent application of these principles should enable the reader to solve far more complicated problems. Further examples are given in the shape of Model Answers to the Arithmetical Questions in the Final Examination on Foreign Exchange of the Institute of Bankers during the past few years, which appear in the Appendix.

CHAPTER XI

THE LONDON FOREIGN EXCHANGE MARKET; OTHER MARKETS

BEFORE the War, the volume of exchange business transacted in London was comparatively small. World economic and financial conditions were relatively stable with the result that the principal exchanges fluctuated only between narrow limits, and bankers and merchants in this country paid small attention to the risk of loss in exchange which might arise from adverse movements in rates. In addition, by far the greater part of the trade of this country, both import and export, was conducted in terms of sterling so that any exchange operations were left to the foreign seller or buyer of goods, while our vast foreign lendings were nearly always made in terms of sterling, and the proceeds were withdrawn from this country by the borrowers in the shape of goods, services, securities, or gold. The chaotic financial conditions which prevailed in most of the countries in Europe immediately after the War led to wild and rapid fluctuations in the values of currencies in terms of each other, and the possible loss owing to adverse exchange movements during the currency of any international debt became prohibitive to the granting of credit, and this was greatly enhanced by the general loss of confidence and prevailing distrust. At the same time all Europe was suffering from a shortage of raw materials, and everyone was anxious to turn the machinery of commerce to peaceful uses once more, and the actual number of commercial transactions suddenly increased greatly while, prices having risen considerably, the amounts required to discharge these transactions were correspondingly larger. The loss of confidence and lack of credit facilities led to each transaction being conducted practically on a cash basis, and the exchange operators of the world found themselves faced with continuous supplies of and demands for currencies in respect of the actual *turnover* of international trade instead of only having to arrange for the discharge of temporary *balances* of indebtedness as in former days. London bankers were even more affected than those in other centres since the pre-war mechanism of the London

Foreign Exchange Market was designed to cope with only the small number of exchange operations which arose out of such part of our trade and finance as was conducted in terms of other currencies, whereas the heavy and rapid movements in exchange rates during the immediate post-war period caused the foreigner to refuse to accept the exchange risk which would be his as long as he dealt in terms of sterling, and so forced our financiers and merchants to deal in terms of foreign currencies.

The development of the London Foreign Exchange Market in 1919 was unparalleled in its rapidity and extent. The old market had been conducted by means of the bi-weekly meetings of dealers and brokers in the Royal Exchange, by personal visits of brokers to the different dealers throughout each day, and only to a limited extent by means of the telephone. The enormous increase in the volume of business and the essential need for rapidity of execution of orders, owing to the extremely rapid and frequent movements in rates, soon proved the old system to be almost useless, and dealers, customers, and brokers alike had recourse to the telephone as the most speedy method of keeping in touch with each other. The existing telephone facilities, however, proved inadequate, and the brokers began to develop as rapidly as possible the system of "private" telephone lines to their clients the banks. The pressure on the international "Trunk" telephone system also became overwhelming, a delay of 4 hours in obtaining a call to Paris being quite common during business hours, and the postal authorities on both sides of the Channel had to take steps to provide increased facilities. To-day, a network of private telephone lines links together the foreign exchange brokers and the exchange operators in the banks and the financial houses, while international telephonic communication has been extended to cover practically all the countries of Europe, and the recent development of long-distance wireless telephony has brought the Americas and the Antipodes within speaking distance. So highly organized have international communications now become that for financial and exchange purposes the whole world can now be regarded as comprising one market only, and a market which very nearly conforms to the definition of the late Professor Marshall.

With the improvement of the necessary machinery for handling exchange transactions in London came an ever increasing volume

of business. The wide and frequent movements in rates made the foreign exchange market the happy hunting-ground of the speculator in every centre of importance, and it is reported that when activity in exchanges was at its height one of the older pre-war dealers remarked that at one time he used to conduct his business in a decent and orderly manner for gentlemen with gentlemen, but that now he was expected to behave like a madman, and to endeavour to do business with all the crooks of Christendom, Jewry, and Coney Island! The scenes in the offices of the exchange dealers and brokers for 8 or 9 hours a day during "boom" periods such as during the immediate post-war years or following the suspension of gold payments first in this country and then in the U.S.A., almost defy description. Anything from six to twenty men crowded into a small room full of switch-boards and telephone instruments, all shouting at the top of their voices, and all striving to follow the conversations of their colleagues while conducting conversations themselves with one, and often two, clients at the same time, waving their arms, making mystic signals to each other, using, in the heat of the moment, language which made the *Evening News* announce that the palm for a certain dubious distinction had passed from Billingsgate to the Foreign Exchange Market!

Composition of the London Market.

From the international point of view the London Foreign Exchange Market consists of those banks and financial houses who maintain foreign exchange departments, and who are regular dealers in foreign currencies. Banks in every other important centre are continually in touch by telephone or cable with these foreign exchange departments, and the bank officials acting as foreign exchange operators must be prepared to quote whatever rates they may be asked for, and on their ability and acumen depends not only the greater part of the profit of their department, but also the reputation abroad of the bank they serve, with resulting accretion or loss of other classes of business from pleased or dissatisfied customers amongst the banks abroad. It must be remembered that competition between banks everywhere for whatever profit is to be made out of keeping the current accounts of other banks, discounting bills for them, making or taking loans to or from them, opening credits for them, executing their orders in the stock markets, etc.,

is very keen, and no one is in such personal contact with representatives of other banks in other centres as is the exchange dealer. Consequently, a dealer who is highly efficient at his work and can establish and maintain friendly relations with exchange dealers in important banks abroad, may produce for his bank other and more lucrative business through the prestige which may attach to his bank through his exchange operations. This represents a difficult task as, owing to the close communications now existing between all the most important centres of the world, deviations in the rates quoted for the same currency in different centres seldom exist for long, and competition for business is so keen that the margin quoted between buying and selling rates (which represents the operator's profit or "dealer's turn") has sometimes to be reduced to very meagre proportions.

As an example of this, it may be mentioned that the sterling-dollar rate was for some years quoted with a margin of not less than $\frac{1}{8}$ c., e.g. $4.86\frac{1}{8} - \frac{1}{8}$, equal to about $\frac{1}{4}$ per mille, but this margin was steadily narrowed down by fierce competition until quotations were made with a "two-point" spread, e.g. $4.86.03 - .05$, equal to about $\frac{1}{2}$ per 10,000, so that a dealer buying at the top and selling at the bottom of such a spread would make a gross profit of only £2 10s. on £50,000! For a time, after our suspension of gold payments in 1931, a return to a fixed marginal quote of $\frac{1}{8}$ c. was made by general agreement, but again internecine competition between the banks caused a demand for a "free market" in all major currencies and, as from 1st March, 1937, the brokers agreed not to maintain any artificial marginal spread, but to quote the actual rates at which they expected to find buyers and sellers, no matter how narrow the spread; a margin of five points is now usual, e.g. $4.86.45 - .50$ or $4.97.73 - .78$, but two or even one point quotes are made on quiet markets. It should also be remembered that the bank charges up to its foreign department a proportion of the general overhead charges of the office, and that the department is treated on the same terms as a customer by the other offices and departments of the bank. It is charged the usual lending rate of interest for any money it is forced to use in its operations, but should these operations result in it being in credit with the bank, it will receive interest only at the bank's borrowing rate. The exchange dealer, therefore, must make a certain profit out of his

operations merely to cover the expenses of his department, and as the margins of profit are so narrow he must endeavour to make his turnover of business as large as possible in order that he may show a net profit after paying expenses.

Moreover, the source of the greatest profit in exchange dealing is almost barred to him. This source is the profit which *may* be made by "taking up a position," in other words, by buying currency to hold for an indefinite period in the expectation of an appreciation in its value, or by "selling short" of a currency in the hope of a fall in its value at some future date. While considerable profits can be made by well-judged or lucky operations of this nature, heavy losses are also likely to be incurred, and such business must be considered as speculation in foreign currencies. It is utterly foreign to the policy of British banks to encourage speculation of any kind, even on the part of their customers and certainly not on their own behalf, and the exchange dealers in London, with very few exceptions, have strict instructions to "go home with a square book," that is, they must see that the total of their purchases for the day of any currency is approximately the same as the total of their sales of that currency.

Consequently, the exchange dealers of the London banks are forced to depend largely for their profits on any small margins which they can squeeze out of their customers or which may exist between the prices ruling in other centres for the same currency at the same time, and on the profits which they may make by "running a position" during the day, which necessarily depends on the ability of the individual dealer to forecast accurately movements in the international value of the various currencies which may take place during the day. For example, a dealer may find awaiting him in the morning a small batch of orders from New York to buy French francs. If, after he has had communication by telephone with Paris and other Continental centres, he finds that French francs appear to be generally in demand, he may decide to "go long" of some of this currency, which he does not at the moment require, in the expectation that the general demand will make the franc appreciate in value, so that he can sell out his surplus at a profit before the close of the day. It is, however, very easy for the most experienced to be misled as to the probable effects of current conditions on the exchanges, especially as there is now so much artificial control of,

and unexpected official interference with, the exchanges on the part of central banking authorities, that even these temporary positions are taken up in only comparatively small amounts.

Internally, the London Foreign Exchange Market consists of the foreign exchange departments of the banks and financial houses, which still number over 100, and the foreign exchange brokers, who still number thirty, but there is no recognized meeting-place.

The market is under the control of the London Foreign Exchange Bankers' Committee assisted by a Committee of the London Foreign Exchange Brokers' Association. Both these bodies originally came into being shortly after the War, but the higher authorities of the banks refused to allow their exchange dealers to commit themselves to any course of action which might limit their freedom to deal how and with whom they chose and they also refused to recognize officially the Brokers' Association. Disciplinary action in the market was therefore impossible and defections on both sides led to both organizations becoming moribund. Our suspension of gold payments in September, 1931, however, gave rise to so many problems and to such a need for common and regularized action that both the Bankers' and Brokers' Associations were re-constituted at the special request of the Bank of England. The Brokers' Association received official recognition and its Committee is called into consultation by the Bankers' Committee as and when necessary. These Committees regulate the working conditions of the market, such as the fixing of the customary "value dates" for dealings in every currency, the rates of brokerage to be paid, the method of handling outstanding payments in a centre in which, for instance, a moratorium has been declared, etc. There is no restriction placed on the entry of any bank or financial house as a new member of the market, save the extent to which its name will be taken by the existing market members, but any new brokerage firm must obtain the consent of both Committees before starting business.

As all business is transacted in the first place by word of mouth only, the standing and reputation of any firm which desires to deal in the market is of the first importance. By common consent no merchant firm or commercial house is allowed to deal direct with the market, but must transact its business with a bank. The operations of the smaller banks are restricted to the extent to which their

names are taken by the larger banks, and any new bank is only gradually accepted as a member of the market as its standing and resources become fully known.

The Foreign Exchange Broker.

As stated above, a foreign exchange broker must either be an established firm already a member of the London Foreign Exchange Brokers' Association or must produce such credentials and such offers of support as to permit both the Brokers' and Bankers' Associations to accept him as a desirable addition to the machinery of the market. The exchange broker is not, strictly speaking, a "member" of the exchange market. The actual "members" are the banks and houses who *deal* in the market and the broker does not *deal* but merely provides the dealers with a channel through which their operations in London can be carried out. His capital is more a reputation for ability and integrity than a large cash backing, since he is not concerned with the payment of or for the amounts of foreign currency passing between the dealers. It is a profession calling for a clear head, a high code of honour, and unlimited energy—together with, at times, a thick skin!

Since the brokers depend entirely on the goodwill of the dealers, their activities are limited to such functions as the dealers will permit them to perform. They must deal only between banks who are recognized members of the market; they must only act as intermediaries in bringing buyers and sellers together, and are not allowed to deal for their own account; they must not take any profit in the rate at which a deal is arranged by them, but must rely for their remuneration on the standard scale of brokerages, for that particular deal; brokers are not allowed to deal with banks in centres abroad, as the dealers here would consider any such attempts as tending to disturb their existing direct relations, and could prevent business from resulting by refusing to take any foreign names offered to them in this market.

The limited activities of the London Foreign Exchange broker are therefore to endeavour to discover amongst his clients, the bank dealers, both buyers and sellers at stated prices in the currency in which he is trading so as to "make a market," and he must then rely for business on his ability or good fortune in persuading a seller to come to a buyer's price, or *vice versa*, or to move both parties to

agree upon some intermediate price. A broker assumes no legal responsibility and cannot be bound or forced by any dealer to conclude business at the rates quoted by the broker. Nor can a broker compel a dealer to stand by a price at which the dealer may have stated that he was prepared to buy or sell. An outstanding feature of the relations between dealers and brokers is, therefore, the spirit of "give and take" which exists between them in the majority of cases, since the dealer knows that if a broker "lets him down" by proving unable to find dealers at the prices quoted, the dealer himself may, in turn, have to refuse on occasion to stand by a price which he has made to the broker. The brokers install and maintain at their own expense, private telephone lines to as many of the banks as will permit them to do so, but this does not imply that such banks will invariably give them business. Owing to the keenness of competition, brokers specialize in certain currencies, certain firms dealing in nothing but American and Canadian dollars, others in the Scandinavian, Swiss, and sundry currencies, others in the French, Belgian, and Italian currencies, etc., and the dealers often find it convenient to put brokers trading in the same group of currencies into competition with each other so as to obtain the narrowest dealing price in any given currency.

The actual part played by the brokers is shown in the description of the working of the market given below, and their ability and activity are undoubtedly a factor in retaining for London the reputation of possessing the freest and most highly organized foreign exchange market in the world.

During recent years, it has become increasingly evident that business in the London market is tending to concentrate itself in the hands of the largest banks, mainly the "Big Five" and their counterparts amongst the American and French branch banks in London, owing to the substantial basis of business provided for such institutions by the operations and requirements of their other offices and customers.

It is the dealers at such institutions who are mainly instrumental in "making prices" in the market, but even amongst these there are very few who are consistently able or willing to make dealing prices in any and every currency for the use of the market in general. The brokers afford a means of keeping secret the prospective operations of a dealer, since a broker is not supposed to disclose the names of either party to the other, where business is proposed, until the deal

has been finally concluded, but it is not unknown for a dealer to "take" a broker at the price quoted and deal for a small amount of currency, not because he really has another operation to cover but merely in order to "get the name" of the other party in case this might provide a clue to the possible current trend of the market.

The Working of the Market.

For the reasons previously given, the London market is very largely governed by the rates ruling in operations initiated by other centres. The first duty of the exchange dealer at the beginning of the day is, therefore, to study carefully the telegrams and cables received from his correspondents abroad giving the closing rates ruling in other centres at the end of the previous day. From these he attempts to form an opinion as to the rates likely to rule on the opening of business, and in this he is assisted by the nature of any orders which he may also have received from abroad by telegram or letter, or from branches and customers here, e.g. a small collection of buying orders for Spanish pesetas from his correspondents in New York and Buenos Aires probably means that other banks in London will have received similar orders, and that, at the opening, buyers of pesetas are likely to be stronger than sellers so that the rate on Madrid will probably tend to appreciate and will open lower, i.e. fewer pesetas to the pound, than the close of the previous day. He is provided with a ruled pad on which he notes the "spot" and "forward" rates of each currency, making alterations with each fluctuation in the rates, and as soon as possible after the opening of business, he receives his "position sheet" from the book-keeping department.

The exchange dealing room is largely filled by telephones and calculating machines, in addition to the exchange operators. Each bank will have from 3 to 8 of its officials acting as exchange operators and usually the work is divided so that the senior dealer supervises the work generally, keeping in touch with world movements in rates by listening to the conversations of his assistants with banks abroad and by means of the private lines to the London brokers, while one or two of his assistants are taking the trunk calls to banks abroad, receiving and decoding cables, while also keeping in touch with the London market by means of the private lines to brokers, and another or other assistants attend to the telephone calls from

branches and home customers. The old type of Post Office telephone switchboard worked on the "plug in" system with "drop indicators" has now been almost generally superseded by the French type of flat switchboard on which connections are made by pressing down studs, and incoming and outgoing calls are shown by red and green lights respectively. All private lines are rented from the Post Office, but extensions can be taken to as many positions on these electric switchboards as is desired. Some banks find 4 positions sufficient, others have as many as 9, and the operator on each position can "listen in" on any line which is being used by another of his colleagues in the same office. These switchboards carry not only the private lines from brokers, but also the lines to certain special customers, and to the principal cable companies, so that messages can be received and dispatched direct from or to the cable room of the company, thus avoiding the delay of sending written messages by hand.

While the dealers are engaged in collecting the opening rates of the day, the brokers are similarly occupied. They commence by obtaining the closing rates cabled overnight from New York to the London agencies of the American banks, who kindly work out the parities between the rates sent them in New York terms and the closing sterling-dollar rate, so that the brokers obtain the equivalent in London terms of such rates. The brokers also endeavour to use their judgment as to the probable trend of rates, though without the same data as the dealers possess, and make their opening rates accordingly.

A broker's office also consists of a switchboard, public telephones and from 4 to 10 operators, but the calculating machines are absent as the broker is concerned only with currencies and not with their sterling equivalents.

The broker then commences to ring his clients, the banks, and to endeavour to secure firm orders to buy and sell so that he can quote a firm two-way price. Assuming that he is dealing in dollars and that he considers the market should open at, say, $4.86\frac{1}{2}$ to $4.86\frac{3}{4}$, he will ring one of the principal dealers and commence after this fashion.

"Good Morning, Sir. I'm trying six and a half three-quarters to open. What do you think?"

The dealer may reply, "I think you're a bit high, old chap. The

overnight rate from New York is only a half, sterling falling, and I fancy Paris may be a buyer again to-day." Broker: "All right. I'll try six to a half then, and see what happens."

He then goes the round of his other clients while his colleagues do the same, since each operator in a broker's office has 8 or 10 banks, or more, to look after regularly and, as far as possible, the same man always serves the same bank. After repeating this rate to several clients, one at last may say—

"Let me know if they come better than the figure," meaning that he is a likely buyer at $6\frac{1}{4}$ or $6\frac{1}{8}$. The broker at once calls to his colleagues, "X bank wants the offer at over 6," and they all proceed to advise their respective clients, "six to a half (or even six to a quarter), likely buyer in between."

By this time the bank dealers will have had their first trunk calls, and will have had to quote rates based on the tentative quotations in the London market, and on their own judgment. For instance, the first dealer mentioned above may have had an early call from Switzerland and, reading the bank there as a likely buyer of dollars, will probably have quoted him " $5\frac{3}{4}$ to $6\frac{1}{4}$." The Swiss operator may say "Can't you improve on $5\frac{3}{4}$?" but the London dealer, not wishing to be "caught short" with the rate likely to move against him, will refuse to improve on this price as a seller. The Swiss operator may then say, "Very well. I'll take fifty thousand at $5\frac{3}{4}$," meaning that he is prepared to buy \$50,000 at $4.85\frac{3}{4}$ per £. The London dealer may not be prepared to sell this amount, but must supply some at his quoted price and so replies, "I can give you only twenty-five thousand at $5\frac{3}{4}$, and my price for the other twenty-five is $5\frac{1}{2}$." After some haggling the Swiss may agree to this, and the London operator will then have sold \$25,000 T.T. New York at $4.85\frac{3}{4}$, and \$25,000 T.T. New York at $4.85\frac{1}{2}$ for payment in New York two business days ahead against sterling payment in London on the same date, this being the customary "value date" (see later) for T.T.s on New York in the London market. The dealer then proceeds to ring, in turn, the various brokers who specialize in U.S.A. dollars and inquires of each the rate which they are quoting. He knows from experience the amount of reliance to be placed on the quotations made by the different brokers and naturally goes to those in whom he has most confidence. One broker may quote him, "Still six to a quarter, might pay between";

the next may have already found better buying inquiries or, at any rate, a lack of sellers, and may quote "Either side of 6 might pay," meaning that he thinks he could find a buyer at 6; others may quote the same as the first "6 to $\frac{1}{4}$," or, " $5\frac{3}{4}$ to $6\frac{1}{4}$." If the dealer can place sufficient confidence in the first broker, he will say to him, "I want fifty at the figure. See what you can do," meaning that the broker is to try to find a seller of \$50,000 at 4.86. The broker at once calls to his colleagues "X bank wants fifty at the figure," and each operator in that office at once begins the round of his clients saying "I want fifty at the figure. (Pause, while the dealer to whom he is speaking says "Nothing there.") No good, sir? How would you offer?" To this inquiry one dealer may eventually reply "I'll give you twenty-five at $5\frac{3}{4}$." The operator concerned immediately calls to his colleague, "You can have twenty-five at $5\frac{3}{4}$," and if by this time no one of them has been able to find a better seller, the man who took the order will go back to the buyer and say, "Sorry, sir, there was nothing there at the figure. The best I can offer is twenty-five at $5\frac{3}{4}$." The dealer having sold at an average of $4.85\frac{3}{8}$, may decide to take the small profit which would be shown by covering at $4.85\frac{3}{4}$, and will say "All right. I'll take that. Try and pick up the other twenty-five at the same price." The broker at once replies "Right. Twenty-five at $5\frac{3}{4}$ you buy from Z bank. I'll try to make it fifty." His colleague will have been listening for the result of the offer and, as soon as he hears this, will "plug in" to the seller and say, "Thanks very much, sir. Twenty-five at $5\frac{3}{4}$ goes to X bank. Could you make it fifty to complete him?" The dealer at Z bank may have a fair number of dollars to sell and on hearing that the buyer at the moment wants no more than fifty thousand, may decide to give the whole amount. He therefore replies, "All right, that's done. Fifty I sell in all to X bank." The broker thereupon calls to his colleague. "O.K. Charlie. Fifty in all from Z to X." The first man at once rings X bank and says, "I've made it fifty in all from Z bank," and the deal is clinched. The processes which subsequently occur in order to give effect to the deal are described below.

On the other hand, the buying dealer may have found in the meanwhile that other centres are small sellers of dollars. Having sold at first at $5\frac{3}{4}$ he can make a dealing price of " $5\frac{1}{2}$ to 6," or " $5\frac{1}{4}$ to $5\frac{3}{4}$," according to his willingness to risk having to sell more

dollars, to other Continental banks with whom he has trunk calls coming through at the time. For example his next call may be to Paris to whom he makes "5½ to 6," and the Paris dealer gives him \$25,000 at 4·86. At the same time one of his assistants may be talking to Amsterdam or Stockholm and will also have quoted "4·85½ to 6." As soon as the purchase at 4·86 from Paris is made, the head dealer will call out "now I'm 5¾ to 6¼ in dollars," and the assistant will repeat this to the dealer to whom he is talking. This may give the foreign dealer the impression that dollars are offered, and he also may wish to sell \$25,000, which he thereupon offers at 4·86. The assistant calls out this offer to the head dealer, but the latter, anxious to make as much profit as possible, will probably reply, "No. I'm really 6 to a quarter now, but I'll take twenty-five at six and an eighth if he's quick." The assistant passes this on, and very likely it induces the foreign seller to come to 4·86½ in case he should "miss the market" altogether. In the meantime the broker may have come back with his offer of twenty-five thousand at 4·85¾, but, under these circumstances, the dealer will then reply, "No thanks. I've bought most of mine abroad. I only want ten thousand at the figure now." On this the broker and his colleagues will go round the market saying "5¾ to 6 a dealer. Seller of twenty-five, buyer of ten thousand," until another bank either gives at 6 or takes at 5¾, or offers to buy or sell at 5¾. If a seller appears at 5¾ the original buyer at 6 will be at once "checked up" to see if he is still a buyer, and if he is no longer interested, as would be the case in the above example, the broker will change his price to "either side of the figure; might come." This process of continual slight changes in rates takes place in every currency all day long, but changes in rates are for the most part made without actual business having taken place, and are due to the changing prices of dealers as and when they receive different tendencies from other centres. As long as a broker has definite orders to buy and sell stated amounts for his clients, his prices are said to be "firm" and he himself will advise his other clients that his rate is so-and-so to so-and-so "a dealer," or "I trade," or "firm." This is a considerable inducement to his other clients to deal with him since they can be sure of buying or selling through him a minimum amount of foreign currency, according to the amounts which the broker says he offers or wants, and so can quote confidently for the moment to

their own customers. At the same time, an order from a bank dealer can be considered to hold good only for a few seconds, half a minute at the most, so that lightning speed on the part of the broker's staff is essential if "firm" orders are to be taken advantage of. Even so, it is by no means uncommon for a broker to get "caught up" through relying too long on such an order and, on being taken at his price by another dealer, finding that the original dealer refuses to stand by the price on the grounds that the broker has been too long. In such a case, the broker must either try to persuade the second dealer to release him from the bargain, or must "owe a name" and try to carry through the deal at the stated price with some other dealer, or must "cut his loss" by covering the deal as best he can, of course at a loss, and pay over the resulting sterling difference to one of the banks concerned.

The above presents but a glimpse of the manifold activities of the market in general and of dealers in particular. All the time, the head dealer is having questions called to him by his assistants such as—

"How will you deal in three months' Spain for (so-and-so) Zurich?"

"X branch want a price for cashing fifty dollars under a letter of credit."

"How will you take a couple of hundred dollars in Can. Pac. coupons from so-and-so?"

"Y branch want to sell a bill on Dresden for five thousand marks due 22nd September."

"How will you take Italy against Paris?"

"How will you sell dollars for to-morrow and buy next Wednesday?"

"Z branch want to buy two thousand yen their option August," and many more.

Also, cables are continually coming in which must be decoded and any orders or proposals of business considered and replied to, and this goes on from about 9.45 a.m. to nearly 6.0 p.m. on any ordinary business day. An exchange dealer is born, not made, and there are not many men who can stand the strain of working at such high pressure day after day indefinitely.

In many cases, branches are allowed to deal in the main currencies at rates which are either sent out overnight or telephoned in the

morning from the Foreign Branch, but the amounts which may be so dealt in are limited to comparatively small sums, and any demands from customers for larger amounts either to be bought or sold by the branch must be referred to the Foreign Branch before a quotation is made to the customer. The daily totals of the small amounts dealt in are sent off in the evening to the Foreign Branch to be included in the dealer's position there the next morning. Also, the assistant dealers are given a certain amount of discretion as to the rates which they may quote without reference to the head dealer, and the latter is content to leave as much as possible to his subordinates while remaining responsible for the policy and general conduct of the department.

Many of the inquiries received by the dealers are passed on to the brokers in case a "counterpart" should exist in the market and to obtain a more or less reliable check on the dealer's own idea of any given rate. The broker must, therefore, be prepared to answer at a moment's notice any demands for unusual rates which may be "fired at" him by dealers. These will usually be requests for rates in respect of operations other than those for which market rates are normally quoted, as, for instance, inquiries for prices for "10, 11, 12, 14, or more days' mail," i.e. G.M.T., when the ruling quotation is for, say, 8 days, or for a forward deal in "broken dates," i.e. dates other than one, two, or three exact months from the "spot" date (which are the forward margins usually quoted in the market), such as "What would you make the 18th July against the end August?" when the "spot" date is 3rd July. The broker does his best to quote what he hopes are the rates at which he could find dealers, but his only responsibility in the matter is that, should he consistently quote rates which ultimately turn out to be hopelessly wrong, his client will lose patience with him and take his business elsewhere.

To return to the example of a completed deal, when the broker has "passed the name" of the two dealers, one to the other, he records the deal in his ledger, and a clerk proceeds to make out contracts. An Exchange Broker's Contract is not a legal document as is a Stock Broker's Contract, and does not require stamping. It is a slip of paper on which is shown the amount bought for account of the buyer (and on the other contract, the amount sold for account of the seller), the class of remittance (T.T., G.M.T.,

cheque, etc.), the centre dealt on (e.g. Paris, New York, Kobe, etc.), the value date (see below), the rate of exchange fixed, the amount of the brokerage, the name of the *seller* on the "bought" contract, and of the *buyer* on the "sold" contract, the date, and the name of the broker. A note is also made of the name of the buyer on the "bought" contract, and the name of the seller on the "sold" contract, and these slips are sent round to the respective banks by hand as soon as possible after the deal has been completed. On receipt of the contract by each bank, a clerk will check the details with the entries in the "position" book or from slips made out by the dealer when he agrees to the deal, and any discrepancies are immediately taken up both with the other bank and with the broker concerned. In the meantime, the "Instructions" departments of each bank will have got into communication by telephone to exchange instructions as to the banks in the foreign centre who will pay over and receive payment of the foreign currency, as agents on behalf of the London principals, though, in many cases, standing instructions are left by the London banks with each other of the names of their paying and receiving agents in the principal centres, in order to avoid taking up time in telephoning instructions in respect of each deal.

The "dealer's slips" are then passed out to the department, and the sterling equivalent is calculated and entries passed either on further slips or on sheets. In the case of a purchase of foreign currency, the "Nostro" account with the agent bank is *debited* with the amount of foreign currency, since the agent will eventually *credit* the London bank with the amount received on its behalf. The foreign currency ledgers are ruled in columns showing currency *and* sterling amounts, so that the amount of foreign currency and its sterling equivalent are debited to the "Nostro" account, and the *contra* entry in sterling is a credit to "Bankers' Payments" or some similar account. A banker's payment is then made out to the debit of this account and handed over to the seller of the currency on the appointed day, a *contra* credit being passed to "H.O. Cash" or "Town Clearing," or some similar account. The payment is then passed through the Clearing House in the usual way, and the sterling side of the transaction is then settled. In some cases the payment is paid in to the credit of the seller's account with a Clearing Bank in order to avoid unnecessary entries in the seller's books and the actual handling of payments by him. Also, on the appointed day,

the agent, in the foreign centre, of the seller will pay over the amount of foreign currency to the agent there of the buyer, and they will each advise their principals, in due course, that the respective "Vostro" accounts in their books have been debited in the one case and credited in the other under a stated "value date." Should this date differ from that agreed upon when the deal was concluded, the aggrieved party here will immediately take up the matter with the other party and claim interest for the number of days' difference, e.g. if a deal is concluded "value 22nd," but the funds are only paid over in the other centre "value 25th," the buyer here will claim three days' loss of interest from the seller as the sterling will have been paid over here on the 22nd, and the payer (the buyer) will not have the use of the foreign currency until three days later. On the day the deal is concluded, and as soon as the entries have been passed from the dealer's slip, and the sterling equivalent calculated and checked, each of the banks concerned will confirm to each other all the details of the transaction by a written confirmation, so that no misunderstanding should arise as to the amount dealt in, the sterling equivalent, the value date, the names of the paying and receiving agents, etc. These confirmations also pass between the parties in the case of deals carried through direct between two London dealers or between a London and a foreign dealer, though, in the latter case, an immediate confirmation of the main details of a deal is usually dispatched by telegram.

Value Date.

This is the term used to define *the date on which a payment over of funds or an entry to an account becomes actually effective and/or subject to interest.*

As regards payments of funds, the value date is usually the same in both centres, i.e. payment over of the respective currency in each centre takes place on the same day, so that no gain or loss of interest accrues to either party. Such payments are said to be *Valeur Compensée*, or "value compensated," or "money here and there the same day," or, simply, "here and there."

As regards entries to an account, the value date is shown in a special column distinct from that containing the date of entry, and such a column is included in the ruling of the ledgers used by banks here for recording entries to their "Nostro" accounts. Whenever

advice of a credit or debit entry is received from a foreign agent, the value date will be distinctly stated, and this is the date from which the entry became effective, and is frequently not the date on which the entry was passed. For example, an agent in a principal town may have received for collection items payable in a secondary centre which will take a day or two to collect. The sub-agent will collect these items in due course, and will credit the account of his principal, the first agent, value as on the date of collection. The agent himself will only receive advice of this credit from his sub-agent in course of mail, but will then proceed to credit his principal, the remitter, value as on the date on which he himself received credit from the sub-agent. Thus, items sent from New York to Denver on 22nd June might be received by the sub-agent on 24th June, and collected and credited by him to the chief agent value 25th June. His advice of credit might not reach the chief agent until 29th June, but the latter would pass an entry *under this date* crediting his principal *value 25th June*.

On the other hand, the chief agent might know exactly how long it would take for items on Denver to be collected and credited to his account, and might be prepared to give his principal immediate credit, "with recourse," should the items eventually be returned unpaid. In such a case he would pass an entry on 22nd June crediting his principal value 25th June. The first example is known as an entry with a "back value" and the second is known as an entry with a "forward value."

In order to arrive at the true balance for interest purposes of such accounts, the entries must be analysed by means of a "ladder" system so that all debits and credits bearing the same value date are summarized under that date, and the net difference is extended and added to or subtracted from the true balance as on the previous value date. Interest is then calculated on each true balance for the number of days between each value date.

The Berlin Market.

This market works on much the same lines as the London market except that a daily meeting of dealers and brokers still takes place on the Bourse at about 1.15 p.m. The banks maintain private telephone lines to each other and to the brokers, and for the greater part of the day dealings take place in a manner similar to that

obtaining in London, but the brokers work for whatever commission they can get.

The meeting at the Bourse provides for the fixing of an "official" rate for each currency. A certain broker is nominated as the official broker for each currency or small group of currencies, and at the opening of the market all bids or offers for any currency are passed to the official broker for that particular currency. The broker concerned then strikes an average between the bids and offers he has received and announces the result as the official rate of the day for that currency. All orders received by the banks for execution at the official rate must then be carried out at the rate so fixed, but the banks are allowed to charge a rate of about $\frac{1}{8}$ per mille under and over the official rate according as to whether they are buying or selling the foreign currency (Berlin quotes "direct" rates in other centres, i.e. German currency per foreign unit).

The New York Market.

This market has several distinctive features. In the first place, business is transacted direct between the banks, or between the brokers and the banks, by means of private telephone lines, but the brokers do not always work as agents only and for a commission, but can deal as principals for their own account, buying at one price and selling at another and receiving or losing any resulting profit or loss. In order that they may do this without having to pass their own names as principals in the market, they maintain accounts by way of margin with certain banks, and are allowed to use the names of such banks for their own dealings on payment of a small commission. Next, commercial firms, of good standing, are allowed to enter the market as exchange dealers and can operate either direct with the banks or through the agency of brokers. Their transactions are mainly sales of long bills on other centres, but they also deal in T.T.'s and cheques. As with London, the only bar to the activities of any bank or firm is the extent to which its name is taken by other members of the market. There is no Bourse or regular meeting of dealers and brokers in New York. All the big banks and many of the brokers maintain private telephone lines to their agents in Boston, Chicago, and other large centres, so that most of the exchange business of the U.S.A. is concentrated in New York, while, owing to the close commercial and financial relations across

the border between the U.S.A. and Canada, New York is an excellent market for dealings in Canadian dollars, and used to afford London dealers a good chance of covering operations carried out in Canadian dollars on this side, but more is now done here.

The Paris Market.

This market possesses several features similar to that in Berlin, and, as with the latter centre, the development of telephonic communication between all the principal centres in Europe has helped to make Paris an important exchange centre. Dealings take place for the greater part of the day by means of private telephone lines between the banks themselves and between the brokers and the banks. The brokers work only as agents but, instead of charging a commission, are allowed to endeavour to secure for themselves a margin between the buying and selling prices which they arrange with the dealers. This margin is returned to them in a monthly total by one party or the other and is known as an "Aval." A daily meeting of dealers and brokers takes place on the Bourse from about 1.30 p.m. to 3 p.m. No official brokers are appointed, but there is an official recorder, and contracts in respect of deals concluded on the Bourse, either between the bank dealers direct or through the agency of a broker, must be passed to him for details to be noted. From these details the recorder compiles a list of the average rate for each currency. This list is known as the *Cours Moyen*, and at one time all orders received from customers to be carried out at the *Cours Moyen* had to be executed at the official price for the currency concerned, but without any margin of profit being allowed to the dealer, as is the case in Berlin. This practice, however, no longer obtains, and, while the *Cours Moyen* is still published daily, it no longer possesses any official status or significance.

In all centres where meetings take place daily at a Bourse, the room in which the meetings are held contains a number of telephone cabinets with private or public telephone lines. The representatives of each bank or broking house who attend the meetings can thus keep in constant touch with their colleagues at their respective offices, and can advise them of the trend of business and changes of rates on the Bourse, and can at the same time receive any fresh orders which may come in, or can arrange any change of policy.

In all cases, while the basis of exchange business is the ever-fluctuating temporary balance of indebtedness between nations on commercial and financial accounts, the professional operators in the banks abroad, and the international syndicates of speculators in exchange, build up a vastly larger volume of business on the basis of the genuine demand for and supply of currencies. It is often the case that such professional operations conducted with knowledge of, or in anticipation of, some genuine commercial or financial exchange requirements result in the world's markets being turned against the genuine operator before ever he has commenced to satisfy his requirements, and he may eventually be forced to complete his operations by buying or selling to the astute professionals, who anticipated his needs and cleaned up the market against him so as to reverse their dealings to him as soon as he is at last forced to operate.

The London Bullion Market

Our early adoption of a gold standard of currency and the institution of a free gold market, coupled with the fact that more than one-half of the annual world supply of gold comes from within the British Empire, has made London the principal centre for dealings in gold as a commodity.

Gold shipments which are purely banking or exchange operations may be conducted between the various gold-using countries, but most of the world's newly-mined gold, and much of its silver, is disposed of through the London bullion market.

Dealings in the market are curiously informal. There are two banking houses and four firms of bullion brokers in London whose reputation is world-wide, and representatives of these six concerns meet each morning about 11.0 a.m., and, after comparing the amounts which they have to buy and sell between them, for account of their various clients, they fix the prices for the day. As the South African gold is always consigned to Messrs. N. M. Rothschild & Sons, the fixing of the gold price takes place at the offices of this institution, while the fixing of the silver prices take place at the offices of one of the brokers, and other firms of brokers and concerns interested are often present. No members of the general public can be present at these meetings, and purchases and sales of gold and silver bullion are, perforce, made through the agency of the recognized brokers.

The need for fixing a price for gold was due mainly to the existence of a difference in the prices at which the Bank of England bought and sold gold. In other centres the central bank may both buy and sell fine gold at the same price, notably in the U.S.A., where the Mint will either buy or sell fine gold at the rate of \$35 per troy ounce fine, and there is, in consequence, no other price possible.

As, however, the Bank of England was compelled by law to buy all gold offered to it at the rate of 77s. 9d. per ounce troy standard and to sell gold in the form of standard bars in a minimum amount of 400 oz. troy at the rate of 77s. 10½d. per ounce standard, the margin between these prices permitted of a certain amount of bargaining in respect of any gold offered for sale, as between the seller and any prospective purchaser. Obviously, no seller would sell for less than the price which he could obtain by selling his gold to the Bank, and no buyer would pay more than it would cost him to purchase gold from the Bank and turn it into gold of a similar fineness to that offered in the market, so that the Bank's statutory buying and selling prices fixed limits to the fluctuations in the price of gold in the open market.

Fine gold is pure gold, unmixed with alloy, but a small proportion of dross is inevitable, and gold which contains 995 or more parts pure gold out of every 1,000 is considered as "fine gold." Standard gold is the mixture of pure gold and alloy used for coinage purposes by a country, and the Coinage Laws always set out the "fineness," i.e. the number of parts of pure metal in a given total of parts, of the metal to be used for coining. The "fineness" of the standard metal varies, but most of the gold-using countries of the Continent and the U.S.A. have adopted a standard metal which is $\frac{9}{10}$ ths fine, i.e. it contains nine parts of pure gold and one part of alloy in every ten parts, while the standard in this country is slightly finer, being $\frac{11}{12}$ ths fine, or 22 carats pure metal and 2 carats alloy in every 24 carats total.

The Bank of England's statutory prices being for standard gold, $\frac{11}{12}$ ths fine, some difficulty has resulted when it was desired to purchase gold from the Bank for export to a country having a different standard of fineness, notably France. The Bank of France is permitted, by law, to purchase only gold of a minimum fineness of 995 per 1,000, which is practically fine gold, and as the Bank of England was often only prepared to sell "standard" or "coin" bars, $\frac{11}{12}$ ths

fine, such bars had to be melted down and refined up to .995 fine before they could be offered to the Bank of France. Refining facilities are limited both in London and in Paris, and the maximum amount which can be handled by the refineries is only just over £300,000 worth of gold per day, so that a purchase from the Bank of £1,000,000 in "coin" bars would take about three days to refine, with a consequent additional loss of interest as well as the refining charge.

The market price is quoted in shillings and pence per troy ounce fine, but, although it is fixed daily, the chief business of the week takes place on a Tuesday, following the weekly arrival of newly-mined and refined gold from South Africa. Fine gold only is dealt in, as the metal sent for sale is nearly always refined, and, as standards of fineness differ, it is more convenient for the world's buyers that the price should be quoted for the pure metal. All dealings are for cash, and no quoted market for future delivery of the metal, or "forward" price, exists, though, in 1933 and 1934, an active forward market in gold was being developed as an adjunct to the Foreign Exchange Market. The authorities, however, feared that this would assist speculation in exchanges and requested that such dealings should be discouraged. The gold is in the form of bars, or ingots, weighing about 400 oz. and is packed in stout wooden boxes holding four bars each.

As the gold offered for sale comes mainly from the one source, there is little or no competition between sellers, but buyers will, at times, compete with each other, through brokers, according to the state of the exchanges. It is an understood rule that orders from "the trade," i.e. from firms needing gold for industrial purposes, such as jewellers, dentists, etc., are first satisfied at the price fixed, and India is also a consistent small buyer, both for industrial and for monetary purposes. The other buyers are exchange operators who can see a profit in moving gold to some centre with a high exchange value to its currency, or governments or central banks who wish to build up gold reserves. As all bids have to be made through a broker, no public information as to the identity of bidders is available, and it is often stated in the Press that a certain amount of gold was purchased by "an undisclosed buyer."

No official figures are issued by the bullion market, but the Customs and Excise Department of the Inland Revenue issues a

weekly statement of imports and exports of gold, giving the value of each consignment and its destination or origin, but as gold purchased in the market is often held here indefinitely for safe custody, these statements do not afford a complete disclosure of the market's operations.

In the silver market prices are fixed in the same way as for gold, but there is no controlling factor in the shape of any legal buying and selling prices by the Bank or by any other body. The price is not quoted per fine ounce troy, but for silver of the former British standard of fineness, viz. .925 fine, or 925 parts pure and 75 parts alloy in every 1,000. The metal is refined down to this standard by the mine-owners or refineries, and is usually put up in bars weighing from 900 to 1,300 oz. troy. Much of the silver dealt in never touches this country, but is shipped direct from the producing countries, such as Mexico, Western U.S.A., and Canada, to the chief consuming countries, such as China and India.

Two prices are fixed daily in the silver market, a "spot" or "ready" price, and a "forward" or "to arrive" price. Most of the silver which actually passes through this country arrives in weekly shipments, and the "spot" price is for delivery within one week from the date of arranging the contract. The "forward" price is for silver to be delivered to the purchaser two months after the date of purchase, and is, in fact, the more important quotation of the two, as most of the business with the Far East is in respect of future requirements by those countries. Both prices are fixed at the time of the making of the contract, but no money passes until the silver is actually delivered. The forward price is quoted either in the same way as the spot price, i.e. in shillings and pence per standard ounce, or in terms of a premium or discount on the spot price. The forward market is a favourite medium for speculation on the part of bullion experts who endeavour to anticipate the probable offerings of and demand for the metal by the time the future date arrives. The mines and refineries are glad to utilize the forward market to fix at once a price for the sale of their current output and so cover themselves against any risk of loss through subsequent fluctuations in the market price, while banks dealing with the Far East are usually purchasers of forward silver to cover their purchases in those countries, of sterling bills.

The price of silver is now subject to great fluctuations, as its use

for coinage purposes is steadily falling, while improved methods of production have increased available supplies. From the high point of over 89d. per ounce in 1919 it had fallen to 1s. per ounce in 1931, and the future outlook remains very uncertain. The effects on the London Silver Market of the operations of the U.S.A. authorities under the Silver Purchase Bill of 1934 are discussed in Chapter XV.

In May, 1935, the London Metal Exchange introduced quotations for silver. Dealings are for *fine* silver in lots of 5,000 oz. and prices are made for deliveries for any date from "prompt," i.e. the same day, up to three months. There is a daily "clearing" and deliveries are made and accepted by means of Warehouse Warrants issued by Messrs. N. M. Rothschild & Sons. Up to the present, this new market has not proved a serious rival to its old-established competitor, the London Bullion Market.

CHAPTER XII

ELIMINATION OF EXCHANGE RISKS EXCHANGE CLAUSES, FORWARD EXCHANGE, AND FOREIGN CURRENCY ACCOUNTS

THE early practice of merchants in this country of buying and selling internationally in terms of sterling led to the development of certain recognized forms of wording being included in bills drawn in sterling by creditors in this country on other countries, so as to ensure that any exchange risk was thrown on to the foreign drawee and that the English drawer should receive the full sterling amount due to him.

In addition, clauses were gradually introduced to provide, in some cases, for the payment of interest by the drawee, and in other cases for payment by the drawee in sterling according to the customary usance in his centre, or again, that a bank should act as the arbiter of the rate of exchange at which the bill should be paid in local currency by the drawee.

An "Exchange Clause" may therefore be defined as a clause included in the wording of a bill which fixes the *method* of arriving at the rate of exchange at which the drawee must pay the bill. The principal exchange clauses still in use in this country are dealt with below, but it must be understood that they apply to *bills drawn on foreign centres in terms of sterling* by creditors in this country.

"Exchange as Per Endorsement."

This is a clause usually to be found on bills drawn in sterling on countries other than Australia, New Zealand, South Africa, India and the Far East, and the South American States. Each of these countries mentioned has its own customary clause and these are treated later.

The following is a specimen of a bill bearing the "exchange as per endorsement" clause—

£200 0 0

London,
27th June, 1934.

Ninety days after sight of this first of exchange (second and third of same tenor and date unpaid) pay to our order the sum of Two hundred pounds for value received, exchange as per endorsement, which place to account as per advice.

JOHN BULL AND Co.

To Messrs. DEUTSCH AND Co.,
Berlin.

The effect of this clause is to enable the bank in this country to whom the drawer sells the bill, to fix the rate of exchange at which the draft will become payable in terms of the foreign currency. It is not necessary that the draft should be sold by the drawer immediately. It may be sent abroad for acceptance and return, and may be sold only a few days before its eventual due date. When it is actually offered to a bank for purchase, the bank dealer will have to pay the drawer or holder the face amount of the bill, and so must allow in the rate of exchange for all expenses of collection, foreign stamp, any loss of interest, and his profit. He must therefore fix a *tel quel* rate of exchange, and this rate he includes in his endorsement of the bill, which will read thus—

“Pay A.B. Bank or order at the rate of.....for £1 sterling.”

On the face of the bill, this rate is written above the sterling amount, together with the resulting equivalent in foreign currency, and the bill then ceases to be a sterling bill and becomes a bill for that amount of foreign currency.

It is always customary for the drawer, as soon as he has sold the bill, to advise the drawee of the rate fixed by the purchasing bank so that the drawee will know exactly how much local currency he will have to provide to meet the bill on its presentation.¹ In some cases, the purchasing bank will quote a rate but will require the drawer to include this rate in his first endorsement and to convert the sterling amount on the face of the bill into the foreign currency at that rate; this is in order that the bank shall not be involved in any dispute between the drawer and the drawee regarding the rate. The clause “exchange as per endorsement” therefore *results in the negotiating bank here being empowered to fix a “tel quel” rate of conversion of the sterling amount of the bill into foreign currency and the bill is thereafter treated as a bill for that amount of foreign currency.* The bank dealer is therefore required to purchase foreign currency from the holder, and he must arrive at his “all in” buying rate by taking the rate at which he is prepared to buy T.T.s in that currency and adding to it (a) interest at the foreign discount rate for such paper from the date of purchase until the estimated date of payment and credit of proceeds, (b) the cost of any foreign stamps and any

¹ It should be emphasized that this clause can only be included in the wording of the bill by the drawer if he has previously obtained the consent of the drawee to this being done.

collection charges made by the foreign agent, and (c) a reasonable margin of profit. On concluding the purchase, the bank dealer will have bought the resulting amount of foreign currency and must cover this by a sale of "spot" or "forward" T.T., or cheque, etc.

" Payable Without Loss in Exchange."

This clause also has the effect of ensuring that the drawer in this country shall receive the full sterling amount of the bill under discount, but only after deduction of all collecting charges and the cost of any foreign stamp. Such bills are purchased by the bank here for their face value, less discount at the rate applicable to such paper from the date of purchase until the estimated date of the arrival of the return remittance, and less the bank's collecting charge (where this is not allowed for in the discount rate) and less any foreign stamp duty. The collecting bank abroad acting as agent for the London bank must eventually forward to its principals a sight draft on London for the face amount of the bill less its own collecting charge and the cost of any foreign stamp. The foreign drawee will have the bill presented to him for payment by the collecting bank, *converted into local currency at a rate of exchange fixed by the collecting bank, and which will be the rate at which the latter is prepared to sell sight drafts on London.*

The drawee, however, is not bound to accept this rate and to make payment of the equivalent of local currency so obtained, *but can tender in payment a sight draft on London for the sterling amount of the bill, issued by any local bank whose name the collecting bank is ready to take*, and which he may have purchased elsewhere at a better (for him) rate of exchange. In this latter case the collecting bank would be deprived of the opportunity of selling a draft on London and so would lose its possible profit on such a transaction.

" Payable by Approved Bankers' Cheque on London for Full Face Value."

This clause is exactly similar in effect to the one above. The collecting bank will endeavour to sell its own cheque on London to the drawee, but must accept any approved local bank cheque on London, in sterling, for the face amount of the bill, if such is tendered by the drawee, in payment. It should be noted that, in both the last two clauses, *neither the negotiating bank here nor the collecting bank*

abroad is empowered definitely to fix the rate of conversion of the sterling amount into local currency, though the latter bank may be able to do so if the drawee will accept its quoted rate.

“ Payable at $\frac{\text{Bankers' Selling}}{\text{X Bank's Drawing}}$ Rate for $\frac{\text{Demand}}{\text{Sight}}$ Drafts on London on Date of Payment.”

This is the usual clause for bills drawn on Far Eastern Countries and on the South American States. The wording and type of return remittance required is varied to suit the customary usage of the drawee country, and instead of “sight” or “demand” drafts, may read “Telegraphic Transfers” or “90 days’ sight drafts.” The effect of any such clause is to empower either the named bank, or the bank shown by the last endorsement as being the agent for collection, to fix a rate of conversion into local currency at which it is ready to sell a remittance on London of the type specified in the clause. The drawee has no alternative but to accept the rate so fixed, and any such clause, therefore, means that the collecting bank sells to the drawee a remittance in sterling on London of the stated type for the face amount of the bill at its own rate. The collecting bank will deduct the cost of any foreign stamps both on the original bill and on the return remittance, and will forward the net proceeds to its principal by a remittance in the form prescribed by the clause. It is not usual for the collecting bank to make a charge for the collection of bills so clausured as its profit is taken in the rate at which it sells the sterling to the drawee in exchange for local currency.

Another variant of this clause is, “Payable at collecting bank’s selling rate for $\frac{\text{sight}}{90 \text{ d/s}}$ drafts on London.”

Clauses on Indian and Far Eastern Bills.

Trade custom between these countries and the United Kingdom has led to the general adoption of an exchange clause of which the wording differs but slightly from that of the last two clauses given above, and it usually reads as follows: “Payable at the $\frac{\text{X bank's}}{\text{current}}$ rate of exchange for demand drafts on London together with all collecting charges,”

It will be noted that the first part of this clause either empowers

the local collecting bank to fix the rate of conversion into local currency and gives the drawee no option but to pay at this rate, or, alternatively, allows the collecting bank to fix a rate of conversion, but gives the drawee the option of tendering an approved sterling draft by way of payment, which he may have purchased elsewhere on terms more advantageous for himself. Should the drawee adopt this latter course, the collecting bank will lose the profit which presumably it would have made by selling him its sterling draft on London. This clause contains an important addition in that it requires the drawee to pay not only the face amount of the bill in sterling but any additional amount which may be added thereto both by the negotiating bank here and by the collecting bank in the foreign centre on account of their respective charges for collection. This means that in the case of a bill for £100 on which both the negotiating bank and the collecting bank wished to charge $\frac{1}{8}$ per cent for the service of collection, the negotiating bank here would forward the bill to its collecting agent in the foreign centre with instructions to forward a return remittance for £100 plus commission of 2s. 6d., making £100 2s. 6d. in all. The collecting bank, on receipt of the bill and these instructions, will add also its own commission of 2s. 6d., and will write over the amount on the face of the bill, "collection charges 5s.," thus making the bill payable for a total amount of £100 5s. It will then convert this amount into local currency at its selling rate for demand drafts on London and will affix any necessary local stamp, but this latter item it will charge against its principal, as the drawee is not asked to pay this charge. The drawee can either pay over the required amount of local currency which is the equivalent of the total sterling amount at the rate fixed by the collecting bank, or, if the wording of the clause permits him to do so, he can tender an approved bank demand draft on London for £100 5s. in discharge of the bill. This draft will be forwarded to the London principal by the collecting bank, who will either debit the cost of stamp and charges to the principal's local currency account or will ask for credit in its own sterling account. The drawer of such a bill can therefore, by negotiating it, obtain the full amount of his bill less only interest from the date of purchase by the negotiating bank here to the estimated date of the arrival here of the return remittance, and less any foreign stamp, as the collection charges are all paid by the drawee.

The Interest Clause.

Also in connection with bills on India and the Far East, the custom has grown up of including an even more comprehensive clause in such bills with the object of passing on to the drawee not only all the collection charges but also the interest charged by the negotiating bank here which would otherwise fall on the drawer.

This clause is known as "the interest clause" and reads as follows :

"Payable at the $\frac{X \text{ bank's}}{\text{current}}$ rate of exchange for a demand draft on

London, together with interest at per cent per annum from date hereof until approximate date of arrival of return remittance in London plus all collection charges." The rate per cent at which interest must be paid by the drawee is fixed and usually filled in by the negotiating bank here, and is based on the rate for bank advances to customers *in the foreign centre*. The negotiating bank here will then calculate the amount of interest at this rate for the estimated period and will add this sum, together with its collecting charge, to the amount of the bill, which then becomes payable for the resulting total amount. The collecting bank on receipt will add its own collecting charge, and will demand payment of the resulting total sterling amount, either in terms of local currency at a rate of conversion fixed by itself or by approved banker's draft in sterling for this amount where the drawee has the option of paying in this manner. It will also have affixed any necessary local stamp, and the cost of this will be deducted from the total sterling amount claimed by the principal, the return remittance being for the resulting net amount.

As the negotiating bank eventually receives the amount due to it by way of interest, and also its collection charge, when the return remittance arrives, the only charge which falls on the drawer is the cost of any foreign stamp. Consequently, when the drawer of such a bill presents it for negotiation to his bank here *he receives at once the full face amount of the bill less only the very small cost of any foreign stamp, and there is no question of the bill being "discounted" by the negotiating bank*, as it will collect the interest on its money from the drawee. Should such a bill be dishonoured and returned unpaid, the drawer must then submit to having his account debited with the face amount of the bill plus interest at the rate stated in the bill and for the full period which has elapsed since date of purchase and plus

all collecting charges, stamps, and expenses. He must then take whatever action is open to him to recover the amounts from the drawee.

Clauses on Australian Bills.

Other slight variations of some of the above clauses are to be found in bills on Australia and New Zealand. The usual clauses are as follow—

“Payable at banker’s drawing rate for demand drafts on London, plus stamp duty,” the first part of which is equivalent to the “payable without loss in exchange” clause, and the second part of which requires collection of the cost of any local stamp from the drawer ;

“Payable at the current rate of exchange for demand drafts on London, together with all collection charges,” which has the same effect as that above, except that the charges made by the banks on both sides are collected from the drawee, but not the cost of any local stamp ;

“Payable with exchange and stamps for negotiating bills on the Colonies as per endorsement,” which is used only on bills which are to be negotiated here by the drawer and which has the same effect as the simple “exchange as per endorsement” clause in that the negotiating bank quotes a “flat” rate of negotiation, i.e. it allows for exchange, stamps, and its own and the agent’s charges in the rate which it endorses on the bill ; the amount of the bill is then converted into Colonial currency at the endorsed rate, the resulting equivalent is written above the sterling amount, and the bill then becomes one for this amount of Colonial currency. The collecting bank will collect this amount, deduct its own commission, and will credit the account of its principal in its own books with the resulting net amount of Colonial currency.

Bills on South Africa.

While several of the clauses given above are often included in bills drawn here on South Africa, there is no special clause in general use. The “Interest Clause” is seldom used on bills drawn on South Africa from this country, but is occasionally used in bills drawn from the U.S.A. on South Africa.

In many cases the drawer will allow for the exchange in his invoice, and will then draw his bill for the resulting amount in South African pounds. In other cases any one of the recognized exchange

clauses, either with or without the additional demand for the payment of collection charges and stamps, is included in the bill by arrangement between drawer and drawee.

Finally, it should be noted that the inclusion in the wording of a bill of any exchange or collection of expenses clause should be arranged for in the original contract between seller and buyer, i.e. the drawer should have obtained the agreement of the drawee to the inclusion of any such clause in the bill. Also no exchange clause can be included in a bill drawn in terms of a foreign currency and the "exchange as per endorsement" clause cannot accompany any other clause which shows that the bill is eventually to be paid in sterling, as once a rate of exchange has been endorsed on a bill under this clause the bill then becomes expressed and payable in terms of the foreign currency.

Collection and Negotiation of Bills.

Where a bank here merely undertakes the *collection* of a bill on behalf of a customer, it acts only as an agent, and will not pay over to or credit the account of the customer with the proceeds until it receives either a return remittance from its agent or advice that it has received credit for the proceeds in the books of its agent.

Where a bank agrees to *negotiate* a bill for a customer, it acquires full rights in the bill and, in most cases of documentary bills, a right to the property in the relative goods, since it purchases the draft for its "present value," i.e. discounts it, and so becomes a holder for value and usually a holder in due course.

The customer for whom the bill is negotiated receives payment or credit of the sterling equivalent immediately, and is thus actually the recipient of an advance from the bank of the full amount of his bill, less interest and charges against the security of the draft and/or documents.

Should the draft eventually be returned unpaid, the customer must refund to the negotiating bank the amount paid to him, plus interest for the intervening period and plus all charges and expenses. The bank must have a reasonable certainty of the ability of a customer to do this, if necessary, before it negotiates his draft, and the "limit" or "sanction" is fixed by the management in respect of this class of business for any customer in accordance with the estimate of his stability in this regard.

Marginal Deposits.

Where a bank does not wish actually to negotiate for their full "present value" the drafts on other centres of a customer, it may arrange to pay over or credit him with a proportion only of the "present value" of each draft. W. F. Spalding in his *Foreign Exchange and Foreign Bills*, page 257, describes the method thus—

"Suppose the drawer offers a bill for £100, the banker will advance 75 per cent and issue a marginal deposit receipt for the remaining 25 per cent, and a similar deduction will be made from each bill passed through the bank. Interest, at an agreed rate, is allowed on these margins from the time the bills are received by the bank until the net proceeds are remitted from abroad, and then, if all bills running are duly honoured and there is no deficiency, the full amount of the margin, plus interest, will be paid over to the client. Where interest bills are drawn, it is customary to allow interest on the marginal deposit at the same rate as that called for in the bills. It would obviously be unfair to collect and retain, say, 6 per cent on a bill for £100 from the drawee, when only £75 had been advanced to the drawer in London, so what the banker really does is to obtain the full interest on the £100 from the drawee abroad, and then when the proceeds are remitted to England, make over to the drawer the interest on the £25 which he holds as margin against the payment of the draft. It is usual to stipulate in the marginal receipts that the deposits are held against 'bill or bills running' and in general the amount will not be released until all bills have been met."

FORWARD EXCHANGE

There is nothing abstruse or difficult in either the principles or methods of dealing in forward exchange. The operation of dealing "forward" in foreign currencies was much more extensively practised abroad than in this country before the War, owing to the comparatively small volume of exchange business conducted in London at that time, but the chaotic conditions of all the exchanges after the War led to a rapid and extensive development of such facilities by banks here. The object of a "forward" deal in any commodity is to fix at once a price for a contract to be carried through on the future date agreed upon, and is intended to free both buyer and seller from any risk of loss which might accrue through fluctuations in the price of the commodity by the time both parties are ready actually to complete the transaction.

Forward Exchange may therefore be defined as an operation in exchange whereby a rate is fixed at once for a purchase and sale of one currency for another which is to be completed at some future date.

Under such an operation the exchange of one currency for another

is arranged for a stipulated date at a rate of exchange fixed immediately, and, no matter what the current rate of exchange may be at the date of the actual exchange of currencies, the exchange is carried through at the rate fixed when the contract was entered into. It thus enables a creditor who has to receive payment of his debt in terms of a foreign currency at a future date, to fix at once the value of his debt in terms of his own currency, or enables a debtor who has to discharge a debt at some future date in terms of a foreign currency to fix at once the cost to him in terms of his own currency of discharging the debt when due. Each party can thus be rendered free from any risk of subsequent loss through fluctuations in exchange rates before the debt matures but, obviously, only one party to a debt need operate, and either the creditor can sell forward his right to the currency of the debtor or the debtor can buy forward the right to the currency of the creditor which he will eventually need to discharge his debt.

Uses of Forward Exchange.

By such operations an importer of goods who has bought in terms of a foreign currency, can fix at once the eventual cost to him of the goods by purchasing forward the amount of foreign currency he will require at a rate of exchange fixed at once. Similarly, an exporter who has sold goods abroad in terms of the foreign currency, can determine his "outturn" in terms of his own currency by a forward sale of the foreign currency at a rate of exchange fixed immediately. Also a person who wishes to invest funds abroad for a short period can eliminate any risks of loss through fluctuations in rates of exchange by effecting a forward sale of the foreign currency which he is buying as "spot" for the purpose of the investment, so that when his investment matures, he has already fixed the rate of re-conversion into his own currency.

Method of Dealing in Forward Exchange.

As with all other exchange operations, the banks are the natural clearing houses for dealings in forward exchange. A bank will buy and sell "forward" currencies in the same way that it will buy and sell "spot" currencies. A customer or another bank, or any member of the exchange markets of the world, can offer to buy from or sell to that bank "forward" currency, i.e. currency for future delivery, and within limits will be quoted a rate as easily as for a "spot"

transaction. For example, an importer of goods from Germany may have received a quotation for a consignment from a likely seller there on terms which grant him three months' credit, so that he will have to pay for the goods in marks in three months' time if he accepts the offer. He can request his bank to quote him a rate at which it will sell to him German marks for delivery three months ahead and, on the basis of this rate, he can work out the eventual cost of the goods to him in sterling. If this is satisfactory, he will close with the bank's offer of the forward currency, and with the offer of the seller of the goods, and he will then know that, no matter what the current market rate for German marks may be on the date when he will have to discharge his debt, he has already fixed the rate of exchange at which he will have to pay for his marks. Again, a bank in New York may wish to invest funds in three months' London bills for the sake of a higher rate of interest to be obtained in London than in New York. To buy such bills it must first buy sterling and, if it does not "cover its exchange," it may lose all the profit from the higher interest rate, and even more, if the rate of exchange has moved adversely to it by the time the bills mature, and it wishes to re-convert the sterling into dollars. Thus, if it makes a purchase of sterling at the rate of \$4.87 to the £ in order to invest in London when interest rates are 1 per cent per annum higher there than in New York, and uses the funds at this margin in London for three months, it will have made a profit for one quarter of a year at the rate of 1 per cent per annum, i.e. $\frac{1}{4}$ per cent on its investment, provided that it can buy back its dollars at not worse than \$4.87 per £. If, however, the rate has moved to \$4.85 $\frac{1}{4}$ per £, it will lose 1 $\frac{3}{4}$ cents on each pound it has purchased, which, over the period, is more than the gain in interest, since $\frac{1}{4}$ per cent of 4.87 is only about 1 $\frac{1}{4}$ cents per £. In order to eliminate this risk of loss, therefore, an investing bank or even a private short-term investor will combine the purchase of the "spot" currency in which it is proposed to invest, with a forward sale of the same currency for the date on which the investment will mature, thus fixing at once the eventual rate of re-conversion of the foreign funds into the home currency.

A forward exchange deal is a definite contract, and a letter or form of contract is taken by the bank concerned from the party with whom the contract is made. As between banks or members of the market, a simple letter of confirmation of the deal is considered

sufficient, but in the case of private customers, including commercial firms and all others than banks and market members, a definite form of contract undertaking due performance must be signed and handed to the bank. In many cases a certain "margin" is demanded by the contracting bank as security for the eventual performance of the contract, and this takes the form of a cash margin, held on a special account and bearing interest at an agreed rate, which must be maintained at anything from 10 per cent to 25 per cent of the *current* sterling value of the operation, according to the view taken by the bank of the standing of the customer. Once a forward contract is accepted by both parties, it must eventually be carried through, and a contracting bank therefore accepts a certain risk of loss should the other party fail to carry out his side of the bargain. For example, if a customer buys from a bank German marks for delivery in three months' time at a rate of 20.48 per £, but fails to take delivery on the maturity date and leaves the marks on the bank's hands, the bank must sell them at the market price then current, which may be 20.50 per £, in which case the bank would stand to lose 2 pfennige on each pound's worth of marks sold to the customer. It is for this reason that a "margin" is often required so that it could be applied against any such loss, and in any case forward contracts with any other party are all subject to "limits" or "sanctions" from the managerial department. Where a "margin" is taken it is, of course, released when the forward contract has been finally discharged.

The details of a forward transaction with a bank are simply that a rate is fixed at once at which the foreign currency will be bought from or sold to the other party; the date on which the contract is to be completed must be stated and agreed upon before the rate is quoted and is an integral part of the contract; no money passes between the parties until the date of maturity arrives (except for any cash margin which may be demanded by the bank), but on that date the funds are paid over in the foreign centre against payment of funds in the home centre on the same day at the rate of exchange fixed under the contract. The bank will, of course, keep records of all such transactions, both in an account under the name of each customer dealt with, and in a "forward" account for each currency in its "Nostro" ledgers, so that its exchange position in "spot" and "forward" currency can be easily ascertained. No entries will be passed by the agent in the foreign centre until the date of maturity

arrives, as he will not be advised to pay or receive the foreign funds until that date.

Forward dealings are carried out in the various exchange markets in the same way as "spot" deals, rates being arranged and contracts passed between brokers and banks, and between the banks themselves as for "spot" deals. The question of "name" is of greater importance for forward deals than for spot owing to the greater risk of loss through the position of one contracting party changing for the worse during the currency of the contract, and so rendering him unable to carry out his side of the bargain.

Forward Exchange Quotations.

Forward rates of exchange are quoted as a "margin" or "difference" against the "spot" rate of the currency concerned, or as a "premium" or "discount" on the "spot" rate, or they may be quoted "outright," i.e. an actual forward rate of exchange in the currency concerned, obtained by allowing for the forward "margin" over or under the current "spot" rate.

The following table, such as would appear in the daily Press under normal conditions, gives the market quotations for the forward "margins" in the principal world currencies.

"The following approximate rates were quoted for forward business"—

—	1 month	2 months	3 months
Amsterdam (b) . . .	$\frac{7}{8}$ - $\frac{3}{8}$ c.	$1\frac{1}{4}$ - $\frac{3}{8}$ c.	$1\frac{7}{8}$ - $1\frac{3}{8}$ c.
Berlin (a)	$1-1\frac{3}{8}$ pf.	$1\frac{3}{4}$ - $2\frac{1}{4}$ pf.	$2\frac{1}{4}$ - $2\frac{3}{4}$ pf.
Brussels (b)	4-3c.	6-5c.	8-7c.
Madrid (b)	5-3c.	8-6c.	9-7c.
Milan (a)	7-9c.	13-16c.	20-23c.
New York (b)	$\frac{7}{8}$ - $\frac{1}{16}$ c.	$\frac{3}{4}$ - $\frac{1}{16}$ c.	$\frac{3}{4}$ - $\frac{3}{16}$ c.
Paris (b)	18-16c.	30-28c.	38-36c.
Zurich (b)	$3\frac{1}{2}$ - $2\frac{3}{4}$ c.	$4\frac{1}{2}$ -4c.	$7\frac{1}{4}$ - $6\frac{3}{4}$ c.

(a) Over "spot," i.e. discount. (b) Under "spot," i.e. premium.

It will be noted that each quotation is lettered either (a) or (b), and these distinctions are stated to be for margins quoted *over* the "spot" rate, i.e. the forward rate is at a discount as against the "spot" rate, and for margins quoted *under* the "spot" rate, i.e. the forward rate is at a premium on the "spot" rate, respectively. Remembering that "discount" is synonymous with "cheaper" and "premium" with "dearer," it can be seen that when the forward

margin is *over* the spot rate (at a discount), the outright forward rate will be cheaper from a general point of view than the spot rate, and that when the forward margin is *under* the spot rate (at a premium), the outright forward rate will be dearer than the spot rate, peaking generally. This applies, however, only to rates quoted in terms of foreign units to the pound, i.e. "currency" rates, and the maxims must be reversed when dealing with "pence" rates, but the number of forward deals in these latter rates is comparatively small, so that forward margins in "pence" rates are not usually quoted in the market or in the Press. The banks specializing in currencies for which the quotations are in pence are always ready to quote forward rates on request, and such rates are compiled in the same manner as for "currency" rates, which is set out below.

To show how the quotations given above should be used, the following examples may be taken.

The margins shown are in terms of the subsidiary unit of the currency concerned or in fractions thereof. Where the margin is at a discount, as in the case of Berlin, the rates quoted mean that for Reichsmarks for delivery one month from date the margin is 'sellers at 1 pfennig over spot' and "buyers at $1\frac{3}{8}$ pfennige over spot"; for delivery two months from date, sellers offer $1\frac{3}{4}$ pfennige over spot while buyers ask $2\frac{1}{4}$ pfennige over spot; and for delivery three months from date, sellers offer $2\frac{1}{4}$ pfennige over spot while buyers ask $2\frac{3}{4}$ pfennige over spot.

The market quotations are for the standard periods of one, two, or three months from spot date, but it is sometimes possible to obtain quotations for up to six months from spot date or for any "broken" period in between, e.g. if the spot date is 6th July, the usual quotations would be for delivery on 6th August, 6th September, and 6th October, but rates could be obtained for, say 6th November, or 6th January, or 22nd August, or 31st December, etc. The rates for periods other than those normally quoted are not always in strict proportion to the normal rates, and an outside buyer should expect to pay rather worse and a seller to obtain rather worse than the strictly proportionate rate for a "broken" period.

Returning to the example above, if the market quotes the spot (or T.T.) rate on Berlin as 20.50— $50\frac{1}{2}$ per £, the market "outright" forward rates for the recognized periods would be—

	Sellers	Buyers
T.T.	20.50	20.50½
1 month forward	20.51	20.51¾
2 months forward	20.51¾	20.52¾
3 months forward	20.52¼	20.53¼

These rates are obtained by adding to the rate at which dealers are willing to sell T.T., the margin which they are prepared to give away to sell forward, and by adding to the rate at which they are prepared to buy T.T. the margin which they require over spot if they are asked to buy forward. It is always possible for a dealer to negotiate in the market in order to arrange a deal at a price midway between the extremes of prices in each case, in the same way as with spot, and his success or otherwise will depend on the tendency of the market and on the desire of another dealer to operate in the reverse way. For example, the three months' "outright" forward rate in marks would probably be quoted as 20.52½-53, instead of 20.52¼-53¼, as dealers on both sides would normally give way to the extent of ¼ pfennig. In quoting "outright" forward rates to customers, a bank dealer, therefore, can usually be certain of obtaining a small margin of profit by undoing his deal in the market at a slightly better price, if he quotes the customer the extremes of the spot rate and the forward margin, but he may on occasion have to allow an additional margin of profit one way if the market appears to have a decided tendency in that direction.

In the case of, say, the Madrid rate, for which the forward margin is at a premium (under spot), the "outright" forward rates in the market, taking the T.T. rate as 52.87-88, would be—

	Sellers	Buyers
T.T.	52.87	52.88
1 month forward	52.82	52.85
2 months forward	52.79	52.82
3 months forward	52.78	52.81

These rates are obtained by a seller deducting from the rate at which he is willing to sell T.T. the margin he requires in his favour for selling forward, and by a buyer deducting from his buying rate for T.T. the margin he is willing to give away for buying forward. Here again, dealings in the market could probably be effected at rates between these two extremes, so that a bank dealer could undo an operation carried out with a customer, at a small profit to himself, if he sold to or bought from the customer at these extremes of prices and covered himself at some intermediate rate in the market.

“ Swaps.”

Operations consisting of a simultaneous sale or purchase of spot currency accompanied by a purchase or sale, respectively, of the same currency for forward delivery, are technically known as “swaps” or “double deals,” as the spot currency is “swapped” against the forward. This is the type of operation carried out by a short-term investor in order to secure himself against loss in exchange during the period of investment. Such transactions consist of a spot purchase of the currency in which it is desired to invest, together with a forward sale of the same amount of currency for a forward date to coincide with the estimated maturity date of the investment. The rate of re-conversion of the foreign funds into home currency is thus secured and the investor can calculate his profit on the basis of interest and capital appreciation, if any, of his investment. The purchase of the spot foreign currency gives the investor immediate funds in the foreign centre of which he can dispose as he pleases. In some cases a foreign bank will have need of sterling for a certain period and will make an offer to a London bank to sell to it the foreign currency on the spot, against sterling, and to buy it back forward, again against sterling, at a margin to be agreed upon; at the same time the foreign bank will offer to take the foreign currency on deposit with itself at a stated rate of interest so as to offer the London bank employment for the foreign funds which it will obtain if it carries out the “swap.” Such an operation is known as a “*swap and deposit*,” both the swap and the deposit being carried out with the same bank abroad by the London bank. The desirability of the operation depends upon (a) the standing of the foreign bank, as the London bank will be entrusting it with the deposit, (b) the forward margin proposed, and (c) the relative rates of interest ruling in the two centres. For example, if the foreign bank is of sufficiently good standing to warrant the deposit being made with it, the profit to be made by the London bank will depend on the difference between the interest which it will lose on its sterling, and the interest which it will receive on the foreign currency deposit, *plus or minus the interest equivalent of the forward margin*. Thus, if money is worth $2\frac{1}{2}$ per cent per annum for three months in London, and a German bank offers a three months’ swap in marks at a margin of 2 pfennige discount (a *premium* on forward marks in London turns into a *discount* on forward pounds in Berlin), coupled

with an offer to take the marks on deposit for three months at 4 per cent per annum, the London bank, should it accept, would make a net interest profit of $1\frac{1}{2}$ per cent per annum for three months, plus 2 pfennige per pound on each pound's worth of marks dealt in, which represents an interest profit of about $\frac{3}{8}$ per cent per annum (2 pfennige for three months is at the rate of 8 pfennige for 1 year; 8 pfennige for 1 year on a spot rate of about 20.50 equals about $\frac{3}{8}$ per cent for the year), so that its total profit would be at the rate of about $1\frac{7}{8}$ per cent per annum for the three months. If the operation were for Rms. 1,000,000 (which is roughly £50,000), the profit for the three months' operation would be $1\frac{7}{8}$ per cent per annum for 3 months on £50,000, or about £235. Another and a more usual form of this operation is that in which an investor (whether a bank, firm, or individual), wishing to have funds available in another centre for a limited time, purchases the required currency "spot" and simultaneously arranges a forward sale of the same amount of currency for a future date when he expects the use of the funds abroad to be at an end. The purchase of spot currency gives him funds immediately available in the foreign centre, against payment of funds in his home currency, while the forward sale fixes at once the rate of exchange at which he will eventually be able to re-convert the foreign currency into home funds. The currency abroad is thus at his disposal during the period before the forward contract matures and he can use it in any fashion he pleases. He can place the money on fixed deposit with a bank in the foreign centre or with a bank in some other centre which is willing to borrow that particular currency, e.g. he can buy spot U.S.A. dollars against a forward sale and lend the dollars for the period to a German bank, or he can use the funds in the foreign Call Money market or in loans on the foreign Stock Exchange, or he can buy bills or short dated investments in the foreign centre, or he can use the funds for operations in securities or commodities, or in any other way in which he thinks a profitable return can be obtained. Such operations are known as "*swap and investment*," and their desirability depends on the profit which might have been obtained on the funds by keeping them in the home currency and the profit to be made by employing them abroad, making allowance for the cost of the "swap," i.e. the discount gained or the premium to be given away in order to sell the currency forward.

As an example of such an operation, if London bills of three

months' tenor can be purchased in the London market at a discount rate of $2\frac{1}{2}$ per cent per annum, while similar bills in the New York market can be purchased only at a discount rate of $1\frac{1}{2}$ per cent per annum, then New York banks and financial houses wishing to invest funds temporarily in three months' bills will endeavour to do so in London as long as the cost of buying spot sterling for dollars and reselling it three months forward for dollars does not absorb too much of the gross interest profit. If the T.T. rate on London in New York is \$4.86 $\frac{1}{2}$ per £, and the three months' forward margin there is $\frac{5}{8} - \frac{1}{2}$ c. discount on the forward sterling, a New York bank can buy spot sterling only by giving \$4.86 $\frac{1}{2}$ per £, and will receive only \$4.85 $\frac{7}{8}$ per £ (4.86 $\frac{1}{2}$ less the buying discount on the forward sterling of $\frac{5}{8}$ c.) for each pound he re-sells forward. He thus loses $\frac{5}{8}$ c. per £ over the three months, which is at the rate of $2\frac{1}{2}$ cents per £ for one year, which on 4.86 $\frac{1}{2}$ is about $\frac{1}{2}$ per cent per annum. As the gross gain in interest is at the rate of 1 per cent per annum, the net gain, neglecting expenses, is at the rate of $\frac{1}{2}$ per cent per annum, or $\frac{1}{8}$ per cent *ad valorem* for the three months; therefore, on an investment of \$500,000 (which is about £100,000) the profit would be, in sterling, $\frac{1}{8}$ per cent of £100,000, which is £125.

The student should note these methods of working out approximate profits, and more particularly *the methods of expressing a fraction in the rate of exchange over a given period as a percentage per annum on that rate, and vice versa.*

It should also be noted, however, that the working in all the above examples is only approximate and is not arithmetically correct. To arrive at an exact result in any calculation of a percentage on a foreign currency exchange rate, one must *work on what the rate has become, not on what the rate was at the beginning of the calculation.* For example, if the dollar-sterling rate falls from \$5 per £ to \$4 per £, the appreciation in the dollar is not \$1 on \$5, or 20 per cent, but \$1 on \$4, or 25 per cent. This is proved by the fact that, in New York, sterling will have depreciated from 4s. per dollar to 5s. per dollar, which is again 25 per cent.

Similarly, if spot Paris is Fcs. 60 per £ and three months forward is Fcs. 15 per £ discount, this latter would be at the rate of Fcs. 60 per £ for a full year, or, apparently, at an interest rate of 100 per cent per annum on the spot rate. Actually, however, a person selling Fcs. 6,000 on the spot and buying them back for delivery in

twelve months' time at Fcs. 60 per £ in his favour would be situated thus—

Sale of Fcs. 6,000 at Fcs. 60 per £ yields	£100
Purchase of Fcs. 6,000 at Fcs. 120 per £ costs	£50

This shows a profit of £50 on an outlay of £100, which is at the rate of 50 per cent only instead of 100 per cent. Consequently, where margins, either of fluctuations in rates or for forward dealings, are wide, the interest yield or rate per cent per annum or actual percentage of difference should be arrived at by expressing the margin as a percentage of the *new* rate when quotations are in terms of foreign units per pound. In the above example, if the forward margin, which is at the rate of Fcs. 60 for a full year, is expressed as a percentage of the *eventual* rate, i.e. Fcs. 120 per £ as the "outright" forward rate, the answer is 50 per cent per annum, which agrees with the result given by working the exact sterling outlay and return.

Where, however, the margin is only fractional as compared with the parent rate, the difference between working the percentage on the old or on the eventual rate is so small as to be negligible—as the reader may discover for himself by re-working the examples on p. 207 and p. 261 and onwards, using the *eventual* "outright" forward rates as the basis of his calculations instead of the spot rates.

Option Forwards.

In many commodity markets and on all the Stock Exchanges, it is possible to deal in an "option to deal," that is, by the payment of a sum of money, the giver purchases the right to deal in a certain quantity of the commodity or in a certain number of shares at a stated price, on or up to a stated future date. He is not bound to exercise his option to deal, but can get clear of his bargain merely by sacrificing the "option money." This is dealt with under the heading of "Put and Call" in the chapter on the Stock Exchange in the author's book *Practical Banking*.

In the Foreign Exchange market in this country, however, none of the banks will grant an "option to deal" in any foreign currency. They will only grant an *option as to the date of the eventual completion of the contract*, so that the dealings known as "option forwards" are "optional" only as to the date of completion by the other contracting party, and are never "options" as to the eventual

completion of the contract, *which must be carried through* at the latest by the last day of the option to complete.

An "option forward" is therefore a contract under which one contracting party cannot state definitely at the time of entering into the contract on what exact date he will be able to complete the contract, and he therefore obtains the consent of the other party that *the contract may be completed on any date between two specified dates, or during a stated period*, at the option of the party to whom such option is granted. The giver of the option must obviously protect himself under such circumstances by taking the view that the contract may be completed on the worst possible day from his point of view, and must quote a price accordingly. Where an option is granted for completion of the contract on any day within one month from spot, for instance, and the spot rate is 20.50 per £ while the forward margin is 1 - 2 points discount, in the case of an option *sale* forward, the seller must take the view that the purchaser may demand delivery on the first day of the option, which would be the normal spot date, and so no discount at all can be allowed, but the spot selling price of 20.50 alone can be quoted; but in the case of a forward *purchase*, the buyer must take the view that the seller may not deliver until the last day of the option, in which case the full one month would have expired and the full discount of 2 points would accrue to the buyer, and he must therefore quote a rate of 20.52 for buying a one month forward option.

In order to show clearly the difference between "outright" or "fixed" forwards and "option" forwards, the following table gives the rates which would be quoted by a bank to a customer for each class of operation, based on the first table given above—

	Sellers	Buyers
T.T.	20.50	20.50 $\frac{1}{2}$
1 month forward fixed	20.51	20.51 $\frac{7}{8}$
1 month forward option	20.50	20.51 $\frac{7}{8}$
2 months forward fixed	20.51 $\frac{3}{4}$	20.52 $\frac{3}{4}$
2 months forward option for period	20.50	20.52 $\frac{3}{4}$
Option over 2nd month only	20.51	20.52 $\frac{3}{4}$
3 months forward fixed	20.52 $\frac{1}{2}$	20.53 $\frac{1}{2}$
3 months forward option for period	20.50	20.53 $\frac{1}{2}$
Option over 2nd and 3rd months	20.51	20.53 $\frac{1}{2}$
Option over 3rd month only	20.51 $\frac{3}{4}$	20.53 $\frac{1}{2}$

Note how the bank gives away the smallest possible discount

for selling any option forward, but takes the full discount for the period when buying, whether the purchase is of a fixed or an option forward.

The following table gives the corresponding rates based on the second of the earlier tables—

	Sellers	Buyers
T.T.	52·87	52·88
1 month forward fixed	52·82	52·85
1 month forward option	52·82	52·88
2 months forward fixed	52·79	52·82
2 months forward option	52·79	52·88
Option over 2nd month only	52·79	52·85
3 months forward fixed	52·78	52·81
3 months forward option	52·78	52·88
Option over 2nd and 3rd months	52·78	52·85
Option over 3rd month only	52·78	52·82

Note here how the bank dealer always takes the worst possible view of the delivery date when *selling* and so allows himself the largest possible premium; but when *buying*, he takes the view that an option may be exercised at the earliest date possible, and so gives away the smallest premium possible, while when the option starts from the spot date, he gives away no premium whatever but only buys at his spot buying price.

Calculation of Forward Rates.

The relation of any forward rate to the spot rate for the same currency, i.e. the forward "margin" or "spread," depends, first, on the relative rates of interest obtainable on similar classes of securities in the two centres, and, secondly, on the relation between the demand for and the supply of forward currency in the world's markets.

The interest factor is the basic factor in arriving at a forward margin. If the rate of discount in Paris for three months' prime bank bills is 2 per cent per annum, while similar paper in London can be purchased at a rate of discount of 3 per cent per annum, there will be a flow of funds from Paris to London of such floating balances as are normally used in this type of investment, to take advantage of the higher yield shown by London bills. As long as exchange movements in the value of the French franc in terms of sterling are confined to within comparatively narrow limits, a certain proportion of transfers of such funds will be carried out "uncovered" as regards the exchange; that is, the French investor will run the risk of being able to buy back as many francs per pound, when he wishes to

repatriate his funds, as it cost him when he originally purchased the sterling in order to buy sterling bills. This leads to a certain demand for spot sterling, as has already been explained, with a consequent rise in the value of the pound in terms of French francs. In other cases and under less stable conditions, French investors will make a transfer of funds only if they can secure their exchange for eventual re-conversion into French francs of the sterling they purchase, that is they insist on covering their spot purchase of sterling by a forward sale of sterling for a date approximating to the estimated maturity of the sterling investment. This means that there will be a general tendency in the world's exchange markets for operators to be asked to buy French francs on the spot against a re-sale of the francs for a future date, both against sterling. As a result spot francs will be offered and forward francs wanted, giving a tendency for the forward franc to be dearer than the spot, i.e. forward francs will tend to go to a premium over spot as against sterling, and a dealer wishing to carry out a "swap" in francs against sterling will have to give more francs to buy his spot sterling than he will receive for his forward re-sale of the sterling against francs. Consequently, a certain loss is incurred in selling spot and buying forward francs, and this loss must be set against the interest profit which will accrue by moving funds from Paris to London; but operators will give away only a part of their gross interest profit, in the form of a premium on the forward currency, and *the premium thus set up will never therefore, under normal conditions, represent a percentage cost equal to the percentage gain in interest, but will remain at a somewhat lower level.* The extent to which the premium on the forward currency will, under such conditions, approach a percentage equal to the percentage margin of interest, depends on the volume of funds in the low interest centre available for transfer to the high interest centre and the consequent pressure of the demand to buy spot and sell forward currency on the latter centre. Force of competition between investors, should the volume of available funds be large or the interest margin of profit be considerable, will cause the net difference between the percentage gain in interest and the percentage loss in the forward margin to become so narrow as to represent a minimum margin of net profit. Thus, taking the interest rates quoted above and working on a spot franc rate of 124.20, the gross interest gain of 1 per cent per annum

is equal to $\frac{1}{4}$ per cent for an investment of three months, and $\frac{1}{4}$ per cent for three months is equal to a three months' forward margin on the spot rate of 124.20 of about 31 centimes premium. Therefore, the maximum forward "spread" under these conditions, and neglecting any other factors, would be 31 c. for three months, and an investor who gave away such a margin in order to transfer funds from Paris to London to gain 1 per cent per annum in interest would be giving away the whole of his interest profit. This of course he would not do, but force of competition between investors might send the forward margin to a premium of 22 or 23 c. for three months, which is equal to about $\frac{3}{4}$ per cent per annum, and so would leave the investor with a net margin of profit of about $\frac{1}{4}$ per cent per annum.

Apart from the effects of differences in interest rates on the forward margin, other factors may arise to cause offerings of or demands for outright forward currency which may then cause variations in the forward margin as based on the interest difference. For example, if, under the conditions given above, French financial interests had reason to suppose that funds would be strongly wanted at home in the course of three months or so, those houses having funds in London might wish to make sure of re-transferring them to France by the time the need arose, and so might be good sellers of forward sterling against francs. The resulting demand for forward francs against sterling would tend to send the premium even higher, and, if such demand were strong enough, it might overwhelm the interest basis and send the premium to 35 or 40 c. for the three months, equal to a loss of up to $1\frac{1}{4}$ per cent per annum. On the other hand, if the spot rate were only 123.88, investors might take the view that this rate was so near the normal out-going gold point from this country to France that the risk of exchange loss on an investment would be negligible, while speculators for a rise in the value of sterling would be ready to sell forward francs at a few points under the spot rate, and under the estimated gold point, say at 123.80 for three months ahead outright. This would mean that the forward margin would only stand at from 10 to 8 points premium, equal to about $\frac{1}{4}$ per cent per annum in spite of the interest margin of 1 per cent per annum.

In general, therefore, it may be stated that the margin between the spot and forward rates for any currency *will be at a premium on spot when the rate of interest here is higher than that ruling in the*

foreign centre, and will be at a discount over spot when interest rates in the foreign centre are higher than those ruling here for similar classes of securities, but the percentage per annum equivalent of the forward margin will fall short of the full percentage per annum difference in the rates of interest.

For the past few years, however, the normal rules for calculating forward margins have gone by the board owing to the enormous and sudden movements of capital from one centre to another, the prevalence of restrictions on exchange dealings, the activities of speculators, etc. This again provides another instance of the moderating influence of effective gold points. As long as gold can move freely at fixed prices between two centres, capital-owners feel secure, there is no need for any artificial control of exchanges, and there is very little margin for exchange fluctuations of which speculators can take advantage. But at the first hint that one or other country may be forced to suspend gold payments, capital takes fright and "flight," the resulting strain on the exchanges leads to government control and the imposition of exchange restrictions and often precipitates the actual event which it is the object of such capital to avoid while speculators are in their element and "bear" the doubtful currency and "bull" some supposedly safe currency for all they are worth.

Under such conditions forward margins cease to be governed by any recognized factors, and it may eventually become impossible to deal in forwards at all. Since foreign exchange is the *exchange* of currencies, no currency can be sold without another being bought and a "flight" of capital from one centre or a "bear" speculative movement against one currency must result in a demand for another currency or currencies. Where capital is invested in bills or securities which have to be realized, some delay may take place before that capital is rendered liquid and capable of being exchanged for another currency. Consequently, the owner, under conditions which have caused him to lose confidence, will sell forward the currency at present held (in the expectation of his funds having become liquid by that time) against a forward purchase of some more desirable currency. It should be clear that to an owner of capital who is seeking to avoid a capital loss of 25, 50, or even 100 per cent, the percentage cost per annum of a forward margin is a matter of small importance, and the movements in forward margins

in the currencies concerned can be as wide and as frequent as those in the spot rates.

Similarly, a speculator against any currency is necessarily looking for a heavy depreciation in the exchange value of that currency. If he expects a capital profit of perhaps 50 per cent in six months, he will disregard entirely the ordinary relationship of the forward to the spot rate since he must use the former to finance his operations. The usual *modus operandi* of the speculator is to sell "out-right" forward at every opportunity but, as these are infrequent, to first buy spot and sell forward, for as far ahead as can be arranged, in the currency to be attacked, against some more stable currency. He then sells the spot so purchased and leaves himself short of the forward, this constituting his "short position," while in the "safe" currency he arranges to remain "long" of forward. The spot sale of the "doubtful" currency is made against a spot purchase of the "safe" currency, which cancels out the spot side of the "swap" in the "safe" currency and leaves the operator long of the forward purchase of the "safe" currency against his short position forward in the "doubtful" currency.

For example, suppose that an operator wishes to "bear" French francs and "bull" U.S. dollars. The conditions ruling at the time are that the U.S.A. has firmly re-established herself on gold but France has had difficulty in balancing her Budget, has lost large quantities of gold, and is not so firmly anchored to a gold standard as she was; also, interest rates for prime three months paper are 1 per cent per annum in New York, 1 per cent per annum in London, and 3 per cent per annum in Paris, while the exchange rates are \$5 per £, Fcs. 76 per £, Fcs. 15.20 per \$; three months forward margins in London are on Paris 25-35c. discount, and on New York 4½-5c. discount (owing to a previous "flight" from the dollar now stopped owing to returning confidence).

The operator first commences to buy spot and sell three months forward francs and to sell spot and buy three months forward dollars. Since the conditions posed above indicated probable loss of confidence in France and increasing confidence in the U.S.A., bids for forward francs and offerings of forward dollars will be limited to current trade needs—a most inadequate counterpart to the sums in which the exchange speculator wishes to deal. Being concerned with a large capital profit, the operator is not disposed

to haggle over a few centimes or cents in the forward margins as long as he can rapidly provide himself with the sinews of war in the shape of a "long" franc or a "short" dollar spot position and can get in before the man next to him. Consequently, he presses both his "swaps" in the world's markets at steadily cheaper prices, i.e. he offers increasingly large discounts on his sale of forward francs and will take a successively smaller discount on his purchases of forward dollars against spot. At various stages he will encounter buyers of forward francs and sellers of forward dollars, each against spot, in the shape, on the one hand, of people who are willing to lend francs against sterling or dollars for three months for the sake of the interest yield shown by the forward margin and, on the other hand, by those who are prepared to borrow dollars against sterling or francs for the sake of the comparative cheapness shown by the reduced discount on the forward.

Eventually, these operations (probably multiplied many times over by those of other speculators) may result in the discount on forward francs reaching even Fcs. 1.75 for three months and that on forward dollars being reduced to $\frac{1}{2}$ - $\frac{3}{4}$ c. for three months. At these rates the forward franc margin bears no relation to the comparative interest rates while the forward dollar margin is much nearer to its proper level. On the interest rates given, investors should be disposed to buy spot and sell three months forward francs until the margin represents nearly 2 per cent per annum, i.e. $\frac{1}{2}$ per cent for the three months period, which, on Fcs. 76 per £, was approximately correctly represented by the former margin of 25-35c., whereas a margin of Fcs. 1.75 for three months represents a giving away of interest at the rate of over 9 per cent per annum. On the other hand, the former distrust of the future of the dollar was shown by the forward margin of $4\frac{1}{2}$ -5c. discount for three months, which is at the rate of 18-20c. for one year, which on a rate of \$5 is equal to giving away interest at from $3\frac{3}{4}$ to 4 per cent per annum. The eventual margin of $\frac{1}{2}$ - $\frac{3}{4}$ c. is equal only to a giving away of interest at the rate of either side of $\frac{1}{2}$ per cent per annum, and is much more in relationship with the relative interest rates. Our speculator at last, or concurrently, proceeds to sell out his spot francs and buy in his spot dollars and again the size of his operations overwhelms the normal demand for and supply of these currencies. Francs tend to depreciate and dollars to appreciate.

and most probably these movements tend to enhance the existing lack of confidence in France and increasing confidence in the U.S.A. Eventually, the speculator's anticipations may prove to be correct. France has to raise her price for gold, thus devaluing the currency, and francs become permanently cheaper in terms of other currencies. Assuming that only a moderate devaluation of, say, 20 per cent is necessary, i.e. an increase of 25 per cent in the gold price,¹ our operator will find the new level for francs is about Fcs. 91 per £, and Fcs. 18.25-30 per \$, with the dollar still at \$5 per £. He can, therefore, close out his short position in francs and long position in dollars (obtained by leaving his forward sales of francs and forward purchases of dollars uncovered) and after some oscillations due to these covering operations, the rates will settle down around their new parities. There being no further inducement to "bear" francs, the pressure to sell forward francs will subside, and the forward margin will narrow in towards its proper level on an interest basis. This description illustrates speculation in exchange and its effects at their simplest, but in actual practice the repercussions are much more complex and widespread as all allied exchanges, both spot and forward, become involved, e.g. Belgium, Holland, and Switzerland in the instance given.

While, therefore, the relative interest rates in two centres is the basis of calculation of the forward margin in the exchange between them under stable conditions, this basis ceases to exert any influence as soon as conditions become abnormal, and indeed for the past few years the abnormal has been so much in evidence as almost to have come to be regarded as the normal. In the instance given above, if the operator loses, on the average, $8\frac{1}{2}$ per cent per annum on his franc "swap" and gains $\frac{1}{2}$ per cent per annum on his dollar "swap," this represents a net loss of 2 per cent on the three months period. If he has to renew his "swaps" for a further three months, should events not have progressed as rapidly as he expected, he is still losing only 4 per cent on his capital for a six months' speculation, and if at the end of that time he makes a gross profit of 20 per cent his net profit will be about 15 per cent on the amount of currency he has dealt in, even after allowing for the 4 per cent cost

¹ If, for instance, a monetary unit is said to contain 100 grains of gold but is devalued by 20%, it will then only contain 80 grains and it will take 125 of the new units to purchase 100 grains of gold, i.e. a rise of 25% in the price of gold.

of his "swaps" and all other expenses. No rules can be laid down for the calculation of forward margins under such conditions, as the extent of their fluctuations is governed only by the estimate of the speculator as to the probable capital profit on his operations and the extent to which he is prepared to deal.

A further incalculable factor exists where official restrictions are imposed either on dealings in exchange or on the granting of overdrafts and credits. In the ordinary way if an exchange dealer can obtain an overdraft or clean credit in a foreign centre at, say, 6 per cent per annum, he will be prepared to use such facilities to enable him to sell that currency on the spot and buy it back forward if the discount offered on the forward, plus the profit on the use of the home funds which he will receive, shows him a greater yield than the cost of borrowing the funds abroad. For example, if a London operator can obtain an overdraft in Switzerland at 6 per cent per annum and a "bear" movement against the Swiss franc is taking place causing forward Swiss francs to be offered at 32c. for three months with a spot rate of Sw. Fcs. 15.90 per £, and three months bills can be purchased in London to yield 1 per cent per annum, the operator can make profitable use of his overdraft facilities in Switzerland. He borrows Swiss francs for three months at 6 per cent per annum, which costs him $1\frac{1}{2}$ per cent on his capital. He sells these francs as spot, against sterling, and buys them back three months forward, thus covering his exchange and showing him a profit of 32c. for the period, which is nearly 2 per cent on his capital. In addition he has the use of the sterling equivalent of his spot sale of francs until it is needed to pay for his forward purchase. This sterling he can use at 1 per cent per annum, which gives him $\frac{1}{4}$ per cent on his capital for the period. He therefore makes $2\frac{1}{4}$ per cent gross on his capital against a cost of $1\frac{1}{2}$ per cent, showing him a profit of $\frac{3}{4}$ per cent, which is at the rate of 3 per cent per annum, neglecting expenses.

Where official exchange restrictions have been imposed, however, overdraft and credit facilities for financial purposes are usually unobtainable. For example, for some years following the inauguration of the "Fascist" régime in Italy the banks there were forbidden to grant overdrafts or to allow "clean" credits to foreigners. As a result, speculation against the lire became extremely difficult as the spot lire needed to commence the "bear" attack could not

be obtained by the usual method of buying spot and selling forward in any quantity, since no one was in a position to supply spot against forward lire, no matter at what interest yield, except the State Bank, and the energies of that institution were, of course, directed towards foiling rather than helping the exchange speculator. As an instance of the efficacy of such measures, it may be mentioned that early in 1934 when a certain opinion became prevalent that Italy would shortly be forced to suspend gold payments, a "bear" attack on the lire was started, and in the effort to obtain spot lire for that purpose the three months forward margin was forced out to a discount representing 20 per cent per annum, and even at that price orders could not be executed. The discomfiture of the speculators was completed soon afterwards when the Bank of Italy entered the market and bought lire and restored the exchange to its former gold parity with the French franc, so that in addition to the heavy cost of borrowing their spot lire, the speculators made a further loss on such spot as they had been able to obtain and sell.

The most unfortunate aspect of a general loss of confidence in a currency or of official restrictions on exchange dealings is the effect on the forward market, which usually at once becomes almost nominal with a corresponding handicap to traders who are genuinely in need of forward exchange facilities to cover imports or exports. It is no part of the business of a trader to speculate in exchange. If he contracts to buy or sell goods from or to a foreign country in terms of the foreign currency, he should do so because he already has, or his experience tells him he will shortly have, a profitable counterpart to such a deal in terms of some other currency. Since trade must be anticipatory, merchants must deal in goods for future delivery, and it should be the business of the financial community to provide the merchant not only with the finance needed to carry part of his stock, but also with the exchange facilities he requires in order that he can fix at once the cost or yield of any foreign currency with which his trading involves him, both spot and forward. Under normal conditions the banking world supplies such facilities with freedom—perhaps too freely—but they should not be allowed to lapse almost entirely during a time of crisis, as was actually the case. It should be the concern of every State Bank to afford such credit and overdraft facilities

to approved banking agents as would enable the latter to provide even restricted forward exchange facilities to genuine commercial interests, where *bona fides* could easily be proved by the production of contracts or shipping documents. Unfortunately, it seems that financial interests have now everywhere come to overshadow commercial interests, and in the consideration of the colossal amounts of non-productive financial debt, the claims of the more modest but far more essential commercial items are made the subject of nationalistic negotiation.

How Banks Cover Forward Dealings.

Where, say, an importer who will have to pay in a foreign currency at some future date for the goods which he has purchased, buys that currency forward from his bank, he is thereafter no longer affected by any movements which may take place in the spot rate for that currency, but when the maturity date of the forward contract arrives, need only pay over the sterling equivalent of the foreign currency at the rate of exchange fixed when the contract was made, and will then receive the amount of foreign currency contracted for. The contracting bank has made itself liable to pay over the stated amount of foreign currency at the rate agreed upon, and, as banks in this country do not take up "open positions" in exchange, i.e. do not speculate on the possible future rate, it must conduct some other operation at once in order to cover itself, in turn, against the risk of an adverse movement in the spot rate by the time the forward contract matures.

Such covering operations may be carried out in several ways, which may be summarized as follows—

(a) In the case of a forward sale, the bank can lay down funds in the other centre immediately by means of purchases of T.T.s, M.T.s, G.M.T.s, cheques, or any other credit instruments payable at sight or at short sight. As the forward margin is normally based on the difference in interest between the two centres, and as the variation from the T.T. rate in the price of the other short-dated instruments is based on the value of money as used in their purchase, this method should show a reasonable profit on an interest basis, and is the one used whenever conditions permit, especially as banks usually need funds in other centres in order to maintain balances with their correspondents there. When the outstanding

balances become larger than is necessary for this purpose, the surplus funds can be used in the foreign Call Money or Stock Markets, or loaned to first class borrowers for the period until the maturity of the forward contract. The limit to this form of covering is the amount of sterling which any bank is prepared to lock up in the shape of foreign currencies, and must be taken in conjunction with the other methods which involve the immediate use of sterling.

In the case of a forward purchase, the bank may be able to use some of the funds it has acquired as cover for its forward sales, or which it holds for account of its customers, and can sell T.T.s, M.T.s, G.M.T.s, or cheques as cover for its forward purchase. The use of this method will depend on the rates of interest which can be obtained for the foreign currency in the other centre, and for the sterling which a sale of the currency would produce. It must be borne in mind that the bank will not receive the sterling for a forward sale, or pay out the sterling for a forward purchase, until the contract matures and in its covering operations it must be guided by the relative cost in interest of using either sterling or the foreign currency which it holds. If sterling is more valuable, from an interest bearing point of view, than the foreign currency, it will endeavour to cover forward sales by some method other than one involving an immediate sterling outlay, while it will cover forward purchases as far as possible by disposing of its available funds in the foreign currency so as to have the use of the resulting sterling.

(b) To cover forward sales a bank may buy long bills on the foreign centre to mature immediately before the date on which it is under contract to provide the foreign currency for its customer, if such bills can be obtained. Here, again, an immediate sterling outlay is involved and the use of this method will depend on the rate of interest ruling in the foreign centre for the class of paper in question (which is the rate of interest which will be shown by the purchase of such paper), compared with the rate of interest which could be obtained by using the sterling in other ways at home or in other centres.

More usually, a bank will cover purchases of foreign bills at tenor by a forward sale of the currency concerned, rather than the reverse, as it is seldom possible to obtain foreign bills for the approximate amount and for a near enough maturity date to

cover any given forward sale just at the moment when they are needed.

Frequently, indeed, a bank will find itself forced to quote for the purchase of foreign long bills on the basis of the forward rate and on an allowance for the interest value of the sterling used, plus cost of stamps and expenses, rather than on the basis of the foreign interest rate for that class of bill. This means that instead of being able to use sterling at the foreign rate, which is probably higher than the home rate, it must use it at the home rate only as, were it to quote on the usual basis, the customer would refuse the rate and would sell the currency "outturn" of the bill forward to the bank, taking an advance at home rates against the security of the bill to provide himself with the sterling in the meantime.¹

As banks in this country never draw and sell long bills, and never re-sell foreign bills from their portfolios, a bank will never cover a forward purchase of currency by a sale of long bills in that currency.

(c) In the case of both purchases and sales forward, a bank can communicate at once with a correspondent abroad, either in the centre concerned or some other, offering to buy from or sell to the agent sterling against the foreign currency concerned, and this may be done either in the shape of a spot transaction or as an outright forward deal for the same date as the contract with the home customer. As banks abroad "run open positions" to a much greater extent than do banks here, it is often possible to find a bank abroad willing to buy or sell its own currency forward as a speculation or in anticipation of some possible adverse or favourable factor which may have come into effect by the time the forward contract matures, and which may cause the spot rate to move in the right direction for the speculator to an extent sufficient to enable him to cover his open position at a profit by means of a spot deal at the then current rate.

(d) In addition to the possibility of finding an outright buyer or seller abroad of a currency "forward," a fairly active market in outright forwards for most currencies exists in London, and a bank will frequently attempt to undo a forward deal carried out with a customer here by means of a reverse outright operation in the London market. Having based its rate to the customer on the margin prevailing at the time in the market here, the bank is often able,

¹ See Questions 2, 12, and 17 in Appendix

after some haggling, to find a counterpart in this market, and can cover an outright forward sale by an outright forward purchase from some other member of the market, and *vice versa*.

Where, however, the spot rate for the currency concerned is fluctuating with any rapidity and to any extent, it is not safe to spend time in seeking an outright counterpart while the spot rate is perhaps moving adversely, as the forward margin seldom fluctuates to the same extent as the spot rate even when speculators are active. Thus if the spot rate for pesetas is 52.30-40, and the three months' forward margin is 10 to 8 c. under spot, a bank might sell pesetas for delivery in three months fixed at an outright rate of 52.15, and would consider itself fairly safe to cover at a profit. If the dealer concerned begins to send his brokers round the market to try to buy three months pesetas outright at the middle prices (9 points under 52.35, making 52.24 outright), he may find that the spot rate is suddenly moving owing to a buying order having come into the market, and is being quoted as 52.10-20. Even should he then find a seller of three months pesetas at 9 points under spot, and can even find the spot at 52.15, the resulting outright price would be only 52.06, showing him a loss of 9 points per £ if he had to cover at this price. Consequently, a dealer will usually cover himself at once in a moving market by buying or selling T.T. at the current rate against a forward sale to or purchase from a customer respectively. By this means he makes sure of his basic rate of exchange and can then look round for the "swap" at his leisure, since he is then merely in the position of needing to sell or buy T.T. against buying or selling for the forward date, respectively, and the forward margin can usually be relied on to remain within a few points of the original quotation no matter to what extent the spot rate has moved in the meantime. In the case quoted above, for instance, if the dealer covered his forward sale by an immediate purchase of T.T., even at the "bottom of the market," viz. at 52.30, and then, later, paid the full "swap" margin of 10 points to sell the T.T. and buy the forward, he then secures his outright forward at 52.20 as against his sale at 52.15, and is unaffected by the subsequent adverse movement in the spot rate.

When dealing with "broken dates" or "option forwards" granted to his customers, the exchange dealer is faced with some difficulty. While it is often possible to deal in a "broken date" in the market and so secure the exact cover needed, it is very rarely that "option

forwards" can be obtained as a market deal. Dealers consider that they have quite enough trouble in "matching up" options which they are compelled to grant to their own customers without further increasing disparities of value dates in their books by granting options to other members of the market who should be quite capable of looking after themselves!

Normally, a dealer is always prepared to have funds standing to his credit abroad and will cover a sale of a "long" forward by a purchase of T.T., M.T., or a "short" forward. Only under conditions of unrest does he cut down his foreign balances to a minimum, and it is at such times that the forward market is most difficult and may even become nominal. Whenever possible, then, the dealer maintains spot balances as cover for his short position in forwards. If he finds himself being asked to buy more forward currency than he is asked to sell, he straightens his book by a "swap" in the market, buying in spot and selling out forward for the date on which he has become too overbought. Again, this operation is simple when "fixed" forward dates are concerned, but it becomes much more complicated when "option" forwards have to be covered.

Sales of "options" by a dealer are nearly always covered by a purchase for the *earliest* date on which the customer can demand delivery, as any delay in taking delivery will merely leave the dealer with an increased balance abroad which he can probably use to advantage by "swaps" of T.T. against G.M.T. or in "day to day swaps" of the foreign currency for sterling. In many cases a customer will purchase a total amount of foreign currency forward at his option over a stated period and then will demand delivery in a series of smaller amounts from time to time. As long as the total is not too large, the dealer is quite prepared for this, and will cover for the total amount for the earliest date. In the case of large total amounts, however, the dealer will spread his covering operations over the major part of the option period. For example, if a dealer sells to a customer on 28th February, 1934, \$100,000 for delivery to the customer at his option over April, May, and June, 1934, the dealer will probably cover his risk in three parcels. The one, two, and three months forward dates would be 2nd April, 2nd May, and 2nd June, while the customer cannot demand delivery before 1st April of any part of his purchase. The dealer will therefore probably carry out three swaps (having covered his exchange risk

by an immediate purchase of T.T.), and will sell, say, \$50,000 spot against one month, \$25,000 spot against two months, and \$25,000 against three months, or such other proportions as the existing state of his forward "book" may show to be desirable. By this method he ensures that he will have available, by the earliest date necessary, sufficient currency to meet all probable requirements of his customer for a month of the option, and this without either using too much sterling in the purchase of spot or of having too large an amount of foreign currency standing to his credit abroad. At the same time, his purchases of two and three months forward ensure that such depletion of his available foreign balance as may have taken place will be made good in time to meet further withdrawals under the option until both balance and option are exhausted or the former at least reduced to normal proportions. Where a dealer has failed to spread his covering operations evenly or has taken too optimistic a view of the date when a customer who has purchased foreign currency for delivery at his option over a period may demand delivery, he may find that withdrawals by the customer under his option are producing an overdraft on the bank's account in the foreign centre. This is a state of affairs which London banks endeavour to avoid, and the dealer will at once adjust the position by a "short swap" in the market, i.e. he will buy spot and sell forward for the nearest date on which he has already arranged for cover to come in. For instance, if in the example given above the customer asked for delivery of \$80,000 on 14th April, the dealer has only provided \$50,000, and his own credit balance is probably not more than \$5,000, so that he will become overdrawn by \$25,000 until 2nd May, when his next forward purchase matures, assuming that no other operations exist. He must, therefore, buy spot for 14th April and sell 2nd May in \$25,000, and any cost to him in the shape of a discount on the forward will, of course, reduce the profit he had expected to make on the deal. Where the forward margin is at a premium the dealer will probably cover the major portion of his sale by a forward purchase for the earliest date on which the customer can demand delivery so as to give away as little by way of premium on the forward as possible, though he will have charged his customer the maximum premium for the latest date of the option.

In the case of forward purchases by a dealer at the option of the

customer, he follows the same method of spreading his risk and, after an initial sale of spot to cover at once his exchange risk, will proceed to buy in spot and sell forward for dates more approximating to the middle and end of the option period than to the beginning. This is because, should the customer deliver the currency earlier than anticipated, the dealer will then merely be left with a temporarily over-large balance to his credit, pending the maturity of his own sale forward, while if the dealer sells forward for an early date of the option and the customer does not deliver until much later in the period, the dealer may again be faced with an overdraft and have to carry out a "short swap" at a loss to adjust the position. These observations are, of course, entirely general in view, and no hard and fast rules can be given for covering any class of forward operation, as the actual form and date of the covering must depend not only on the state of the dealer's "book" and on his facilities or arrangements with his correspondent abroad, but also on his own view of possible movements in the spot rate and forward margin of the currency in which he has dealt.

Foreign Currency Accounts.

Finally, a method of occasionally eliminating the risk of loss in exchange is that by which a creditor accepts payment in terms of the currency of his debtor and converts the foreign currency into his own at a suitable opportunity or uses the funds in the purchase of goods in the foreign country or in some other fashion. The elimination of eventual loss in exchange depends, in the first case, on the possibility of eventually converting the funds into home currency at a rate of exchange which shows the holder no loss on the whole transaction and which depends in turn on the movements which take place in the exchange value of the currency concerned. In the second case, the elimination of exchange loss depends on whether the funds have been used abroad as profitably as they could have been at home and on whether the eventual "outturn" from the goods purchased or the profit made on any other use to which the funds may have been put, coupled with the rate of exchange obtained when they are eventually brought home, shows no loss on the original transaction. An example of this latter case occurred during the heavy depreciation in the Australian exchanges when many creditors of Australian debtors had the Australian fund

placed to the credit of a Foreign Currency Account, i.e. held for them in terms of Australian pounds, and used such accounts to pay for purchases of Australian produce. This produce was brought home and sold, and the eventual "outturn" in many cases was greater than if the original debt in Australian pounds had been sold as currency at the current market quotation.

Foreign Currency Accounts, however, cannot be considered to provide an absolute safeguard against risk of loss in exchange, as is the case with the exchange clauses or in dealing forward, and their utility is limited to those who are able to operate expertly in exchange, when an element of speculation enters, or who are able to make profitable use of a foreign currency in their normal trading or financial activities.

CHAPTER XIII

EXCHANGE RESTRICTIONS

TRADE depression and financial crises have occurred from time to time over the whole period of the world's history and, no doubt, to each successive generation the current crisis appeared to transcend any which had gone before. The complexity of the modern economic structure, however, has created a tendency for any disaster to produce effects much more far-reaching than was formerly the case. A comparison of the effects of an earthquake on the western seaboard of America a thousand years ago with the effects of such a happening to-day, with all its concomitants of escaping gas and water, cutting off of electricity, shortage of the necessities, and the decencies of life, etc., will serve to illustrate the point. Man's belief in himself being boundless, many and varied efforts have been made in the course of the succession of post-war crises to stem the current of events and to stop, or at least to palliate, the normal working of economic forces. The problems which have arisen and the attempts which have been made to cope with them are too vast and too widespread to be examined under any one head, and yet they are so closely interlocked one with the other that the consideration of any one facet inevitably leads to other facets thrusting themselves into prominence.

Since the term "economics" is nowadays made to cover every form of social activity, it is customary to refer to all troubles connected with such activities as "economic problems." Whether the trouble is a strike of coal miners in Fifeshire, or a default in the interest payments on its external debt by a small South American State, an "economic problem" arises, and it is a fact that cause and effect seem to be mixed so inextricably that an unbroken circle, "vicious" or otherwise, seems to be presented. In the final chapter of this book the outstanding economic and financial events of the past decade are lightly touched on and in the present chapter an attempt is made to explain and classify certain conditions which have resulted from the efforts made to cope with one aspect of the diversity of problems. It is impossible to treat in a few paragraphs of the world-wide series of events and mistakes which led to the

taking of such steps, and it is even impossible to deal in detail with the actual steps, since these are themselves continually being revised and amended. It is proposed, therefore, to deal only with what are known as "exchange restrictions" from a general viewpoint, and to state broadly their causes, operations, and effects.

In the first place, the primary law of modern social existence may be stated that we must produce in order to consume, or that we must sell in order to buy. This should mean, *ipso facto*, that the interchange of commodities and services should everywhere be made as simple and as easy as possible. International trade demands not only that the passage of goods and services between nations should be facilitated but that the means of payment for such goods and services should be freely obtainable. In other words, the economic ideal is "free trade" in both commodities and services and in foreign exchange. The balance of payments between the nations of the world on trading account must tend to cancel out within a little. Young undeveloped countries may trade at a loss for a time through their need to import the means of development before the growth of their ability to export. Older countries can trade at a profit by importing raw materials or supplies and exporting finished products, but they must develop their potential markets by judicious loans to other countries out of their trading profits. The progress of the world depends upon the steady accumulation of savings and the investment of those savings in the further development of the more backward parts of the globe. It is of the first importance that the invested savings should be used productively, either directly or indirectly, and of equal importance that consuming power should keep pace with increased production. The external consuming power of any country depends upon its supply of foreign exchange which, in turn, depends upon the proceeds of its exports and its ability to borrow from other countries. A country which has borrowed in the first place to enable it to develop must eventually become self-supporting, if it is to continue to exist, and as a result it tends to become less of a borrower and more of a lender. If general progress is to continue, fresh lendings must be directed towards fresh territory, and original borrowers must not be shut out of new markets or they will find no outlet for their produce, and so be unable to repay their borrowings. It is of no use to lend a man money with which to start a business and

then to place every obstacle in the way of that business. Also, it is useless to lend money to a man who is already in debt if he proposes to use the loan for some purpose which is not connected with his business and will not increase his earning capacity. What applies to the individual applies also to communities or nations. Borrowings can be repaid only out of income, and any lender should first consider whether his loan is likely to increase the income of the borrower to the extent necessary for the payment of interest on and capital repayment of the loan. Increased income can result only from increased sales of products—whether of goods or services. If the borrower is in any way prevented from disposing of an increase in his output or if his borrowings are used in a manner which does not increase his output, his income will prove insufficient for the discharge of his debt and the lender will be the ultimate loser.

These generalities form the basis of the recent prolonged crisis. When a country incurs a debt abroad, that debt can be discharged only out of the available supply of foreign exchange. Normally, the nationals are taxed internally in terms of the home currency and the proceeds are used in the purchase of the necessary sum in foreign exchange. For such a purchase to be possible, the country must be a creditor on trading account, and the surplus due to it is absorbed by official purchases of foreign currencies on debt account. This is clearly illustrated by our own debt payments to the U.S.A. which, for some few years, were made possible only by heavy internal taxation and by a favourable balance of international payments from various causes. Where the total debt incurred has grown too large for the country to support or where the existing load of debt is rendered too heavy by a falling off in exports or by a fall in the world price for such exports, then drastic measures must be taken to restore equilibrium between income and expenditure.

Tariffs and Export Bounties.

Since any reduction in imports or any increase in exports tends to move the balance of payments in favour of the country concerned, one of the most obvious methods by which a government can intervene to correct an unfavourable balance of payments is to impose restrictive or even prohibitive duties on the import of certain goods and/or to offer subsidies, bounties, or "drawbacks" to exporters of certain staple home products. Since the external

selling price of any commodity is its internal price combined with the exchange value of the home currency in terms of others, the normal tendency is for a world-level of prices to be reached by adjustments in either internal prices or exchange rates. Where import duties are imposed or export bounties granted, this equilibrium is disturbed. In the former case, either the eventual selling price of the foreign goods taxed becomes so high in the home country as to discourage altogether purchases of those commodities—which means a definite loss to the total trade of the world—or such selling price is perforce raised above the level at which home producers can supply a similar article—which means a diversion of world trade from the foreign to the home country, but probably with a small reduction in volume owing to the higher price. In the latter case the home exporter is subsidized at the expense of his own taxpayers; he can probably sell more goods abroad through the reduction in his selling price which the bounty should render possible, but this merely means a diversion of world trade. Further, this very diversion means a loss of trade to some foreign producer of similar goods which can only contract his potential consuming power while the home taxpayer must necessarily contract his consuming power in other directions in order to provide for the further taxation out of his current income.

The whole effect of import tariffs and export bounties is therefore restrictive and constrictive but, as with armaments, each nation is afraid to be the first to deprive itself of weapons, and instead of the common woes of the world having induced a desire for common action, the World Economic Conference of London in 1933 disclosed a deplorable spread of a nationalistic rather than an internationalistic spirit amongst those responsible for the destinies of nations. The archaic “most favoured nation” clause in trade treaties between countries has also turned from a gesture of goodwill into an Old Man of the Sea because mutual concessions between any two countries are often prevented through such concessions having to apply automatically to half-a-dozen or more other countries by the operation of the “most favoured nation” clause in a trade treaty concluded many years previously.

It is temporarily possible, however, for a country to provide itself with a favourable balance of payments sufficient to meet its obligations on debt account by means of tariffs and bounties. The

ultimate diversion of and reduction in world trade must, in the end, react unfavourably on all and at best can result only in constant amendments and adjustments which of themselves prove a disturbing element in the general progress of the world.

Quotas and Licences.

In cases where a country's balance of payments still remains adverse even after the operation of a system of tariffs and/or bounties (which often happens when too heavy a deadweight of unproductive debt has been incurred) more drastic steps may be taken to control trade by means of "quotas" and/or licensing systems for permission to import or export certain classes of goods. Under the "quota" system the government, as it were, rations the country as to the quantity of any specified commodity which shall be imported. Recognized importers of that commodity are allowed to clear through the Customs only a fixed proportion of their normal imports, taken over a basic period, e.g. for January, 1934, each importer might be allowed to clear only 60 per cent of his average monthly clearances over the twelve months ended June, 1933. The "quota" system can be used as a weapon for international trade warfare as can tariffs. The system can be elaborated to permit of a reduced total of imports of a given commodity being spread disproportionately over the countries of origin according to the concessions granted by those countries to the home country. For instance, a reduction in the total imports to 60 per cent of an earlier volume may be so arranged that the most friendly or closely-allied of the countries of origin, or the one forming the best customer for the products of the home country, is given preference by instructing home importers that, of the reduced total, 80 per cent, say, may be taken from the most favoured country of origin, and of the balance 10 per cent may be taken from the next best customer or ally, 5 per cent from another, and $2\frac{1}{2}$ per cent each from two others, leaving other possible producers of the commodity without a share in the market. Again, the effect is restrictive and constrictive. Potential consumers can become buyers only after their own produce has been sold and purchasing power thus acquired. A seller deprived of the opportunity of selling becomes a buyer without the means of purchase.

The method of permitting the import and export of specified

goods only under licence operates in very much the same way. In order to limit demands for foreign exchange on the part of importers, the government will require application to be made to an official department for permission to import certain classes of goods. Permission is signified by the issue of a licence which acts as authority for the importer to clear his goods through the Customs. Obviously, complete discrimination on the part of the officials is possible. Certain importers may be favoured over others; the total quantity of the commodity allowed to be imported can be rigidly controlled, the countries of origin can be favoured according to the needs of the government or the whims of the officials, etc. Licences to export are usually a concomitant of exchange control, which is dealt with below. The whole process is objectionable, not only because of the hindrance to trade, but also because of the possibilities of abuse and corruption which present themselves.

Exchange Control and Exchange Restrictions.

The external value of a currency, i.e. its exchange value in terms of other currencies, depends normally on the relation between the world demand for and supply of that currency. Where a country has a credit or debit balance on trading and financial account over a period the resulting steady excess of demand for or supply of that currency will cause its exchange value to move accordingly. As long as the country is a member of a gold group, gold will move to or from that country and others within the group, and the balance of payments can be thereby adjusted. If the country is a consistent creditor or debtor, either so much gold will flow to it as to drive weaker members of the group off gold or so much gold will leave it as to force it off gold itself. The only preventive of such ultimate effects is a steady flow of loans for productive purposes from established creditor countries to younger and less developed countries. There is, therefore, a rigid control of exchange fluctuations between countries on a full metallic standard of the same metal, but the extent of this control is limited as to time by the relative balances of indebtedness compared with the relative stocks of gold.

Where a country abandons any tangible base to its currency that currency becomes "free" and, in the absence of any official steps, "uncontrolled" and its value in terms of other currencies is left to be determined by its relative purchasing power. The most

usual causes of the abandonment of a metallic or "currency exchange" base to a currency are—

(a) Official borrowings from abroad or any enforced contraction of external debt, e.g. Reparations, too heavy for the normal resources of the country. The service of such debts in the shape of interest and capital repayments creates a demand for foreign exchange in excess of the ability of the country to supply either by way of a favourable balance of payments or by exports of precious metal. The stocks of the latter steadily become depleted until there is an insufficient or no backing to the currency. The metallic standard is perforce suspended.

(b) An excess of production of staple commodities at a time when general consuming power abroad is contracting. If such disparity between supply and demand is general, a fall in world prices must follow, with the result that the income accruing to the exporting countries is materially reduced, their balance of payments is seriously disturbed, and an outward flow of gold as in (a) will occur, with similar results. Under such conditions the government will often try to bolster up prices by "rationalizing" the industry, or by raising a fund to buy up and destroy the supposed surplus or by payment of "bounties" to producers out of new taxation. Most of these artificial measures have always failed, however, and the only cure, in default of steps being taken universally to increase the general purchasing power, seems to have been the operation of the somewhat harsh law of "the weakest to the wall," i.e. allowing the price to fall until those producing at a loss are forced out of production, and the total supply thereby reduced to a nearer accord with the effective demand. The heroic measures taken in Australia from 1929 to 1933 constitute an excellent example of the benefits ultimately obtained by treating such a situation in such a fashion.

(c) Bad or extravagant internal financing, unbalanced budgets, industrial unrest or inefficiency, are all likely to lead to a "flight" of capital from the country. This once more results in an undue strain being placed on the available supply of foreign exchange and on the stock of gold, with similar results to those given in (a). It is usually in the effort to prevent the abandonment of a metallic standard that exchange restrictions have been imposed, and these have been continued in conjunction with a greater or less degree of

official "control" over the exchanges when such abandonment has finally taken place.

Forms of Exchange Restrictions.

Exchange dealings being dealings in currency and it being part of the duty of a government to safeguard the currency, all restrictions on exchange dealings are originally imposed with the object of preserving currency stability. Such restrictions may be only moderate in their inception, but they tend to become more and more onerous and drastic as their contractive effect develops. The systems of import and export licences, "quotas," etc., referred to above are in the nature of exchange restrictions, as their object is to reduce the effective home demand for foreign exchange, and/or to increase the supply by artificial measures. It cannot be too strongly emphasized that State interference with trade or exchange is nearly always due to a too heavy load of unproductive debt having been incurred, the service of which is too great a strain on the normal exchange resources of the country. In the effort to compromise with its creditors, the debtor State will first make strenuous attempts to meet its obligations, then offer part payments in foreign exchange and part in terms of the home currency (with restrictions on how these shall be used) and probably in the end will ask for or be forced to declare a moratorium, or cessation of debt payments.

The expression "exchange restrictions" is applied not only to official regulation of dealings in foreign exchange, but also to any disabilities attaching to the ownership of certain forms of the home currency. A study of the examples given below will make this clear. In their early form, exchange restrictions usually consist of regulations requiring importers to apply for licences authorizing them to purchase in the open market the foreign exchange needed to pay for their imports. This is very similar in operation and effects to a system of licences for the goods themselves. See Example 1. The next stage is for the State to require all exporters of home produce to sell only in terms of foreign currencies, and to hand over the eventual proceeds in such foreign currencies to the government banking agent, which will pay out the equivalent in home currency to the exporter at the "official" rate of exchange. These combined restrictions give the government complete control over the foreign exchange resources of the country. It buys up all the

exchange available at an arbitrarily fixed price, which probably bears little or no relation to the actual international value of the currency, and retains for its own purposes such quantity of this "pool" as it may require. Only the balance is available to importers for purchase under licence, and then either at a price which shows a handsome profit to the government or by tender, which means that the highest bidder stands the best chance, i.e. that the currency tends to depreciate further through more and more home units being offered by eager importers in the endeavour to obtain the foreign units desired. See Example 2.

Each of the main methods is capable of refinements. An exchange "quota" system may be introduced, allowing the purchase at the official selling rate of a monthly allowance of exchange based on the average over a previous period; arbitrary "rationing" of exchange to buyers may be resorted to; exporters may be required to hand over only a proportion of the proceeds in foreign currency of their exports, leaving them free to dispose of any balance in whatever manner they choose, etc. Again, import and export restrictions and official control of exchange dealings are usually combined, and may be reinforced by regulations against the granting of "clean" credits or overdrafts to foreigners (to prevent outside speculation against the currency), by the enforced surrender on the part of home owners of any assets which they may hold abroad, usually at an arbitrarily fixed price, and by the prohibition of the export of capital in any form. All such restrictions entail the appointment of a government banking agent or the creation of some special body to handle the State monopoly in exchange, such as the Exchange Control Commission in the Argentine, the Centro Oficial de Contratacion de Moneda in Spain, or the Exchange Equalization Account working through the Bank of England in this country.

All these restrictions are fairly simple both to operate and to understand. The serious complications arise when restrictions are placed on the actual use of certain funds in the home country. Since the object of the government when imposing any trade or exchange restrictions is to reduce the demand for and increase the supply of foreign currencies against the home currency so that a larger balance of foreign exchange shall be available for government purposes, it follows that this object would be defeated if foreign owners of capital were able to withdraw that capital from the

country at will, or if foreign exporters were allowed to take payment from home importers in terms of the home currency and then offer that currency for sale in the exchange market, or if existing home debtors to foreign creditors could have any pressure brought to bear on them by the latter to discharge such debts immediately in full either by payment in home currency (no foreign exchange being available) or in goods, services, or securities. To prevent such possibilities, the restrictions on trade and exchange are frequently reinforced by restrictions on the working of foreign-owned accounts, either banking or trading, by restrictions as to the uses which may be made of the proceeds of specified operations in trade and finance, and, more drastic still, the declaration of moratoria on certain forms of foreign debt. These latter may be entered into with the more or less reluctant consent of the main creditors, in which case the stigma of complete refusal to pay by the debtors is modified by using the term "Standstill Agreement." This means that, there being no method of putting a nation into bankruptcy, realizing its assets and generally "winding up" its affairs, the creditors have to accept such arrangements for the repayment of their dues as the debtors think fit to offer. This will eventually prove to be the minimum possible without doing irreparable and lasting damage to the future borrowing powers of the debtors. Invariably a large proportion of the original capital will have to be written off as a dead loss by the creditors, and this will induce a general reluctance, for some time following, to subscribe to any "foreign" loans, no matter for what purpose they may be issued. Since most of the debts covered by the moratorium will have been incurred on account of financial operations or of unproductive government borrowings, while the cessation of foreign lendings will operate against the development of world trade in general, commercial interests are likely to suffer still further constriction owing, indirectly, to the overwhelming weight of "credit money" created during and since the War, which is continually seeking employment as a commodity instead of performing its proper function as the hand-maiden of the exchange of goods and services.

In the examples of exchange restrictions which follow, mention is made of "moratoria" and "standstill agreements," the release of "frozen" balances, etc. The first step under a moratorium on exchange dealings is to forbid the transfer out of the country of

any sums in the home currency owned by foreigners. Such balances are then described as "frozen" and, in many cases, further additions are continually being made to such balances, as through the operations of a foreign-owned trading concern, e.g. a railway, which likewise become "frozen." The remittance outward of profits due to the foreign owners becomes impossible, and the pent-up demand for exchange eventually reaches a point which is impossible of satisfaction out of any likely resources of the country. Such debts have then to be capitalized and their redemption spread over a long period, but this again adds to the total burden of external debt due by the country and its ultimate liquidation presupposes an increase in its net income which can be possible only if its trade is allowed to increase—a doubtful possibility in these days of universal restrictions and nationalism. The same principle is applied to financial debts. Where credits have been granted by other countries to home nationals for trading, financial, or stock exchange operations a purchase of foreign exchange must be made eventually in order that the home debtor may discharge his debt to the foreign creditor. Such credits may have been running for years, being carried on by a series of periodic renewals of the bills drawn under them, and the funds raised through the original drawing of bills will have been remitted to the borrowing country long since. Should a moratorium on foreign debts be declared by that country, the foreign grantors of such credits will be compelled to renew them, fully or in part, for an indefinite period, since the foreign exchange needed to pay them off cannot be obtained by the debtors. Such debts are usually made the subject of a "standstill agreement," under which very small percentages of the amounts outstanding are paid off periodically, the remainder having to be renewed by the creditors or written off as a loss, while the creditors will usually place restrictions on the utilization by the debtors of any existing "credit lines" which have not been fully availed of or of any fresh "credit lines" which might conceivably be granted. The renewals of acceptances drawn under such agreements in respect of outstanding engagements are known in the market as "standstill bills," and command a somewhat worse rate of discount than does home commercial paper.

Where certain classes of foreign owned deposits or balances are permitted to be used for specified internal payments only, or where a block of accrued external debt has been re-capitalized all or in

part, such internal currency balances or new scrip will usually only sell at a heavy discount. In some cases the existence of such cheap forms of the currency and credit system of the debtor country has been used to provide a kind of bounty for home exporters in order to enable them to sell abroad at under the real external price for such goods, and so increase somewhat the volume of foreign exchange available to the debtor country as a whole. For instance, in Example 4 below it is shown how a German exporter, under certain conditions, might accept payment for his goods partly in foreign currency and partly in the shape of scrip issued in respect of "standstill" debts. He could accept the scrip at its face value, since the Conversion Office would credit him with the full nominal value in marks, but the foreign purchaser of the goods could obtain such scrip at a heavy discount owing to its very limited utility for such purposes as compared with the volume in existence. Thus if he is buying German goods to a value of Rms. 18,000 with the exchange at Rms. 12 to the pound, he would have to provide the exporter with £1,500 if the latter required payment in full in foreign exchange. If the exporter is allowed to take payment of only 66 $\frac{2}{3}$ per cent in foreign exchange and the remainder in "standstill scrip," which is standing at a discount of, say, 25 per cent, or in "blocked" marks, which stand at a similar discount, the importer need only pay £1,000 in sterling to the exporter and the purchase of Rms. 6,000 in scrip or "blocked" marks will cost only £500, less 25 per cent, i.e. £375, making a total outlay of £1,375 only. Such a difference in cost may well determine whether a buyer makes the purchase of such goods or not. Note how the discount on instruments or balances which cannot be freely disposed of, is taken in the form of less of the foreign money being given for a stated amount of the depreciated currency than would be required by the existing rate of exchange for "free" units of that currency.

The following examples of official restrictions on trade and foreign exchange operations are intended only to illustrate the principles and main forms of such restrictions as outlined above; though in existence at the time of writing, they may have been materially altered by the time this edition is actually published. The courtesy of the Management of the Swiss Bank Corporation, London, E.C.2, has allowed all these examples to be extracted from a brochure, entitled *Foreign Exchange Restrictions*, published by that Bank.

EXAMPLE 1

LITHUANIA

Restrictions on foreign exchange transactions have been in force since the 1st October, 1935.

In the case of all payments abroad exceeding the amount of 100 litas per fortnight, a permit from the Exchange Commission is required.

Application for this permit may be made either by the importer himself or by the collecting bank, and must have full documents attached (invoices, Customs receipts, etc.) to prove that the exchange is in fact required to cover imported goods. A large number of articles, which are classed as luxuries, can only be imported with a special permit from the Licence Commission of the Department of Commerce, and this permit must in this case also be attached to the documents. The delay between the deposit of the application for a foreign exchange permit and the date it is granted is normally between three and seven days.

There are clearing agreements with Germany, Italy, and Latvia.

There are no special provisions governing the disposal of balances resulting from drawn bonds, the sale of securities, etc.

EXAMPLE 2

URUGUAY

The control of foreign exchange transactions and of imports has, since the "Economic and Financial Readjustment" Law of the 9th of November, 1934, been in the hands of the Comisión Honoraria de Importación y Cambios, which is responsible for distributing the available exchange, and grants import permits according to the quotas fixed periodically by the Banco de la Republica.

There are three types of exchange—

The *Official Exchange* is reserved for Government requirements and derives from the sale by exporters of a proportion varying from 10 per cent to 80 per cent of the foreign exchange they obtain.

The *Free Managed Exchange* is available for payment of imports but can only be sold when the importer is in possession of an exchange certificate from the Comisión Honoraria. This exchange derives from the sale by Uruguayan exporters of the exchange accruing to them under the quota arrangements, but such sales can only be done under notification of and authority from the Comisión Honoraria.

The *Free Exchange* is dealt in without restriction, except that the authority of the Banco de la Republica must be obtained in case of transactions exceeding £1,000 for account of firms abroad. Free exchange may be used for payment of any imports, except in the case of countries with which there are clearing agreements.

Goods can only be cleared through the Customs after a permit has been obtained from the Comisión and when the importer can prove either that he has paid for them or that he holds the necessary exchange to do so. The import permit enables the holder to import the goods in question within 120 days. The foreign exporter should assure himself before sending off the goods that a permit has been duly obtained.

In the terms of the law of the 9th of November, 1934, the importer with an import permit may obtain an exchange permit from the same

body, the *Comisión Honoraria*. The importer must furnish the *Comisión* with a certificate from the Bank to the effect that the exchange has been duly secured and on the strength of this authority the importer will be able to get the goods cleared.

When payment is made in "free managed exchange," the importer must, during the fortnight following the granting of the import permit, procure 20 per cent of the value of the goods by buying exchange or executing an exchange contract, failing which the import permit becomes invalid. The goods cannot finally be cleared through the Customs until all the requisite exchange is secured.

There are clearing or similar agreements with Belgium, France, Germany, Italy, and Spain.

There is no restriction on the transfer abroad of the proceeds of sale of Uruguayan internal securities or the balances resulting from payment of coupons, etc. Such securities may not be exported without a permit, but the latter can be obtained without difficulty. On the other hand external bonds may not be exported and securities in the country or those which may be imported must be notified to the *Dirección de Crédito Público* which regards them as blocked (they must be deposited with an authorized bank) and any change of ownership must be duly notified. Interest on such securities is paid regularly in currency and may, like that on internal bonds, be transferred abroad at the rate quoted for free pesos.

It is recommended that bills drawn in foreign currency should bear the clause "payable by banker's cheque on . . ."

EXAMPLE 3

ROUMANIA

Foreign exchange is subject to severe restrictions and imports are governed by a system of quotas. The National Bank of Roumania allots exchange against presentation of documents from which it can be proved that a commercial transaction is involved. As a rule, the following are demanded: original invoice, Customs certificate, certificate of origin and receipt for taxes paid.

Applications for an import permit or for an allowance under a quota must be made to the respective authorities concerned by the importer, while applications to the National Bank of Roumania for allocation of the exchange required for payment of imports must be made through a duly authorized bank.

Applications for an allowance under a quota must be accompanied by a transfer visa from the National Bank and the time required for such an application to be approved consequently depends on whether the quota in question has been fully used already and on whether the necessary exchange is available.

Since the 1st of December, 1935, a system has been in force under which foreign exchange, whether resulting from exports or from any other source, has to be handed over to the National Bank, which pays the exporter a premium of 38 per cent over the official rate of the exchange in question. To provide funds for payment of such premiums, all imports are subject to a charge of 38 per cent, payable to the National Bank when the exchange is allotted. Importers have also to pay a tax of 12 per cent when the Customs clearance is completed; this tax is

calculated not on the invoice value of the goods, but on the average values indicated for each category of goods in the Customs tariff.

As the National Bank takes over all foreign exchange which may be forthcoming, against payment of the 38 per cent premium, including exchange reserved for State requirements, a special tax of 12 per cent has been imposed on oil exports which serves to cover the deficit caused by the new Budget regulations.

There are three types of lei account—

(1) *Free lei*, originating from sale of foreign exchange to the National Bank by foreign banks or commercial firms.

(2) *External lei*, representing balances of foreign firms accrued before the 18th of May, 1932, or accumulated subsequently under the authority of the National Bank or the proceeds of coupons on securities held prior to the above date.

(3) *Internal lei*, representing balances placed to the credit of foreigners without special authority from the National Bank and proceeds of coupons on securities acquired since the 18th of May, 1932.

Free lei can be used freely but foreign exchange can only be obtained against them with the permit of the National Bank.

There is no longer any practical distinction in the utilization of "external" and "internal" balances. In no circumstances can either category be used to pay for exports, but they may be used for the following purposes—

(a) Investment in real estate or in industrial undertakings.

(b) Purchase of Government bonds, shares or other securities.

(c) Payment of fees, salaries, etc., in respect of services rendered to the owner of the lei.

In the case of (a) and (b) advice only is necessary, but in the case of (c) the sanction of the National Bank has to be obtained.

Such blocked balances may also be used in the country by foreign travellers and tourists, subject to the approval of the National Bank, with which the usual form of application must be lodged. In such cases there is a limit of Lei 7000 per person per week.

According to Roumanian law, a debtor in Roumania is not released from his liability in respect of any debt until the creditor has been paid in full in the currency in which the debt was contracted. It is customary for collecting banks to release documents or bills drawn in foreign currency which have fallen due against a temporary deposit in lei and a written undertaking in favour of the remitter to the effect that liability is assumed for any eventual loss in exchange on final settlement.

There are clearing agreements with the following countries: Austria, Belgium-Luxembourg, Bulgaria (in course of discussion), Czechoslovakia, Finland, France, Germany, Greece, Holland (practically suspended), Hungary, Italy, Poland, Portugal, Switzerland, Turkey, the United Kingdom and Yugoslavia.

The import of lei bank notes is only allowed if proof has been furnished that the notes were exported with the National Bank's approval and have been abroad since the 18th of May, 1932. Otherwise, they will be placed to the credit of an account which will remain blocked as long as foreign exchange restrictions continue.

It is advisable that bills drawn in foreign currency should bear the "effective" clause.

GERMANY

EXAMPLE 4

There is a strict and complete control of foreign exchange.

Clearing and similar agreements exist in the case of a large number of countries, viz. Austria, Belgium-Luxembourg, Bulgaria, Czechoslovakia, Denmark, Estonia, Finland, France, Greece, Holland, Hungary, Italy, Latvia, Norway, Poland and Danzig, Portugal, Roumania, Spain, Sweden, Switzerland, Turkey and Yugoslavia, also with Iceland and Lithuania. Special arrangements affecting foreign exchange also exist in the case of the Argentine, Brazil, Chile, Iran, Colombia, Nicaragua, Panama, the Union of South Africa, and Uruguay.

The special payment arrangement over a "Sonder" account of the Bank of England with the Reichsbank, which formed part of the payments agreement with Great Britain of the 1st November, 1934, ceased to operate on the 9th of January, 1935. Business between these two countries can now only be done on a basis of either free Reichsmarks or sterling.

In so far as business is concerned which is not affected by clearing agreements, certain monthly quotas of exchange, which have been reduced from time to time, are granted to regular importers and to firms outside Germany which were accustomed to maintain accounts with German banks for trading purposes prior to the introduction of exchange control.

Such general permits do not, however, any longer enable the holder to transfer balances to the free account of a foreigner and require the amounts in question to be provided in the currency of the beneficiary himself, except in the case of transfers to beneficiaries in countries with which there is a compensation or clearing agreement. In this case, payments may only be made in Reichsmarks to the account of the Bank of Issue of the foreign country concerned. Foreign exporters should receive satisfactory assurance from their German importers of their ability to remit payment out of their quota before shipping the goods.

For all payments, transfers or remittances exceeding the amount of the quota the approval of the competent foreign exchange authorities is required. Without this approval, payment cannot be made even in blocked account.

In the case of general permits, the German importer must present the foreign exporter's invoices to the German bank which provides the foreign exchange or make a declaration that the payment represents settlement for imported goods.

With the exception of permits granted to shipping agencies, insurance companies and individual permits granted for purposes other than those of trade, it is no longer permitted to send abroad cheques drawn in Reichsmarks and permission to do so is only granted in special cases. Even when general permits have been granted, payments are governed by the particulars set out above.

Bills drawn in foreign currency can be paid in Reichsmarks unless they bear the "effective" clause.

As a result of the foreign exchange restrictions successively introduced by the German Government from July, 1931 onwards, there came into existence a considerable number of different types of mark

account to the credit of foreign holders, among which may principally be mentioned the following—

1. *Free Reichsmark Accounts* (Freie Reichsmark-Konti), i.e. accounts constituted after the 15th of July, 1931, and resulting either from the sale of foreign exchange or specifically approved transfer on the part of a person residing in Germany to a German foreign exchange bank for account of a foreigner or from transfer from the free Reichsmark account of one foreigner to that of another. Such balances may be used freely for all payments in Germany and permits can also be granted for their conversion into the currency of the foreign owner and their transfer abroad.

2. *Securities Blocked Mark Accounts* (Effektenspermark-Konti), i.e. balances resulting from the sale or redemption of securities. Such balances may be used freely for the purchase of German securities expressed either in Reichsmarks, gold marks or some concrete value and admitted for dealing on the German stock exchanges, with the principal exception of Reichsbank shares and Young and Dawes loans. If the account was the property of the foreigner in question prior to the 15th of April, 1932, it can also, subject to permit, be used for the purposes specified below as applicable in the case of all other kinds of blocked mark account.

Coupons or dividend warrants belonging to foreign holders may either be held pending further developments, or their proceeds, when a certificate of foreign ownership is forthcoming, may be paid over to the Konversionskasse für Auslandsschulden with a view to receiving funding bonds of this latter institution.

3. *Old Mark Accounts* (Alte Mark-Konti), i.e. balances of foreigners existing before the 16th of July, 1931, and blocked under the terms of the foreign exchange regulations.

4. *Emigrant Blocked Mark Accounts* (Auswandererspermark-Konti), i.e. accounts of persons who have left the country and so lost the rights which the German foreign exchange regulations allow to persons residing in Germany.

5. *Note Blocked Mark Accounts* (Notenspermark-Konti), i.e. accounts created by the transfer of German Reichsmark notes by a foreigner to an account with a German foreign exchange bank.

6. *Credit Repayment Blocked Mark Accounts* (Kreditrückzahlungs-Spermark-Konti), i.e. balances resulting from the repayment of a credit opened for a resident in Germany by a foreigner before the introduction of foreign exchange restrictions granted since and repaid into the blocked account of a foreigner.

7. *Other Blocked Mark Accounts*, including accounts resulting from the sale of property in Germany by a foreigner, estates inherited, maturing insurances, etc.

Permits to operate the accounts described under headings 3 to 7 and securities blocked marks dating from before the 15th of April, 1932, may be issued for the following purposes—

(a) Up to 2,000 Reichsmarks a month may be drawn by the owner and his family for travelling expenses in Germany other than for business.

(b) If the holder of the account purchases goods in Germany for his own account 25 per cent may be paid from his own blocked account,

provided that the remainder is met in foreign currency or in free Reichsmarks.

This is, however, seldom possible, as blocked mark payments are prohibited by so many clearing agreements. In any case, a permit for such a transaction will only be possible if foreign raw and semi-manufactured produce does not represent more than 20 per cent of the invoice amount.

(c) For repairs, etc., to house property owned by the holder or for payment of taxes.

(d) For payments to needy persons in Germany.

(e) For economically justified investment in Germany provided such investment is for a period of not less than five years.

Registered Marks, i.e. blocked marks arising from the repayment of credits originally granted in foreign currencies which the German debtors have effected in Reichsmarks pursuant to the provisions of the German Credit Agreement of 1933, Clause 10. For the purpose of controlling the use and the investment of such accounts, they are entered on a Register kept by the Treuhand-Gesellschaft m.b.H. of 1933, which is under the control of the Reichsbank (this explains the designation "registered credit balances"). The foreign creditor is called "registered holder." The German banks with which the registered holders may maintain their registered credit balances are styled "selected banks" owing to their having been selected for this purpose by the Committee of Foreign Creditors, together with the Reichsbank.

Registered marks are generally used by foreigners travelling in Germany. Nationals of countries which have subscribed to the Standstill Agreement can, in the terms of the latest arrangement, only acquire such marks from registered holders in their own country. Such marks are now styled "Reisemarks" and, as a rule, a traveller can only draw Rm. 50 per day and Rm. 1,500 per month, but registered holders have the right to issue letters of recommendation to their clients in the terms of which they may draw Rm. 100 per day or Rm. 3,000 per month.

With the permission of the Reichsbank registered marks may also be utilized for payments to needy persons in Germany with a limit of Rm. 200 per person per month.

Sondermark Accounts may originate from the payment of funds of German importers to the special account of the relative foreign Bank of Issue with the Reichsbank. In such a case they can only be used for payments in Germany and in some instances a further restriction is imposed by the Reichsbank to the effect that Sondermarks can only be used for the payment of German goods shipped to the country in question. Funds resulting from securities ("Altbesitz"), the proceeds of coupons encashed, rents, etc., may also, if special request has been made and the requisite permit granted, be credited to Sondermark account, but purchase of German goods with such marks is not permitted. Sondermarks can also with the necessary permit be used for meeting personal expenses of the holder and his family, etc.

In the case of Great Britain, the use of Sondermarks was introduced by the Anglo-German Exchange Agreement of the 10th of August, 1934. This, however, ceased to have effect upon the coming into force of the Anglo-German Payments Agreement referred to on page 395.

"Askimarks" (*Ausländer-Sonderkonti für Inlandszahlungen*) which

originate with the sale of goods in Germany are particularly used for execution of business in compensation of merchandise transactions especially with a view to facilitating the import of essential articles to Germany. The establishment of such accounts and disposal thereof is subject to a permit being obtained.

Under certain conditions, the permit of the authorities can be obtained for the utilization of the various types of blocked mark enumerated above for many different forms of transaction. They consequently command varying values in accordance with the importance of the purpose to which they can be devoted. Thus, for example, various categories of blocked marks may be used without a permit for the purchase of securities expressed in reichsmarks, gold marks or in some concrete value, with the principal exception of Reichsbank shares and Dawes and Young loans. If they are sold, the proceeds will, however, be credited to a Securities Blocked Mark Account. Only if a permit is obtained can the proceeds of a sale or the purchase price, if it be lower than the proceeds, be transferred to the original account.¹

Methods of Exchange Control.

Any form of official interference with the freedom of dealings in foreign exchange is, of course, a form of exchange control. Normally, a form of control over fluctuations in exchange rates is exercised by the working of the gold standard. Such control is automatic as long as free gold markets are maintained, and is also rigid for all practical purposes. Where a currency is divorced from any international common denominator, as where a gold standard country suspends gold payments, it must be left to find its own level in terms of other currencies, in which case it will fluctuate continuously with every change in the temporary international balance of payments and with the operations of exchange speculators, or else some official action must be taken to "control" the exchange value of the currency, i.e. to prevent or at least to limit wild and constant fluctuations in exchange rates.

The most drastic form of official action is that by which all exporters are compelled by law to sell only in terms of the currencies

¹ Following the absorption of Austria by Germany in March, 1938, the former Austria currency was replaced by the Reichsmark, and the system of "registered" marks for tourist purposes was also introduced. As the sale of "registered" marks does not provide "free" foreign exchange for Germany but merely reduces her liability under "standstill" agreements and as foreign tourist traffic in Austria was estimated to be worth about £7,000,000 in foreign exchange annually, a new form of mark for tourists, to be issued by the Deutsche Golddiskontbank, was introduced. Any buyer of "registered" marks must also purchase 25 of the new marks for each 75 "registered" marks. The proceeds of the new marks provide "free" foreign exchange while the rate of "registered" marks reduces the "standstill" liability as before. These new marks have become known as "Degeo" marks.

of buying countries and to hand over to the home Central Bank or State Bureau the entire proceeds of such sales. Such foreign currency will be purchased from the exporter by the central authority only at an arbitrarily fixed "official" rate of exchange in terms of the home currency. At the same time importers wishing to buy goods from abroad must first apply for a licence to import and must also apply to the central authority for the allocation of the necessary foreign exchange. This latter will only be sold to them at another arbitrarily fixed "official" rate (which may bear little relation to current market quotations), and which even then may only be obtainable in a series of small amounts. It is under such conditions that clandestine dealings in exchange take place and which lead to the creation of a "Black Bourse" or illegal exchange market. Such markets have persisted under these conditions in spite of rigorous attempts to suppress them, as the prospects of large profits for the operators appear to outweigh the fears of fines and imprisonment. A slight relaxation of this form of control is to be found when the central authority is permitted to offer specified sums of foreign exchange for sale by tender to prospective buyers who already hold the necessary licences, instead of "rationed" sales at the "official" rate.

In a still more relaxed form, the duty of acquiring all foreign exchange from exporters and allotting it to importers may be handed over to approved home banks instead of being carried out by the State Bank or a State Bureau. Even so, it is usually stipulated that official buying and selling rates shall be fixed and that a stated percentage of all foreign exchange acquired by the banks shall be sold to the State at the fixed price.

Greater relaxation still is shown by the system under which approved banks are allowed to deal freely in foreign exchange, but must submit periodical summaries of their transactions to a government department or to the State Bank. Any bank which is considered by such authority to have dealt unwisely or to have facilitated speculation in the currency may be reprimanded, and is liable to have its freedom of action curtailed or even withdrawn. As mentioned earlier, a ban on the granting of overdrafts or "clean" credits to foreigners is also nearly always imposed under all these conditions, and this is sometimes reinforced by a ban on the public issue of loans for foreign account.

Finally, there is the method by which the Central Authority endeavours to prevent, or to limit, fluctuations in the exchanges by entering the market as a seller or buyer of other currencies as the need arises and according to the requirements of the market, which otherwise is left completely free to deal as it chooses. Given a high degree of efficiency in operation, this method would be by far the most satisfactory of any system of "control," since it imposes no hindrance on either trade or financial activities, but allows the normal economic life of the country to proceed as usual. Its drawback lies in the fact that, while the Central Authority can always sell the home currency and accumulate a stock of other currencies, it cannot buy its own currency indefinitely in exchange for others unless it possesses ample balances or credits abroad on which it can draw, or an ample stock of gold at home. A country which has had to render its currency temporarily inconvertible, to produce the need for exchange "control," is not usually in a position to command any resources in gold or foreign assets or credits, since these must have been utilized before the currency was allowed to become inconvertible. It is quite possible, however, for such steps to be taken as will prevent exceptionally wide and rapid fluctuations in the exchanges without hoping to arrest completely a definite world trend either for or against the home currency.

It is on this latter principle that our own Exchange Equalization Account appears to have been worked. The events which led to the inception of this Account and its composition are dealt with in the last chapter of this book, but it may be mentioned here that the actual mechanism of the working of the account is one of delegated agency. It is not known outside those actually responsible how, when, and where decisions as to policy are taken, but it can be seen that the organization is somewhat military in character. Army Headquarters consist of the Cabinet, the high permanent officials at the Treasury and the Governor of the Bank of England and his chief assistants. Corps H.Q. is the Chief Cashier's Department at the Bank of England under whose control the Foreign Exchange Section is placed. Divisional H.Q. consists of a series of Committees, such as the London Foreign Exchange Bankers' Committee, composed of senior officials of the banks, both home and foreign, the accepting, discount, and issuing houses, and other financial interests. Brigade H.Q. is the senior officials in each of

the big banks who are responsible for the working of the respective Foreign Exchange Departments. The actual battalions in the front line are the exchange operators themselves and their assistants. As in the War, each actual combatant can see only his own portion of the battle, though he may glean news of what is happening on other parts of the front. By means of a system of collating a number of reports, each stage in the organization passes on a condensed summary of events and views in its own sector at regular intervals. In the early stages these reports and the meetings of the Committees were very frequent, but latterly the urgency has disappeared, and a more leisurely routine has developed with the lessening in frequency of the operations of the Account.

When the Account is or proposes to be active, the exchange operators must pass on to their immediate superiors such news as the quarters from which any special demand for or offering of sterling appears to be coming, the apparent strength of such a movement, any facts or rumours gleaned in the course of telephone conversations with foreign centres, and their own views on the outlook. Each Brigade H.Q. then sends its representatives to one of the periodic meetings of Divisional H.Q., where reports and views are compared and a summary sent forward to Corps H.Q. Certain members of Divisional H.Q. are also in direct touch with Army H.Q. and their views, as well as the summary of reports and news from various special quarters served up piping hot by Corps H.Q., are available to the High Command. A decision on policy having been taken by the latter, the instructions are passed on to Corps H.Q. In order that even the massive organization of the Bank of England should not be swamped by a myriad of small transactions which the operations of the Account have to satisfy, a system of summarizing was again adopted. Certain leading battalions were singled out for "shock troops" to undertake the actual market dealings in detail. These consist of the six largest Clearing Banks and two other prominent British banks which have a powerful backing. The detailing for duty of these battalions is done by Corps H.Q. in the person of the Chief of the Foreign Exchange Section at the Bank of England, and it has been the practice to leave operations to not more than two at a time of these eight banks, though, in an emergency, the whole force has been sent in to operate simultaneously. The instructions may be given through Brigade

H.Q. or direct to the battalions concerned, and they usually take the form of an order to buy or sell a given currency against sterling at a stated price up to a certain amount or until a stated time. For example, the Bank official (who is, of course, connected by private telephone to all his agent banks) may 'phone through to two of them in succession with orders to commence at 10.30 a.m. to buy all French francs offered to them at not worse, i.e. not at a lower rate, than 105 fcs. per £, and to continue until each has bought Fcs. 10,000,000, or until 12.0 noon, or until further orders, reporting every few minutes as to the total dealt in. The bank dealers concerned proceed to operate as directed, purchasing whatever French francs are offered to them, either in the London market or abroad or by customers, at a rate of Fcs. 105 per £ or over and reporting every few minutes to the Bank official the total so far dealt in, or even more frequently if large amounts of francs are coming forward. At the end of the time fixed or when the order is completed, or when the Bank gives instructions to stop, the final total is reported by each of the dealers concerned. If Army H.Q.'s orders require the rate to be held at a given level indefinitely, fresh instructions will be given at once by the Bank to another two of its agents. If speculation appears to be rampant and large amounts are passing, the new instructions will be given by one official at the same time as another is cancelling the old, so that there shall be no break in the continuity of operations. As quite a lot of speculation in a currency on a "short view," i.e. for a day or a few hours only, takes place when a speculative movement on a longer view appears to be rife, it is the duty (and sometimes the pleasure!) of the battalions operating to report the existence of such "short view" speculation. The report goes forward through the various channels, and if supported by similar views from other quarters, a counter-attack may be made. Supposing that a definite "bear" attack on the French franc is being made with the result that U.S. dollars and the price of gold both tend to cheapen in sympathy, the authorities will at once endeavour to minimize, if not to prevent, such a disturbance of the equilibrium of the pound in terms of gold and gold currencies. Orders are given as described above for the purchase of all French francs offered at or over a rate of, say, Fcs. 105 per £. Control of the franc rate automatically controls both the dollar rate and the gold price owing to the gold link between them.

Purchases at this rate are continued for some hours what time the "short view" speculator has "gone short" of francs in the early selling rush in the hope of buying them back more cheaply by the end of the day. At last the selling pressure appears to slow down and immediately Corps H.Q. is notified of this by the battalions then operating. If the moment seems opportune, Corps will issue instructions, probably to two fresh battalions, to "go in and buy francs down to $104\frac{1}{2}$." This means that the operators, instead of merely absorbing what francs were offered to them, are to take the offensive and bid all over the world for French francs at successively lower prices. The operators are kept in touch with each other by Corps and after at first bidding, say, $104\frac{7}{8}$, the buying price will be steadily lowered by stages until the rate of $104\frac{1}{2}$ temporarily decided upon has been reached. In the meantime the "short view" speculators will have been viewing these operations with growing alarm and, not being privileged to know how far down the "control" proposes to bid the rate, the more nervous of them begin to take fright and decide to cut their losses by buying in the francs of which they are short. The real long term speculative movement having spent itself for the time being and such operators being quite prepared to await events before covering in, there is no real selling of francs anywhere, and the steady bidding of the "control" is likely to cause any prospective genuine sellers to hold off. Consequently the "short view" speculator finds no joy in life and no francs on offer, and at long last finds the "control" completely dominating the market and prepared to deal at, say, $104\frac{3}{8}-\frac{1}{2}$. He then has the mortification as well as the loss of buying back from the "control" at $104\frac{3}{8}$ the francs which he had sold to them earlier in the day at 105! Where, however, a definite world trend for or against sterling makes its appearance, the authorities are quick to realize it, and no attempt is made at any prolonged stand at any given rate. All efforts are concentrated on minimizing the day-to-day fluctuations as far as possible, so that the least possible harm shall be inflicted on the trading community. Then, as soon as the time seems ripe, a definite stand is made to establish a new level of temporary stability until fresh conditions arise.

This method by which the authorities delegate the actual dealing to agent banks means that the Bank itself only has to handle transfers of currency in bulk. If, for instance, two agents have each

had an order to buy francs for two hours, one may have bought Fcs. 15,275,000 in 25 different deals while the other may have bought only Fcs. 11,850,000 in 18 different deals. Each agent will have to carry through the routine settlement of its deals with the 25 and 18 counterparties respectively, but will each carry out only one deal with the Bank itself by which the first will sell to the Bank a total of Fcs. 15,275,000 and the second a total of Fcs. 11,850,000. The Bank has thus only two transfers to make in respect of what are really 43 transactions, thus materially lightening the physical labour of dealing with the accounts of the "control." The agents must, of course, pay cable and telephone costs, overhead charges, and, on some deals, brokerages, and to cover these expenses the Bank makes a small allowance in the rate at which it takes over bulk transactions from its agents, e.g. francs bought by the agents at Fcs. 105 per £ may be taken over by the Bank at Fcs. 104 $\frac{3}{8}$ $\frac{1}{2}$ per £.

Following the suspension of gold payments by France in September, 1936, the Bank of England commenced to deal in its own name as a member of the exchange market with other members of the market through a limited number of selected brokers. This may foreshadow the development of a new technique and possibly ultimate complete centralization of exchange operations with the Bank. The detail work is carried out by the Bank's own staff.

Our initial experiments in exchange control in an endeavour to prevent the eventual suspension of gold payments were necessarily costly. Foreign currencies were borrowed and sold for sterling at only a little under the existing gold parities of \$4.86 $\frac{3}{8}$ and Fcs. 124.21 $\frac{1}{4}$, but had to be bought back later on, in order that the loans might be repaid, after the 25 to 30 per cent depreciation in the exchange value of sterling. Even though such purchases were made to the best advantage, there must have been a loss on the total borrowings (which amounted to the equivalent of £130,000,000) of about £28,000,000. It is often stated that this loss, which falls on the Exchange Equalisation Account and ultimately on the taxpayer should it exist when the Account is wound up, is covered by the appreciation in money value of such gold as was held by the Bank of England at the time of our suspension of gold payments.¹ This is not strictly correct. The Account is only likely to be wound up and the gold in the Bank re-valued if and when

we are in a position to resume gold payments and fix a definite gold value to the pound. The profit on the original stock of gold in the Bank must depend entirely on the extent to which the pound is devalued by reducing its gold content and legally fixing a higher price for gold, but the *realized* loss in exchange is already fixed in terms of pounds, and must be met in some way or other. If the pound is eventually devalued by 25 per cent, the profit on revaluing the Bank's gold would be more than enough to cover the initial exchange loss, but a devaluation of 10 per cent or less would leave a deficit between the two items. On the other hand, there is no doubt that the subsequent operations of the Account have mostly been conducted at a profit, and in view of the magnitude of the amounts dealt in the total profit must be very large. Though conjectural guesses are really futile, expert opinion held that the Account had made anything between £10 and £15 millions profit in the first two years of its working, so that even if only a moderate devaluation of the pound is eventually decided upon, this profit, together with the profit from the revalued gold holding, should wipe out the original loss and present the country with a small bonus as a reward for its confidence.

SUMMARY

The results of such restrictions may be summarized briefly.

Advantages.

(a) If applied moderately and in time, they may force a reduced consumption of unnecessary imports and give a mild stimulus to exports sufficient to restore the equilibrium of the country's balance of payments, and to prevent a suspension of specie payments and a resulting depreciation in the purchasing power of the currency.

(b) Even if accompanied by a suspension of specie payments, they can prevent extreme and over-frequent fluctuations in the exchange value of the currency, and so relieve the trading community of what would be an additional handicap.

(c) They can act as a decided deterrent to speculation in commodities of all kinds as well as in exchange and securities.

(d) They may afford a sufficient breathing space to a government to enable it to come to fresh agreements with its creditors, and to take other steps to rectify or ameliorate the existing adverse position.

Disadvantages.

(a) They undoubtedly tend to disguise and obscure the true state of country *vis-à-vis* its neighbours. The internal price level as compared with the world price level should always be reflected in the state of the exchanges, and *vice versa*, so that the natural corrective forces of comparative purchasing power can have play.

(b) Their effects must be constrictive and restrictive of world trade in general. Every seller is a potential buyer, and the reduction of buying on the part of the country imposing the restrictions must be eventually reflected in a loss of buying power elsewhere, thus intensifying any general world depression.

(c) The importance of a free and active forward market does not seem to be appreciated when "control" regulations are introduced. With the uncertainty as to the future of the currency produced by the imposition of restrictions on exchange dealings, the normal factors on which a forward market relies are largely prevented from operating, and official steps for the maintenance of a forward market are seldom taken, thereby creating further difficulties.

(d) In common with all other attempts at legal control of normal activities, they lead to various methods of evasion of the regulations being practised. There are always those who will break the law if the prospect of financial gain is sufficiently great, and the bringing into being of a "Black Bourse" or clandestine dealings in exchange may result in the quoting of unofficial exchange rates which are as pessimistic as the "official" rates are usually optimistic. Such operations may also rouse a feeling of resentment against the authorities on the part of those who are too law-abiding or too nervous to indulge in such illegal dealings.

(e) The effort to maintain the exchange value of the currency at an artificial level may have the result ultimately of lowering the standard of living, as the legal purchasing power of the unit is probably being kept above its actual level and a rise in internal prices is likely to follow. Unless, which is not usually probable, a rise in wages and salaries also takes place, the internal purchasing power of the community is reduced, with a consequent diminution of internal trade which must eventually be felt elsewhere in the general reduction of world trade which must follow. (Cf. the remarks of Dr. Schacht, President of the German Reichsbank, on the imposition of restrictions on the import of raw wool, etc., into Germany in March, 1934.)

CHAPTER XIV

PERSONAL AND COMMERCIAL CREDITS

THE term "Credit" has already been defined as "the confidence of man in man," and in financial and commercial transactions this confidence is displayed by the willingness of a creditor to grant to a debtor time for payment of the debt, either on the oral or written assurance of the latter that such payment will be duly effected.

The granting of credit necessarily depends on the status of the person to whom credit is given, and while individuals may enjoy such a local reputation as to command credit from the members of their own community, in international trade and finance it is not always possible for the creditor to be sufficiently acquainted with the status of a prospective debtor to enable him to estimate accurately the risk he might run in according credit. Consequently, as the leading banks and financial houses in all the principal countries of the world enjoy an international reputation, the practice has grown up of utilizing their superior reputation to facilitate transactions which require credit, in cases where such credit might not have been accorded to the individual. Reference has already been made elsewhere to the way in which large merchant firms in London eventually developed into merchant bankers until the commercial side of their businesses became extinct, owing to the more profitable business of lending their names to firms of lesser standing. This is the principle which underlies all forms of bank credit, and may be defined as "the substitution of the superior credit of the bank for the inferior credit of the individual."

It may first be stated that any "credit" in the banking sense of the term, is one which involves the active co-operation of a bank, and any form of trading credit comes under quite a different category.

It is proposed here, therefore, to deal only with the various forms of credit in which some part is played by a bank or financial house, though the liability of the bank may not always be directly engaged.

Types of Credit.

While credits may be divided into the two *classes* of Personal and Commercial, which form the title of this chapter, each of these classes

may be of any one or more of the several *types* which follow, and this distinction should be clearly grasped.

The two main types of credits are—

(a) Bank; (b) Negotiation, or "Authorities to Purchase."

A *Bank Credit* is a credit in which drafts are drawn on a bank and/or the bank directly engages itself for the eventual payment of the amount of the credit.

A *Negotiation Credit*, or "*Authority to Purchase*" gives rise not to drafts on a bank, but to drafts on a merchant firm or individual, though the bank issuing the credit may engage itself as surety for the eventual payment of the relative amount.

The distinction between these two types is important, because Bank Credits give rise to Bank drafts or "Bank Paper," which commands the best local market discount rates, while a Negotiation Credit gives rise to trade bills, which are discountable only at a worse rate for the seller.

Each of these two main types will also be one or more of the following subsidiary types—

(a) Confirmed or Unconfirmed.

(b) Irrevocable or Revocable.

(c) Sight or Acceptance.

(d) Clean or Documentary.

(e) Fixed or Revolving.

(f) Omnibus.

Before proceeding to define these types, it is necessary to define the *parties* to a credit.

The Customer is the person at whose instance the credit is opened, and is the person ultimately liable for payment under the credit.

The Issuing Bank is the bank actually opening the credit at the request of the customer, i.e. the bank whose credit is substituted for that of the ultimate debtor.

The Negotiating Bank is the agent bank of the issuing bank in the other centre, and may or may not engage itself under the credit (see below).

The Beneficiary is the person in whose favour the credit is opened, and is therefore the principal creditor.

The relation of these parties to each other and their respective rights and duties are dealt with later.

A *Confirmed Credit* is one under which the issuing bank confirms

either directly, or indirectly through the negotiating bank, to the beneficiary, that drafts drawn under the credit will be duly honoured. In the case of a bank credit, confirmation by the issuing bank means that it engages itself to honour all drafts drawn within the terms of the credit, and such credit therefore constitutes as direct a liability on the part of the issuing bank as when it places its acceptance on a bill. A confirmed bank credit is therefore the safest guarantee of payment that a creditor can have, since he knows that if he conforms strictly to the terms of the credit he will eventually receive payment of his debt from the issuing bank irrespective of the ability or willingness of the ultimate debtor to effect payment. As the issuing bank so directly engages itself on behalf of the customer on whose instructions the credit is opened, it must regard the granting of such a facility to the customer as the equivalent of an advance to him, and so must take every precaution to obtain adequate security for its commitment, and should be quite sure that the standing and reputation of the customer warrant the giving of such an engagement on his behalf.

Where a credit is advised through an agent bank, it is held by some authorities that the beneficiary is not entitled to regard the credit as fully confirmed until the negotiating bank adds its confirmation to him that the credit has been opened and that it is prepared to honour drafts drawn within the stipulated conditions. Further, some authorities hold that a confirmed credit is equivalent to an irrevocable credit, but the strength of this contention is doubtful, and it is still the practice to describe a credit as "Confirmed and Revocable" or "Confirmed and Irrevocable" according as to whether the issuing bank desires to retain the right to terminate the credit under advice to the beneficiary. In point of fact, however, a bank which has issued a confirmed credit would cancel it before the stated expiry date only after receiving the consent of the beneficiary to such cancellation, and this consent must be given in writing or properly authenticated. It may therefore be accepted that under banking custom, *a confirmed credit can be cancelled only by the consent of all the parties to it, particularly the beneficiary.* In the case of *Stein v. Hambros Bank of Northern Commerce*, 1921, it was held that a confirmed credit implied an absolute obligation on the part of the issuing bank which it could not avoid without the consent, not only of the beneficiary, but also of the negotiating bank.

An Unconfirmed Credit is one which does not carry the undertaking of the issuing bank that drafts drawn under the credit will be duly honoured. In most cases, however, a negotiating bank will insist on an undertaking being given by the issuing bank that *drafts negotiated prior to the receipt of advice of cancellation* shall be duly honoured. Consequently, it is not safe for a bank to issue an unconfirmed credit without taking reasonable security from its customer, and although it is the practice for the negotiating bank under an unconfirmed credit, expressly to disclaim all responsibility and liability, the issuing bank must be prepared to remain liable to the negotiating bank for drafts negotiated by the latter prior to its receipt of advice of cancellation. An unconfirmed credit is usually stated to be also a revocable credit, and in the case of *Cape Asbestos Co., Ltd. v. Lloyds Bank, Ltd.*, 1921, it was held that a revocable credit may be cancelled by the issuing bank at any time after its issue and without notice to the beneficiary.

As regards the beneficiary, therefore, no protection is afforded by an unconfirmed credit, and he cannot be assured that his drafts will be honoured, even though he complies strictly with the terms of the credit, but as the commission charged by the issuing bank is at a much lower rate than that charged for a confirmed credit, debtors will use such credits whenever the creditor will consent to them and their use is largely confined to firms between whom business relations have existed for some time, and where a fair degree of mutual confidence exists.

With and Without Recourse.

It is always open to the beneficiary under a credit, to stipulate with his debtor that the credit shall be opened for drafts drawn "without recourse." In the case of a confirmed bank credit, this precaution on the part of the beneficiary is needless as he has the assurance of the issuing bank that his drafts will be honoured. In the case of unconfirmed or revocable credits, however, it is always possible that his drafts may be dishonoured on presentation, and that the negotiating bank will therefore turn to him for reimbursement. If a beneficiary consents to accept an unconfirmed or a revocable credit, he will often stipulate, therefore, that the credit shall be opened for drafts to be drawn by him "Without Recourse" so as to relieve himself of further liability once the drafts have been

negotiated. It is for this reason that the negotiating bank will usually demand the undertaking of the issuing bank that drafts negotiable under an unconfirmed credit will be honoured if negotiated prior to receipt of advice of cancellation.

Irrevocable or Revocable Credits.

As these terms imply, a credit may be either irrevocable or revocable on the instructions of the issuing bank with or without instructions from the customer. As stated above, an irrevocable credit, even though unconfirmed, can be cancelled only with the consent of all parties thereto and especially that of the beneficiary. A revocable credit is one which is subject to cancellation at the option of the issuing bank, either on its own authority, as when it is not satisfied with the current standing of its customer, or actually on instructions from the customer.

Where a confirmed credit is said to be revocable, the beneficiary and/or the negotiating bank can demand the eventual payment of drafts negotiated prior to the receipt of notice of revocation, but no further objection to the cancellation of the credit should be raised.

Sight or Acceptance Credits.

These terms are used to distinguish between a credit which calls for payment at sight, or on demand, or on presentation, which is known as a sight credit, and a credit which gives rise to the drawing of drafts at tenor which need acceptance, either by the issuing bank in the case of a bank credit, or by the customer in the case of a negotiation credit, such credits being known as acceptance credits. It is also customary to distinguish acceptance credits by prefixing the name of the centre on which the bill is to be drawn and where it will eventually become payable, e.g. a credit opened by a London bank for drafts to be drawn on it at tenor, would be known as a London acceptance credit, a credit opened for the acceptance of drafts by a bank in New York would be known as a New York acceptance credit, etc.

Clean or Documentary Credits.

Here again the terms speak for themselves. A clean credit is one under which payment will be made on demand, or acceptance of a tenor draft given, without the presentation of any documents or other evidence of the existence of a debt, or of value to be given in

exchange for the payment or acceptance. A documentary credit is one which calls for the presentation of documents in support of the demand by the beneficiary for payment or acceptance of his draft. Such documents are usually shipping or commercial documents, but they may be legal documents, such as a discharged mortgage, an assignment of a life insurance policy, etc. The shipping and commercial documents which are usually encountered in connection with documentary credits are dealt with later, in the description of the working of a documentary credit which follows. The term "Documentary Credit" has been applied by some writers as covering only credits opened for the negotiation by a bank of documentary drafts drawn by an exporter on an importer. This use of the term is, however, far too narrow and a documentary credit is now held to be "any credit calling for the production of documents."

Fixed or Revolving Credits.

These terms apply to the amount for which a credit is opened. A fixed credit is one which is opened for a stated total amount, though this may be availed of by one or more drafts, but the credit becomes completely exhausted as soon as the total has been drawn. A revolving credit is one under which an indefinite amount may eventually be withdrawn, and such credits are of four types—

(a) For an unlimited amount to be drawn at any time and with no limit to the total of drafts which may be outstanding. This amounts to a "blank" credit and is rarely granted.

(b) For an unlimited amount in total, but with a specified limit to the amount of drafts which may be outstanding at any one time; further drafts can be negotiated only after the maturity of one of the outstanding drafts has reduced the outstanding total.

(c) For an unlimited amount in all, but with a limit to the amount which may be drawn at any one time. Further drawings may be made only after the payment of the previous drawing.

(d) For a limited amount to be drawn within any given period. Once the amount which can be withdrawn within the stated period has been exhausted, no further drafts can be drawn until the commencement of the next period when the credit automatically becomes renewed, but no balance can be carried forward from the previous period.

Omnibus Credits.

This is a somewhat obsolete term applied to a kind of revolving credit which is sometimes granted to merchants or shippers to enable them to obtain advances against their merchandise. The granting bank (or issuing bank) permits drafts for round amounts to be drawn on it by the beneficiary against a general lien over the goods of the beneficiary. It may also be used for the same purpose between principal and agent to allow the latter to draw in respect of local produce purchased by him for shipment to the principal. They are called "Omnibus" because they carry as security a general pledge on whatever merchandise may be in the possession of the grantee.

Syndicate Credits.

The greatly increased size of modern industrial units (due to amalgamations, "rationalization," *cartels*, etc.), the setting up of marketing boards and other systems of selling in bulk, have led to demands for temporary finance of sums far too large for any one bank or acceptance house to entertain as a single engagement. For example, the financing of the exports of Chilean nitrate during a normal season requires a credit of at least £5,000,000. Such unusually large requirements are financed by a group of banks and/or accepting houses acting together as a syndicate, and the resulting total credit is known as a "syndicate credit." Each member of the group assumes liability for a stated portion of the total, and drafts may be drawn by the beneficiary either on each member for this fixed proportion or on one member or more designated by the group to pay or accept drafts for the total amount on behalf of all of them. In the latter case the operating members will be protected by a formal agreement signed by each member setting out the liability of each and undertaking that such proportionate payments shall be made to the operating member (or members) at the proper time.

The Uses of Credits.

The original object of a credit was to avoid the necessity of transfers of actual cash in times when such transfers were attended by no little risk. Consequently they took the form of a letter addressed by the grantor to his agent requesting that certain moneys should be

held at the disposal of the grantee, either with or without the fulfilment of certain conditions which were set out in the letter. With the growth of the practice of substituting the superior credit of a bank or well-known merchant house for the inferior credit of the individual, the form of letter sent to the beneficiary to advise him that the grantor was prepared to pay cash or to accept bills for account of the grantee, was merely adapted from the existing recognized form of letter to meet the requirements of any particular case. To-day, certain types of credits are in such general use that printed forms, with blank spaces for the eventual filling in of the details, are used by all the principal banks throughout the world, and these forms follow a more or less recognized wording according to the type of credit required.

Personal Credits are intended to save an individual the trouble and risk of carrying larger sums than usual in cash when he travels to countries other than his own. The usual types of such credits and the methods of their operation are described below.

Commercial Credits are designed to facilitate the granting of credit by one merchant to another in cases where either the buyer is entirely unknown to the seller or where the seller is not prepared to grant credit on the unsupported standing of the buyer. They are also of great use in financing the growing and harvesting of primary products, the movement of crops, the working up of raw material through the various stages of manufacture to the finished product, the credit granted by the wholesaler to the retailer, or by a principal to an agent in the case of goods sent on consignment, and the development of new markets by an exporter. In all these cases a bank or accepting house can be found which is ready to accept bills drawn on it against the security of the growing or harvested crops, the raw material in transit to the manufacturer, and the various other stages between the raw and manufactured state, until it finally passes into the hands of the consumer and is paid for by him. It is not always necessary that the commodity forming the security should be actually sold and that the buyer should have a credit opened in favour of the seller. The owner of produce, the manufacturer of the finished article, the exporter sending goods on consignment, may all arrange for credits to be opened in their own favour under which they can draw bills against the security of the commodity they own. Whenever such bills have been accepted

by the grantor of the credit, they become readily negotiable instruments which the holder can turn into immediate cash by discount. Thus the system of commercial credits permits a larger stock of goods or produce to be carried by the owner than could be done with his own capital alone, gives the seller of goods an instrument which he can turn into ready cash and thereby obtain an immediate return of his outlay or capital in producing that commodity, and allows a buyer time in which to dispose of the goods he has purchased and to obtain payment for them, so that he in turn is able to provide the necessary funds to the grantor of the credit to meet the latter's acceptance at maturity. A credit granted to an exporter to assist him in financing his shipments, pending the sale of the goods, and under which he himself draws drafts on the issuing bank, is known as an "Exporter's Credit."

Commercial credits must be distinguished from purely financial credits. Under these latter, finance bills are drawn, and the security against them is usually only the reputation of the grantee. Such credits are of considerable use in facilitating the transfer of funds from one centre to another for financial purposes, but, as has already been pointed out, the Bank of England here discriminates between bills drawn under commercial credits in respect of *bona fide* trade transactions, and those drawn under finance credits for purely financial purposes, so that there is always a limit to the facilities for the discounting of such paper.

PERSONAL CREDITS

The types of credits designed to permit travellers, or those temporarily resident in other centres, to use the local branch or agent of their own bank for the purpose of obtaining cash by means of drawing cheques are of several forms.

One of the most usual methods is that under which a customer of one branch is enabled to draw cheques on another branch or agent of the same bank. Such an arrangement is a confirmed clean sight bank credit, and is usually of a "revolving" nature, since the branch or agent where the cheques are to be cashed is instructed to honour such cheques drawn on the grantor branch up to a certain amount at any one time, further drawings being permissible only after advice of payment of all or some of the outstanding drawings has been received. The process in this case is that the grantor branch

instructs the paying branch or agent by letter to honour the cheques of its customer up to a certain amount for a stated period, and encloses a specimen signature of the customer. The customer will in due course confirm with the paying bank that the credit has been established and he can then draw cheques on his own branch and cash them with the paying bank. The latter will treat him as its own customer for the time being, and will effect payments under the terms of the credit, provided that the signatures to the cheques agree with the specimen signature forwarded by the grantor bank.

Travellers' Facilities.

Travellers' letters of credit are designed to avoid the necessity for persons travelling abroad to carry with them large amounts of cash. They may be regarded as confirmed irrevocable clean sight bank credits of the "fixed" type, since the amount may not exceed a stated total, though this total may be withdrawn by means of one or several drafts.

Travellers' letters of credit are of two kinds: (a) General or "world-wide," and (b) Special or "limited." They may also be commercial as well as personal in that they may be issued to permit a traveller to pay for foreign goods purchased in the course of his journey, and in such cases drawings would have to be accompanied by the documents of title to the goods.

A general or "world-wide" travellers' letter of credit is in the form of a letter addressed by the grantor bank to its branches and agents abroad in general, and requests that the bearer of the letter, whose name is given, should be granted any usual facilities in the way of information, advice, etc., and should be allowed to obtain payment of his sight drafts on the grantor bank up to the total of the amount stated in the letter of credit. In other words, the foreign branches and agencies are requested to negotiate the drawings of the holder of the letter of credit up to a certain stated total, and the grantor bank undertakes to honour such drawings on presentation, provided that they are properly drawn under the terms of the credit. The grantor bank will issue these instruments only against payment in cash of the full amount of the credit plus its commission, or against the debit of this total sum to the account of a customer. A document known as a *Letter of Indication* is also issued with the credit. This document is in the form of a book, in the front of which

is a letter addressed generally to the foreign branches and agencies of the bank, advising them that a letter of credit, of which the serial number and the amount is given, has been issued in favour of a named party. A space is provided for a specimen signature of this party who is, of course, the grantee. This specimen signature is given by the grantee in the presence of an official of the grantor bank, and it is a condition that the Letter of Credit and the Letter of Indication shall be kept separate by the holder. Where these instruments have to be sent by post to the grantee, they are always dispatched by separate posts.

On the back of the letter of credit, columns are ruled in which the various agencies enter details of the amounts withdrawn through them by the holder. These credits may be issued in terms of sterling or of a foreign currency. In the latter case, they can be availed of only in the country in whose currency the credit is expressed to be payable. In the former case, the paying agent has to buy the sterling draft from the holder and will therefore pay out local currency to the equivalent of the sterling amount drawn at the rate of exchange applied. After each part withdrawal the paying agent, who will have compared the signature on the draft with the specimen signature given in the letter of indication, will hand back both documents to the holder. When the final draft exhausting the total amount of the credit is drawn and paid by an agent, the Letter of Indication only is handed back to the holder and the exhausted Letter of Credit is attached to the final draft and sent forward to the grantor bank. Where a holder does not completely exhaust a credit, he can obtain on his return a refund of the unused portion by handing back the Letter of Credit to the grantor bank.

A "Limited" or special traveller's letter of credit is one which is addressed specially by the grantor bank to a limited number of its branches or agents abroad. It may be issued in sterling or currency and is also accompanied by a Letter of Indication. The method of use is the same as in the case of a general traveller's letter of credit.

An early development of the original letter of credit, in order to avoid any necessity of sending advice of their issue to the branches and agencies at which they were payable, was a type of credit in the form almost of a cheque drawn on the branches and correspondents generally of the issuing bank for round amounts in sterling. This instrument, which is still in fairly general use, is really a sight draft

issued by the grantor bank on itself, and requiring only the signature of the holder to complete it. The usual form of these documents is as follows—

CIRCULAR NOTE
THE DEPOSIT BANK, LIMITED
LONDON

No..... 19 ..

Circular Note for TWENTY POUNDS Sterling.

Gentlemen,

This Circular Note should be presented to you by..... whose signature appears on our Letter of Indication No..... with which he/she has been furnished. Please pay him/her or his/her order the value of TWENTY POUNDS sterling at the current rate of exchange.

£20.

We are, Gentlemen,
Your obedient servants,
THE DEPOSIT BANK, LTD.

TO The Branches and
Correspondents of the Bank.Manager.

On the back appears—

TO THE DEPOSIT BANK, LIMITED
LONDON

£20.

At sight pay to the order of.....
TWENTY POUNDS sterling for value received at the rate
of.....

(Holder's signature).....

Date.....

It will be noticed that the note is for the round sum of £20, but they are also issued for £5, £10, and £50. The grantee pays cash or has his account debited immediately on their issue, but can obtain a refund of any notes subsequently returned.

A letter of indication is also issued in connection with such notes in the same way as for a traveller's letter of credit, and the holder will eventually present one or some of his notes, together with the letter of indication to any of the branches or agencies named in the latter document, and will obtain payment against delivering up the notes of an equivalent amount of foreign currency at the paying agent's buying rate for sight drafts on London. The holder must complete the form of draft which appears on the back of the note in the presence of the paying agent who will then compare the signature given with that appearing in the letter of indication. The completed note is then sent forward by the paying agent for collection in the ordinary way, as a sterling sight draft on the grantor bank.

A more modern development of the circular note is a form of cheque issued by the grantor bank on itself and designed to avoid the need for the issue of a letter of indication, and also to render possible the encashment by a holder of any given amount for which the cheque is issued, instead of having to accept several circular notes to make up a total sum.

These cheques are usually in the following form—

TRAVELLER'S CHEQUE

Payable in all countries of the World.

Payable within Twelve Months from

No. 19....

Drawer's Endorsement.....

(To be given in the presence of the Paying Agent.)

To THE DEPOSIT BANK, LIMITED,
LONDON.

Pay Self or Order Signature of Drawer.....

Twenty Pounds Witness to Signature of Drawer.....

T. £20.

OR THE EQUIVALENT ABROAD Manager.
AT CURRENT RATES OF EXCHANGE Branch.

It will be noted that the actual order to pay is addressed to the grantor bank and signed by the grantee, and that the draft is then countersigned by a signing officer of the issuing bank as witness. The holder on presenting the instrument for encashment at any of the branches or agencies of the grantor bank will be required to complete the space left for his endorsement, and his signature will be compared with that appearing at the foot of the instrument. The paying agent will then effect payment in local currency at his buying rate for sight drafts on London, and will send the instrument forward for collection and credit to his sterling account in the ordinary way. Usually a letter of indication is dispensed with, but some banks still issue such a document with the issue of travellers' cheques as an extra precaution.

Travellers' cheques in blank, known as Circular Cheques, are sent by the issuing bank to its various correspondents to be issued to persons in other countries who propose to visit the country of the issuing bank. They are in the form of a cheque drawn on the grantor bank, and are intended to be signed by the foreign purchaser in the presence of the selling agent, and again signed by the purchaser in the presence of the issuing bank before payment is made.

The selling agent receives local currency at his selling rate for sight drafts on London, and will advise the issuing bank of any sales which may have been made, at the same time authorizing the latter bank to debit the sterling account of the selling agent, on effecting payment. They thus constitute an effort on the part of the grantor bank to induce the maintenance of sterling accounts with it by its correspondents abroad in order at least to cover payments made by it in respect of such circular cheques as its agents may sell.

An essential feature of all personal credits is that while they substitute the credit of the bank for the credit of the individual in that the bank assumes responsibility for the eventual payment of encashments made against such instruments, its responsibility is undertaken only against full cash deposit being made by the individual. The benefit to the individual is therefore that his drafts are cashed abroad under the guarantee of a bank where they would probably be refused payment if tendered on the strength of his name alone, and that he is saved the trouble and risk of carrying larger sums than usual on his person. As will be seen from the description of commercial credits which follows, the essence of such credits is that they are to a large extent granted on the security of merchandise or other property, and with only a small cash deposit or even without any immediate cash payment whatever.

COMMERCIAL CREDITS

The use of bank credits in order to finance merchandise from its raw to its finished state, has already been dealt with, and it is credits granted for such purposes which constitute the real substitution of the superior credit of a bank for the inferior credit of a firm or individual.

The issue of such credits is practically equivalent to an advance to the grantee, and is usually made against the security of the merchandise concerned to the extent of about 80 per cent of its value.

Where such a credit is granted, it is of prime importance that the grantor bank should take into consideration the standing of its customer, the grantee, and the nature of the merchandise in respect of which the credit is to be opened. Regard must be had to the current market value of the goods as compared with the amount for which the credit is required, to the nature of the goods, whether

perishable or otherwise, and to their realizability. Full precautions must be taken to see that the issuing bank obtains the full title to the goods, either direct or through any other agent through whom the credit may be advised. Details of the opening and utilization of a commercial credit are given below.

Commercial credits opened for financial purposes are known as "Finance Credits," and they are usually granted by banks only to other banks and financial houses of the highest standing. The security taken may be a deposit of approved stock exchange securities, title deeds to property, a cash margin of about 25 per cent of the amount of the credit, or may be entirely "clean," that is granted on the security of the name of the grantee alone. Such credits are used for the creation of "Finance Bills," the uses and abuses of which have already been dealt with.

D/A and D/P Bills.

Where a bill has documents attached to it, and such documents are stated by the wording of the bill to be deliverable to the drawee of the bill against his *acceptance* of it, the bill is known as a "D/A" bill or "Documents against Acceptance." Where the documents are stated by the wording of the bill to be deliverable to the drawee only on *payment* of the bill, it is said to be a "D/P" bill or "Documents against Payment." As the object of giving credit, either direct by the seller to a buyer or by means of a bank credit, is to enable the buyer to dispose of the relative goods so as to render the proceeds available to meet his debt to the seller, and as the buyer cannot obtain delivery of the goods from the carrier without being in possession of the relative documents, it should be clear that while a D/A bill gives the drawee (the buyer) possession of the goods through immediate possession of the documents, a D/P bill gives possession of the goods only *after he has paid the bill*, and thereby discharged his debt to the seller. A D/P bill is, therefore, incompatible with the granting of credit, and all bills drawn under commercial credits must be D/A bills in order to fulfil the essential basis of the granting of credit.

Parties to a Credit.

The person first concerned with the opening of a credit is the buyer, or debtor, who eventually becomes the grantee. He must

approach his bank with the request to open a credit, and should this request be granted the bank then becomes the grantor of the credit, or the issuing bank. Where the credit is to be advised by the issuing bank direct to the person in whose favour it is opened, who is the beneficiary, no other intermediary is needed and the beneficiary can either forward his drafts direct to the issuing bank for acceptance or payment, or can offer them to any local bank for purchase or collection. A confirmed bank credit advised direct to the beneficiary is a document which should enable the latter to negotiate his drafts through any local bank, as it is evidence that such drafts will eventually be honoured, providing that the terms of the credit are complied with.

Where a credit is advised through another bank, that bank then becomes the negotiating bank, and may or may not be asked by the grantor bank to add its confirmation to the credit. Where it is asked to give its own confirmation of the credit to the beneficiary, it will charge a commission to the grantor bank for doing so, as it thereby assumes a direct liability to the beneficiary. In the absence of such confirmation being given, the negotiating bank is not an actual party to the credit, and is under no obligation to the beneficiary to negotiate his drafts, though if it consents to open a credit it might be held responsible to its principal, the grantor bank, for any subsequent refusal to negotiate.

Where then a grantor bank appoints an agent in a principal centre near to the beneficiary's address and advises the credit through it, or advises the beneficiary direct that drafts must be presented to such a named agent, that agent becomes the negotiating bank and the beneficiary must present his draft, together with the letter of credit, to that bank for purchase. There is never any question of an agent bank who is authorized to negotiate drafts drawn under a letter of credit granted by its principal being asked to *make advances* to the beneficiary against his drafts. Either such drafts will be found to be in order and complying with the terms of the credit, after careful examination by the agent bank, in which case it will purchase them at its current buying rate for such paper on the centre on which they are drawn, or it will find some flaw or discrepancy in the draft and/or documents and will refuse to negotiate, i.e. purchase, except under fresh instructions from its principal or against an approved letter of indemnity furnished by the beneficiary.

Opening a Credit.

As the granting of credit facilities to a customer is in the nature of an advance, special forms of instructions are used by banks which must be completed by the customer who asks for a credit to be opened on his behalf. He must state (*a*) the name and address of the beneficiary, (*b*) the amount of the credit, (*c*) the period of its validity and its expiry date, (*d*) whether drafts are to be drawn on the bank or on himself, (*e*) whether they are to be drawn at sight or at a stated tenor, (*f*) whether the credit is to be confirmed or unconfirmed and irrevocable or revocable, (*g*) whether it is to be advised by cable or by letter, (*h*) whether the agent bank is to be asked to add its confirmation, (*i*) the exact nature and description of the documents which must be surrendered, (*j*) the exact nature, description, quantity and quality of the goods to be shipped, (*k*) whether shipment must be made in one consignment or whether partial shipments are to be allowed, (*l*) the ports of shipment and destination, and any other necessary details. The form usually also includes a letter of hypothecation, and the whole is signed by the customer over a sixpenny stamp to render legal the agreement contained therein.

If the bank is prepared after consideration to open the credit on behalf of the customer, it will send off the advice by cable or by mail, as instructed, direct to the beneficiary or through an agent bank. No letter of credit is handed to the customer as is the case with a personal credit. In the case of a negotiation credit, or "Authority to Purchase," an agent bank in the beneficiary's centre must obviously be used, as such a credit is an instruction to a local bank to purchase drafts drawn within the terms of the credit by the beneficiary.

The actual letter of credit issued is in some such form as those given on pages 326-7, the first one being that for a confirmed bank credit for drafts to be drawn on the issuing bank and the second that of an unconfirmed negotiation credit for drafts to be drawn on the customer or a named drawee other than the issuing bank. It should be noted that in the case of an unconfirmed negotiation credit, the agent bank in the other centre will usually refuse to accept the opening of such a credit unless it receives the assurance of the issuing bank that all drafts negotiated in accordance with the terms of the credit by the agent bank before it receives notice of cancellation from the issuing bank shall be duly honoured by the drawee on subsequent presentation.

THE DEPOSIT BANK, LIMITED
LONDON, E.C.2

.....19..

Dear Sirs,

CONFIRMED CREDIT No.....(which please quote).

We beg to inform you that we have received advice from
.....that they have opened with us a
Confirmed Credit in favour of.....
by order and for account of.....
to the extent of £..... (say.....)
valid untiland available by your drafts on us
ataccompanied by—

Invoice
Consular Invoice
Full set "shipped"
Bills of Lading to
"order"

Weight Note
Certificate of Origin
Insurance Policy or Certificate
covering Marine and War Risks
.....

all relative to a shipment of.....
.....
per S.S..... from..... to.....
in.....shipment(s), consigned to.....
..... before

All drafts drawn under this Credit must contain the clause, "Drawn under L/C No.....dated....." and we hereby undertake to honour such drafts on presentation provided that they are drawn and presented in strict conformity with the terms of this Credit.

Yours faithfully,

Countersigned—

.....Manager.

THE DEPOSIT BANK, LIMITED
LONDON, E.C.2

.....19....

¹ Advice of Negotiation Credit No.(which please quote), which does not carry our confirmation and is subject to cancellation without notice.

Dear Sirs,

We beg to inform you that we have been advised by.....

.....that they have issued their.....

Credit in favour of.....

by order and for account of.....

to the extent of £..... (say).....

valid here until..... and available by drafts at.....

.....drawn on.....

with.....recourse, to be accompanied by—

- | | |
|-----------------------|---------------------------------|
| Invoice | Weight Note |
| Consular Invoice | Certificate of Origin |
| Full set of "shipped" | Insurance Policy or Certificate |
| Bills of Lading to | covering Marine and War Risks |
| "order"..... | ..... |

all relative to a shipment of.....

per S.S.....from.....to.....before.....

consigned to.....

All drafts drawn under this credit must contain the clause "Drawn under L/C No..... dated....."

We are requested to negotiate drafts drawn in accordance with the terms of this Credit, but this advice is given for your guidance only, and does not convey any undertaking on the part of this Bank to negotiate such drafts.

Yours faithfully,

Countersigned—.....Manager.

.....

¹ Printed in ink of a distinctive colour to call special attention to this disclaimer of liability.

Usual Shipping Documents.

The custody of goods by a bailee and the handing over of goods by a consignor to a transport agent and their ultimate shipment to the consignee is evidenced by one or more of the following documents—

1. A Dock or Warehouse Receipt ;
2. A Wharfinger's Certificate ;
3. A Mate's Receipt, or
4. A Bill of Lading.

A *Dock or Warehouse Warrant* is a receipt given by the owners of a dock or warehouse stating that certain specified goods are held by them registered in their books in the name of a specified person. The warrant will state clearly the number of packages and the marks thereon, together with a reference to the vessel from which they were unloaded, if such was the case, and a description of the alleged contents of the packages. A *Wharfinger's Receipt* is a similar document issued by the owners of a wharf. Each of these documents must be accompanied by a *Delivery Order* which authorizes the holder of the goods, i.e. the dock, warehouse, or wharf, to deliver the goods specified therein to the order of a named person, and this order should be signed by the person in whose name the goods are registered. The warrant and delivery order combined make a *quasi-negotiable* instrument, but any person taking delivery of goods by means of such documents cannot obtain a better title than that of the person from whom he takes the goods. In other words, where a *bona fide* purchaser of a *negotiable* instrument secures by his action a full legal title to the property conveyed by the instrument, even a *bona fide* purchaser of a *quasi-negotiable* instrument cannot by his action invest himself with any rights to the property which are not possessed by the seller. A negotiable instrument can, except in certain cases, become the full legal property of a subsequent *bona fide* holder for value, but *quasi-negotiable* instruments of title to stolen goods cannot give a *bona fide* holder for value any legal rights as against the true owner of the goods.

A *Mate's Receipt* is not a desirable document for use as cover for advances, or as a "document of title" under a letter of credit, as it is merely a receipt signed by the mate of a vessel into which goods have been loaded, acknowledging the receipt on board of the goods specified in the documents. The obvious drawback to such documents is that the mate may not have authority from

the shipowners to load such goods, and there is always the possibility of a forged receipt being produced. This instrument is merely intended as a temporary acknowledgment of the liability of the vessel and shipowners pending the preparation of a complete set of bills of lading.

Bills of Lading is a term applied to the documents signed by the master of a ship or by the shipowners or their agents acknowledging the receipt of goods for carriage, specifying the ports of shipment and destination, and the conditions under which the goods are accepted for carriage, a full description of the goods, their markings and alleged contents, and undertaking to deliver them to the consignee or to his order or assigns upon payment of the freight stipulated. A bill of lading is usually made out in sets of two or three copies, all of which are signed and which state that they are respectively the original, duplicate, or triplicate copy. An unsigned copy is retained by both the ship's owners and the master, but all the signed copies together constitute the complete set, *though delivery of the goods will be made from the vessel against production of one signed copy only*. For this reason a bank should always insist on receiving the complete set of bills of lading in respect of any goods against which it makes advances, or a payment under a credit, to avoid the possibility of any missing copy being used to obtain prior delivery of the goods. The generally acceptable form of bill of lading states definitely that the goods named in it have been shipped on board a named vessel, but another form exists where the goods are stated to have been "received for shipment" by a named vessel or by the following vessel. This latter form is not favourably regarded by banks, as any delay in shipment might result in the cancellation of the purchase by the buyer, or, in the case of perishable goods, might result in serious deterioration.

In some cases goods must be sent for some distance overland and then by boat to their ultimate destination, or *vice versa*, and for such shipments a "through" bill of lading is issued by the first carrier. Usually the vessel which will carry the goods cannot be specified, and they are not always considered acceptable by a bank.

In connection with all bills of lading care must be taken by the bank to see that no adverse comments on the condition of the goods have been made by the carriers when drawing up the bill. If, for example, a bill of lading for a shipment of coffee bore a note, "several

bags torn and stained with sea water," this would constitute what is known as a *foul* or *dirty* bill of lading in distinction to a bill bearing no comments whatever, which is known as *clean*.

In all cases of advances or payments against documents of title to goods the bank should see that adequate insurance is provided against all risks, and these may be many and diverse. In the case of butter or meat in cold storage, for example, the insurance should cover the risk of a breakdown in the refrigerating machinery which might result in the serious deterioration of the produce.

Owing to the possible complications which might ensue, banks are usually averse to having any "document of title" made out in their favour, and normally require that such documents shall order delivery of the relative goods to be made to a named consignee, his order or assigns, or to bearer. As with advances against documents, however, the bank issuing a documentary credit may desire to retain the legal rights in the goods, and so will request the beneficiary (who is usually also the consignor) to have the documents made out to his order and endorsed in blank, when the goods become deliverable to bearer, and also to sign a further document known as a *Letter of Hypothecation*. This instrument is a document of charge which conveys to the bank the full right to and property in the goods concerned, pledges the goods to the bank as security, and authorizes the bank to deal with the goods in any way which may be necessary, to store and insure them at the signatory's expense, to pay any freight due to the debit of the signatory, and to sell them should it see fit, applying the proceeds in discharge of the pledgor's indebtedness. Should the amount realized by the goods prove insufficient to cover the debt and charges, the bank still has recourse against the signer of the Letter of Hypothecation for any remaining balance.

Alternatively, the issuing bank may ask for the documents to be made out in favour of its customer, the consignee, and will then ask the customer to sign a Letter of Hypothecation. It should be noted that the beneficiary cannot be asked by a *negotiating* bank to sign a Letter of Hypothecation unless the original terms of the credit, as set out by the issuing bank, call for the production of this document. Exceptions to this rule may arise if the negotiating bank is operating under an unconfirmed credit and has any reason to doubt the standing of either the beneficiary or the issuing bank.

Another form of safeguard for the issuing bank where documents have to be handed over to the customer before he reimburses or covers the bank for its payment or acceptance on his behalf, is to allow him to have possession of the documents (and so of the relative goods) against his signature to a *Trust Receipt*. This document gives a similar charge over the goods in favour of the bank to that conveyed by a Letter of Hypothecation. The signer agrees that the property in the goods remains vested in the bank, that he will store, insure, and deal with the goods as trustee on behalf of the bank, that he will hold the goods and the eventual proceeds thereof in trust for the bank, paying over the proceeds as and when received, and that he will be responsible to the bank for any balance remaining due in respect of his debt against the goods should the proceeds of the sale prove insufficient to cover this amount. This practice is not general in this country, though it is common in Far Eastern countries, but its virtual effect is to grant what is tantamount to an unsecured credit to the signer of the Trust Receipt.

Utilizing the Credit.

It is of the first importance that the terms of any credit should be strictly complied with by all the parties thereto. Where a beneficiary receives advice of a credit direct from the issuing bank, he must prepare his documents in strict accordance with the terms of the credit and must send his draft direct to the issuing bank for payment or acceptance as the case may be, or may arrange for his local bank to purchase the draft from him on the strength of his letter of credit. Where a credit is opened locally through an agent bank, that bank is responsible to its principal, the issuing bank, for the proper execution of the terms of the credit, and is entirely liable for any loss should it pay or purchase drafts and documents which are not strictly in accordance with the terms of the credit.

As soon as the beneficiary receives notice of the opening of the credit, he proceeds to prepare the relative goods for shipment. When they are ready he hands them to a carrier, usually a steamship company; effects insurance on them and obtains an insurance policy; prepares his invoice and obtains any other necessary documents, such as a Consular Invoice, Weight Certificate, etc. When he obtains the carrier's receipt, e.g. the bill of lading, he can then draw his draft and present it with all the documents attached, direct to

the issuing bank or to the local bank where an agent bank is being employed.

The following points need special mention.

The "Red" Clause.

In certain trades, notably the wool growing industry in Australia, the producer is faced with fairly heavy expenses of production, and may have mortgaged his crop to obtain funds with which to meet these expenses. The mortgagee will not relinquish his lien over the produce until he has been paid off, and the grower cannot obtain control of the crop until this has been done. For credits opened for shipments of such produce, it is customary to include a clause printed in red ink and known as a "Red" clause, which authorizes the local bank, through whom the credit is opened to make advances *at its discretion* to the beneficiary without the production of any documents. These advances are subsequently deducted, plus interest, from the purchase value by the local bank when negotiating the eventual drafts of the beneficiary with the correct documents attached.

Partial Shipments.

While the Conference of International Chambers of Commerce at the Hague, in 1930, laid down certain generally accepted principles regarding the practice in respect of credits, this country made certain reservations against the general agreement arrived at there. One reservation was in respect of partial shipments. Where a credit is opened for a specified quantity of merchandise and no authority is given by the customer, at the time of opening, for shipment of the total quantity to be made in two or more parts, it is the practice of British banks to refuse to honour under such a credit any draft drawn in respect of a part shipment only of the total quantity laid down by the credit. Where such a draft is presented, it will be refused payment or acceptance as the case may be, with the answer "No instructions to accept part shipments." An agent bank will thereupon communicate with its principal and the principal with the customer, stating that a draft in respect of a part shipment has been presented and asking for definite instructions as to whether the draft is to be honoured or definitely refused. Only on fresh instructions from the customer, therefore, will drafts drawn against part shipments under a credit be honoured by the issuing bank or its agent.

“Received for Shipment” Bills of Lading.

Another reservation by banks in this country is in respect of bills of lading which read “Received for shipment per S.S.....or following steamer,” or any similar wording. The definite form of bill of lading reads “Received on board the S.S.....,” showing that the goods have actually been loaded on board the named steamer and will consequently leave for their destination almost at once. Where the bill of lading shows, however, that shipment by some following steamer may be effected, there is no guarantee as to the steamer on which the goods will be actually shipped or when they will leave the port of shipment, and, after delivery to the shipping company, they may be left lying in a warehouse or on a quay under conditions which may render them liable to deterioration, and which may not be covered by the terms of the insurance policy. British banks, therefore, will honour drafts drawn against “Received for Shipment” bills of lading only under express authority from the customer to do so.

Insurance Certificates.

An insurance certificate is the term applied to a form usually issued by an insurance company or broker, stating that insurance has been effected on stated terms in respect of specified goods. It also applies to a certificate issued by an insurance company stating that a declaration has been made in respect of certain goods by the holder of an “open” or general insurance policy, and that the goods specified are to be held covered by the company under the terms of their “open” policy. British banks again made a reservation in respect of insurance certificates, other than those issued by insurance companies showing that a declaration has been made under an “open” policy for a larger amount. An insurance certificate of any other class is not held to be a good delivery in respect of a C.I.F. contract under British law, and banks here will accept such documents under credits opened by or through them only after the receipt of express authority from the customer to do so.

Examination of Documents.

It must be repeated that it is absolutely essential for all drafts drawn under and documents relative to any commercial letter of credit to comply strictly with the terms on which such credit is

opened. The utmost care is therefore necessary on the part of any bank which proposes to negotiate on behalf of a principal, or to pay or accept as a principal, or as a party responsible for the draft drawn on a customer, when examining any draft or documents under a credit issued by or through it.

In general it may be stated that no discrepancies whatever will be passed by the bank responsible. Where any discrepancy is apparent, the draft should be dishonoured and fresh instructions sought from the customer, *though where the beneficiary or presenter is well and favourably known to the bank concerned, it may accept his indemnity against any loss which may arise by reason that the bank honours the draft and documents containing the discrepancy.* If the beneficiary or presenter is not known to the bank concerned, or is not considered of sufficiently good standing for his own indemnity to be accepted under such circumstances, he may be asked to provide an approved bank indemnity against any loss. In any event, however, a bank honouring a draft and documents containing any discrepancy remains liable to its principal (whether as the agent bank to the issuing bank, or as the issuing bank to its customer) for all consequences arising from such discrepancies, and it can be held liable for damages by its principal and cannot debit any relative account but must look to the giver of the indemnity to cover its liability in such a case.

Each detail of a draft and documents must agree exactly with the details given in the relative letter of credit. For example, where a credit is opened for a shipment of "Foundry coke," a bank would not be justified in taking documents relative to a shipment of "gas coke," but if a credit were opened for a shipment of "coke" simply, the bank can accept documents describing the goods as "coke," "foundry coke," or "gas coke." As soon as the beneficiary has prepared his draft and all the necessary documents, he presents these either direct to the issuing bank (where the credit is opened direct to him by that bank and is for drafts to be drawn on that bank), or through the agent bank of the issuing bank (where the credit has been so advised to him, and whether drafts are to be drawn on the bank or on the person or firm for whose account the credit is opened).

Where a draft is presented for negotiation to a local bank, and is found with the relative documents to be in order, the local bank will purchase it for its "present value" from the presenter at a "flat"

rate of negotiation, i.e. the rate, including loss of interest, foreign stamp, and any charges, will be based on the rate of interest applying in the drawee centre to that class of paper. Drafts drawn on a bank can be sold in the foreign centre at the finest market rates, while drafts drawn on a merchant firm or individual rank as trade paper and only command a worse rate of discount in the other centre.

A beneficiary may draw drafts "without recourse" only where the terms of the credit expressly state that this is allowed. As the object of any commercial credit is to give a seller of goods either immediate cash or an instrument which he may turn into cash and so satisfy the debt due to him, a beneficiary under normal circumstances is not prepared to run any risk of his draft being dishonoured and recourse being had to him for a refund of the amount in question. Under a bank credit the risk of dishonour is negligible, except where the credit is unconfirmed and revocable, but even in this case any risk is eliminated as soon as the issuing bank has given its acceptance to the draft, or if a local bank negotiates it. Under a negotiation credit (or an authority to purchase), which always gives rise to drafts drawn on a merchant firm or individual and which consists merely of instructions to the local agent bank to purchase such drafts from the beneficiary, the risk of recourse to the latter is always present unless the credit is confirmed by the issuing bank or the local bank. It is therefore usually only under a negotiation credit that any provision is made for drafts to be drawn by the beneficiary without recourse to him. It will be noted in the specimen form of such a credit given above that a space is left for the word "Out" to be added where the beneficiary is to be relieved of all liability in this respect.

The bank to whom the draft and documents are presented, whether it be an agent bank for negotiation or the issuing bank itself, must exercise the utmost care in its examination of these articles. It must see—

(a) That in the case of an agent bank it is authorized to negotiate and has some undertaking from the issuing bank to honour drafts properly drawn under the credit.

(b) That the credit has not expired, and that both draft and documents are dated prior to the expiry date of the credit.

(c) That in the case of a revocable credit no notice of revocation has been received.

(d) That as regards the draft, its amount is within the available amount of the credit, that it is properly drawn and signed and bears the correct reference to the credit under which it is drawn, and that it is for the invoice amount or for the correct proportion thereof.

(e) That the invoice shows the exact details of quality and quantity of goods called for by the credit, and at the correct price or given value.

(f) That the bills of lading agree with the invoice as regards quantity and description of goods, ports of shipment and destination, and are to the correct consignee or endorsed in blank; also that there is a complete set, that they are "on board" and not "Received for shipment," that they are "clean" and either marked "Freight paid" or have a freight receipt attached, and that they are duly signed by or on behalf of the carriers and are correctly stamped.

(g) That the insurance policy shows the same quantity and description of goods as the other documents, and is for a declared value in excess of the invoice value, and is, in fact, a full and complete policy and not merely an insurance certificate.

(h) That any other documents called for by the terms of the credit, such as a consular invoice or a weight certificate, are also presented and agree exactly with the other documents and with the terms of the credit.

If all is found to be in order, an agent bank will thereupon purchase the draft from the presenter for its "present value" and will forward draft and documents to its principal, either requesting credit in its account with the principal, or debiting the account of the principal in its own books. The issuing bank, whether it receives drafts and documents from an agent or whether these are presented to it direct, will subject all of them to the same close examination. If again, all is found to be in order, the issuing bank will effect payment of demand drafts, or will accept drafts at tenor on behalf of the customer for whose account the credit was opened.

In the case of a negotiation credit (or authority to purchase), the draft will be drawn on the customer and will be purchased by the negotiating bank in the other centre, with an allowance for interest at the rate applicable to trade paper as against the rate of interest applicable to prime bank paper which it will use in the case of drafts

negotiated under a bank credit and drawn on the issuing bank. The trade draft will be sent forward to the issuing bank, who will present it to the customer for his payment or acceptance as the case may be, and the eventual proceeds will either be credited to the account of the negotiating agent or disposed of in accordance with instructions sent by the latter when remitting the bill.

The Customer and the Issuing Bank.

It must be repeated that the opening of a credit by a bank on behalf of a customer is equivalent to the granting of an advance to that customer against the security of the goods to which the credit relates, or such other security as may have been accepted; also that the object of a credit is to enable a beneficiary to obtain either immediate cash or an instrument which he can turn into cash, in discharge of the debt due to him, while it allows the debtor time in which to find the money with which to reimburse the bank; and that this is usually effected by giving the debtor control of the relative goods so that he may dispose of them and receive payment in his turn.

In order to give the issuing bank a complete lien on such goods, and where the goods themselves represent the security for the credit, the issuing bank will take a letter of hypothecation from the grantee before issuing the credit. The form and effects of this document have been dealt with in a paragraph above. It is not usual for a negotiating bank to demand a letter of hypothecation from the beneficiary before negotiating his drafts, but this would, of course, be done where such a document was called for by the terms of the credit, or where the negotiating bank had no undertaking from the issuing bank that drafts under the credit would be honoured if in order.

When the issuing bank has finally approved the draft and documents presented to or through it, the point arises as to how the grantee can obtain possession of the goods before discharging his debt to the bank. In most cases the bank is prepared to regard the original letter of hypothecation as sufficient security, and will hand over the documents of title to its customer for him to deal with the goods. In other cases, however, where the standing of the customer is not considered to be sufficiently good to allow this to be done, some form of collateral security, or a cash margin, may have to be deposited by the customer with the bank before the documents are

handed over to him. Where no letter of hypothecation was originally given, the documents may be handed over against a trust receipt, the form and effects of which have also been dealt with in an earlier paragraph.

When the importer eventually obtains the documents he must then proceed to take delivery of the goods from the carriers as soon as possible. In the case of goods on board a vessel, the bill of lading will stipulate that discharge must be effected within so many days after the arrival of the vessel at its destination. Any consignee or owner of goods on that vessel who neglects to take delivery of such goods within the time stipulated in the bill of lading for discharge, becomes liable in "demurrage" to the owners of the vessel. "Demurrage" is a penalty imposed by the owners for each stated length of time which elapses after the stipulated time for discharging the goods from the vessel, e.g. if discharge is called for within two days of arrival, demurrage will commence to run from the third day and will be usually at a fixed cost per day based on the freight-earning capacity of the vessel.

It is most important, therefore, that no delay should take place either between any negotiating bank and the beneficiary, between the issuing bank and the beneficiary or any negotiating bank, or between the issuing bank and its customer, but the documents covering the goods should be passed forward as quickly as possible so that they may arrive in the hands of the importer by the time the vessel carrying the goods arrives, or at least very shortly afterwards.

Should the importer find any loss of or damage to his goods, he will put forward a claim against the insurance company who may, in turn, be able to claim on the carriers. Disputes regarding the goods themselves must be settled direct between the buyer and seller unless any bank concerned in the relative credit has permitted itself to accept documents which are not strictly in accordance with the terms of the credit. In such a case, the importer might have a right of action against the bank concerned.

It will be appreciated that the field covered by the subject of credits is so wide and the points which can be raised are so many and so varied, that it has been possible here to give only an outline of the forms, purposes, and methods of utilizing the main types of such instruments. The student is therefore referred to the special textbooks on the subject for further details.

CHAPTER XV

AN OUTLINE OF INTERNATIONAL CURRENCY HISTORY SINCE 1918

COMPLETE books, large and small, have already been written on the subjects covered by the title of this chapter, and it is possible here to give only a brief survey of the main points involved.

Briefly, it may be said that the Great War of 1914-1918 completely disorganized the social and economic life of all the principal nations of Europe, and its subsequent effects were so devastating and cataclysmic that the most able minds of the time were unable to envisage the needs of the situation then presented. The destruction of material wealth, the colossal amounts of the paper debts which had been built up, the psychological effects on the masses of the populations of the warring countries, gave rise to problems unprecedented in their breadth and seriousness. Grave mistakes of policy and tactics were made which had painfully to be remedied subsequently, and it can only be left to the historians of later times to allocate precisely the praise or blame accruing to the individuals who bore the grave responsibility of making a new world to arise from the ashes of the old.

All the belligerents had drawn the flower of their manhood from useful industrial occupations to be employed in the wanton waste of war. The production of consumable goods was exclusively directed towards the needs of war. The savings of nations were dissipated and their future profits mortgaged in the payment of the enormous sums needed to carry on hostilities. Small wonder that the aftermath of such a terrific world upheaval is still with us, and that the leaders of the nations came near to annihilation by the Frankenstein monster of their own creation.

Conditions after 1918.

The conclusion of peace found all the belligerent nations, with the exception of the U.S.A., almost on the verge of national bankruptcy. In all cases, national gold holdings had been centralized and conserved as a final means of providing the sinews of war. Gold coins had universally disappeared from circulation, and national currencies

consisted of inconvertible paper. The gold standard was everywhere abandoned, except in the U.S.A., where, by virtue of her late entry into the War and the enormous profits she had made by supplying munitions to the belligerents, unexampled prosperity ruled. The world standard of value was, therefore, the dollar, for the time being, and the measure of the depreciation of all the inconvertible paper currencies was their exchange value in terms of the dollar.

All the European countries had financed their part in the War by inflation, either in the form of issues of paper money or by short-term loans, and only in the case of this country was any attempt made to provide for current expenditure by increasing current revenue through increased taxation. Government measures of control of the exchange values of currencies by means of credits abroad, foreign loans, the commandeering of internally-owned foreign securities, and, to a lesser extent, the earmarking of internally-held gold for foreign account, prevented the normal effects of such inflation from being shown in the exchanges until some months after the conclusion of peace and the removal of control.

In the case of this country, the dollar-sterling exchange was controlled, or "pegged," by the Government, through an Exchange Committee, from 6th January, 1916, to 20th March, 1919, at the rate of \$4.76½ per £. All the methods mentioned above were successively made use of as we undertook the major part of the financing of the War, not only for ourselves, but for our Allies, and the sterling-dollar exchange was, therefore, for some time a European-dollar exchange. When the control of the exchange was removed in March, 1919, the effects of inflation and of our inconvertible paper currency became apparent. In accordance with the purchasing power parity theory, which was then only dimly perceived, the exchange value of the pound became what it was worth as an internal purchasing agent. The scarcity of all the normal commodities of life, due to decreased production and increased consumption on military account, had led to a stupendous rise in prices which was accentuated by the sudden heavy increase in demand caused by the return to civil life of the men who had been engaged on war service. Those who had remained at home on work of national importance had already been hard hit by the rise in the cost of living, and had demanded, and obtained, successive increases in wages and salaries. More money was being earned, but the rise in prices lowered the purchasing power of money,

and each rise in wages was followed by a further rise in prices, leaving *real wages* unaltered or even lower than before. This reduction in the internal purchasing power of the pound was soon reflected in its external purchasing power, as shown by its exchange value, as soon as control of the exchange rate was removed. The dollar value of the pound fell steadily from the "pegged" rate of 4.76½ until it reached the then lowest record of 3.20½ in February, 1920.

At this point, the world demand for replacements of the destruction of war began to make itself felt in our favour. We had been the first to feel the effects of inflation and of an inconvertible paper currency, owing to our position as chief debtor to the chief creditor, the U.S.A., and the gravity of the position had made politicians, as well as financiers, take every possible step to restore our prestige as a financial nation. Taxation was increased to an unheard-of extent, an annual budget surplus was speedily established, and all the orthodox methods of sound finance were employed to repair the ravages of war. By 1923, the value of the pound in terms of the dollar had improved to about 4.70, showing that improving trade and very gradual deflation of the greatly inflated credit system had begun to operate to raise the purchasing power of the pound both at home and abroad. The restoration of international confidence in the pound was materially hastened by the arrangements made by the Government, in 1923, with the Government of the U.S.A. for the funding of our debt to that country, under which we agreed to pay off both principal and accrued interest over a period of fifty-two years by annual instalments, payable half-yearly, commencing with the enormous sum of £29,000,000 and rising to £33,000,000 yearly. This was done before any arrangements had been made with us by our debtors for the funding by them of the vast sums due to us, and created a deep impression all over the world.

The policy of steady deflation pursued in this country gradually raised the value of money in terms of commodities, i.e. caused a steady fall in prices, while the influx of gold into the U.S.A. and the expansion of credit which had taken place there caused a fall in the value of money, i.e. a rise in prices. At the same time, by arrangement between the two Central banks, interest rates here were maintained at a higher level than ruled in the U.S.A., and with the improving financial position of this country and the cheapness of sterling in terms of dollars, large sums were attracted to this side

for investment. From 1924 onwards, the position had been made so stable that a return to a gold standard was made in 1925, and the international value of the pound was thereby restored to its pre-1914 level. The wisdom of this step has since been greatly debated, and there seems now good reason to believe that the result was to make the exchange cost of the pound so high as to make our goods too dear for foreigners to buy, and that this acted as a material cause of the depression of later years; but those responsible for the decision had before them the prestige of London as a financial centre, and were, perhaps, induced to place financial interests before trade interests, without a true conception of the probable effects. It can now be seen, however, that an immediate effect was to make debts contracted in terms of paper repayable in terms of gold, and the *gold value* of the goods and services received as consideration for such debts was, at the time, expressed as a *paper value*; in other words, debts contracted in terms of paper pounds had to be redeemed in terms of gold pounds. As the purchasing value of the paper pound was, at one time, equal to only about 12s. 6d. in terms of gold pounds, only that equivalent in goods and services had been received by debtors for each paper pound's worth of debt, but repayment had to be made in terms of a gold pound, i.e. a full gold pound's worth of goods and services. This, for one thing, greatly increased the burden of interest and sinking fund for the National Debt, and added about 25 per cent at least to the cost of discharging our debt to the U.S.A.¹

On the other hand, our ex-enemy and our Allied debtors displayed no such readiness to fix the eventual amount of their debts to us or to come to any arrangement for the eventual discharge of such debts, but allowed the exchange value of their currencies to find the approximate true level of internal and external purchasing power (which was, of course, very different from the former gold value), and then proceeded to arrange for payment of their debts *in terms of their depreciated currencies*. In other words, they endeavoured to effect payment on the basis of the *current* purchasing power of their currencies, so that very little more in terms of goods and services should be required to discharge their debts than they had received when the debts were incurred on a gold basis. This may be best

¹ Though this was somewhat offset by the exchange depreciation of the dollar in terms of pounds, the difference being the margin by which the pound was overvalued in terms of gold. Cp. pp. 283 and 284.

explained by suggesting that we might have settled our debt to the U.S.A. by offering to remit the same quantity of goods and services which we had originally received, but which had been handed over to us on the basis of the purchasing power of a gold pound, but which were then only worth 15s. in gold owing to the depreciation of the paper pound.

The policy of this country throughout had been one of *deflation*, i.e. an attempt to improve the purchasing power of the currency both at home and abroad until it reached its pre-1914 level, while the policy adopted by other countries had been almost uniformly one of *devaluation*, i.e. reducing the nominal gold value of the currency unit to correspond with the internal and external purchasing power of the paper currency in terms of gold.

FRANCE. The end of the War found France with a greatly inflated currency and credit system. So sure was she, however, that the entire cost of the War would be borne by Germany that she took no steps to impose additional taxation on her nationals, but embarked on extensive schemes of reconstruction which were financed by further inflation in the shape of short-term advances by the Bank of France. As time passed and no payments were received from Germany, the natural economic effects of such a policy made themselves felt, and the purchasing power of the franc fell steadily. This was, of course, reflected in its exchange value, which also fell steadily, until even French nationals became uneasy about the stability of their own currency and a "flight from the franc" began.

From a pre-1914 parity of 25.2215 fcs. per £, the exchange value of the franc in terms of sterling had depreciated to about 70 fcs. per £ by the middle of 1923, and, thereafter, the increasing world confidence in sterling and its general appreciation in terms of all other currencies, together with the ever-growing inflation of currency and credit in France, caused the French rate to fall still further and more rapidly. Early in 1924 the rate had fallen to about 120 fcs. per £ and the French government of the day then arranged credits in London and New York, against the "earmarking" of gold by the Bank of France, to meet the demands for foreign currencies against sales of francs. These credits were used in an attempt to restore the exchange to somewhere near the old parity, and it was actually brought down to under 65 fcs. per £ within a month. The authorities then found, however, that such a sudden appreciation in the value

of the currency was having a disastrous effect on the trade of the country, as such a rapid rise in the external purchasing power of the franc could not possibly be so quickly reflected in an adjustment in internal prices. Official control was then relaxed, and finally abandoned by a new government. Successive governments continued the previous policy of financing current expenditure to a large extent by short-term borrowings, instead of by imposing further taxation and obtaining a budget surplus, and continually postponed any funding arrangements of their debts due abroad, still in the expectation of forcing payment in full from Germany. The occupation of the Ruhr district of Germany was also undertaken at about this time as a measure of coercion, but this subsequently proved to be a costly step both financially and politically. The resulting further inflation and loss of confidence engendered, both at home and abroad, caused a continuous fall in the value of the franc until, in 1926, an alarming "flight from the franc" took place and the exchange fell to 250 fcs. per £ in July 1926. The government was then forced to intervene hastily and drastically. The credits in London and New York were re-established, emergency legislation for the control of all foreign exchange operations was passed, heavy increases in taxation were made, and *pourparlers* commenced for the funding of war debts due to this country and to the U.S.A. Within a few days the rate had been improved to about 150 fcs. per £, and by the end of 1926 it was being held at about 124 fcs. per £. Offerings of francs by French nationals had very largely ceased, and the still low exchange value of the franc had begun to act as a subsidy to the French export trade. The Bank of France was therefore able to hold the franc stabilized *de facto* at 124 fcs. per £ from early in 1927 onwards, and, in June, 1928, *de jure* stabilization was effected by the devaluation of the old franc through a reduction in the theoretical gold content of the unit so as to give it a gold parity with the pound of 124·2134 fcs. instead of the old parity of 25·2215 fcs. This, of course, amounted to partial repudiation of all debts originally contracted in terms of the old franc, but evidently France considered that as Germany had done the same thing without being ostracized by the rest of the world (see below), there was no valid reason why she should not do the same. The ethics of such a step are debatable.

As has been previously mentioned, however, the new parity undervalued the franc externally, and its comparative cheapness in terms

of other gold currencies still acted as a subsidy to French exports and her balance of trade steadily improved, while the impetus to her industries made her a potent factor in the world's markets, and for a long time prevented any real unemployment amongst her people. At the same time, all the capital exported during the "flight from the franc" was not repatriated for a considerable period, and the resulting income from foreign investments was a further factor in causing a world demand for francs gradually to arise. As confidence returned to her nationals, and the improving internal conditions demanded further financing, the capital previously sent abroad was gradually brought home, and this further increased the demand for francs. These main factors are those responsible for the rate of exchange with this country being held almost continuously from 1929 onwards at a point at which gold left this country for France and referred to in the Press as "the gold drain to France." Even in 1931, French balances in this country were still estimated to be in the region of £80,000,000 to £100,000,000, and the repatriation of a large part of these balances was a contributory factor to our enforced suspension of gold payments in September of that year. Following the suspension of gold payments by this country in September, 1931, and subsequently by the U.S.A. in March, 1933, France became the leading protagonist of the gold standard on the former orthodox lines and gathered round her what came to be known as the "gold bloc," consisting of herself, Belgium, Holland, Switzerland, and certain of the Central and Southern European countries whose currencies were either linked directly to gold or indirectly to it through the French franc. The continuance in this country of a "managed" currency, and a considerably higher sterling price for gold and the eventual devaluation of the U.S. dollar in terms of gold in 1934, made it increasingly difficult for the French authorities to insist that the franc was really worth, as a purchasing agent, its theoretical legal gold content. If it takes \$35 or £7 to purchase an ounce of gold and 7 tons of coal can be purchased either in the U.S.A. or this country for \$35 or £7 or 1 ounce of gold, it is useless to insist that 525 fcs. equals 1 ounce of gold, and so \$1 = 15 fcs. or £1 = 75 fcs. if 7 tons of coal in France costs an ounce of gold or 735 fcs. As that old friend of our youth, Mr. Euclid, said: "Things which are equal to the same thing are equal to one another" and the obviously approximately correct parities under

such conditions, would be 735 fcs. = 1 ounce of gold or \$1 = 21 fcs., or £1 = 105 fcs. Because the franc was thus overvalued in terms of gold, French exports steadily dwindled (the high cost of the currency in terms of others making French goods too dear for foreigners to buy in spite of a pronounced fall in French internal prices) while imports increased. All the orthodox measures for deflation of the currency and reduction of internal money prices were taken, but the resulting general reduction of incomes caused a big reduction in the taxable capacity of the country and, with a pressure for ever-increasing schemes of social reform and betterment, each succeeding Budget showed an increasing deficit. Exports of capital and withdrawals of foreign-owned funds were resumed towards the end of 1934 and every six months seemed to see a further "flight from the franc." Valiant efforts were made by the authorities to bolster up a position which was unsound internally and externally. Enormous amounts of gold were allowed to be withdrawn from the country in the hope of both satisfying the universal demand for other currencies against francs and of forcing yet further deflation of currency and credit as a result, but at long last the gold reserves were reduced to what the French War Office Staff considered a dangerously low level as a "war chest" and eventually the suspension of gold payments and a further devaluation of the franc in terms of gold was announced on the evening of Friday, 25th September, 1936.

In order to avoid immediate dislocation of markets and to give time for reflection to the world at large, it has always been customary for important announcements of this nature to be made by the government concerned after business hours on a Saturday. It is interesting to note that on this occasion the decision was arrived at before sunset on a Friday and the announcement made later on the same evening. Friday, 25th September, 1936, was the eve of the Jewish New Year and it is popularly supposed that the then Premier of France, M. Blum, being of the Jewish Faith, insisted that the decision should be taken before the arrival of the New Year so as to leave behind him the responsibility for such a step! The repercussions elsewhere are touched on later in this chapter. Within the next few days a law was passed reducing the theoretical gold content of the franc from 65.5 milligrammes $\frac{9}{10}$ fine to anything between 49 and 43 milligrammes $\frac{9}{10}$ fine, at the option of the government—a

sufficiently wide margin! The gold holding of the Bank of France was re-valued at a price representing a gold content of the franc about mid-way between these two extremes and the resulting profit was used partly to reduce budgetary deficit and to redeem some maturing government short-term indebtedness, while a sum of 10,000,000,000 fcs. (ten milliards of francs) was set aside to form an Exchange Control Fund. Dealings in exchange were suspended in Paris for five days, except that the Bank of France gave facilities in special cases, and on the resumption of a free market the "control" authorities quickly established their ascendancy by imposing a rigid grip on the rates for the leading currencies.

For some weeks prior to the actual event, world opinion had been that a second devaluation of the franc was inevitable sooner or later and an enormous "bear" speculative position against the franc had been built up. The French banks, at the request of the Bank of France, steadily curtailed credit facilities, refused overdrafts to foreign customers and only dealt in "forward" currencies after being fully satisfied that a genuine commercial transaction was thereby assisted. The franc depreciated steadily in terms of sterling from the middle of July onwards, falling from just over 74 fcs. to near 77 fcs. per £. Had it not been for the operations of the British Exchange Equalization Account (acting largely it is believed at the request of the French Authorities) in supporting the franc strongly at various stages, the depreciation would have been much greater and more rapid. The francs bought by our E.E.A. were immediately turned into gold which was "earmarked" by the Bank of France for account of our authorities. This had the same effect as our own action in 1931 of pledging our gold as security for foreign credits and constituted a drain of gold from France's reserves even greater than that which we ourselves suffered. The sterling exchange was the main bridge over which capital exports from France to this country and to the U.S.A., as well as speculative operations, were passed, but gold also left France for the other countries of the "gold bloc." At the same time, speculative pressure on the forward market caused forward margins to rise to almost prohibitive discounts. The margin for three months francs against sterling was for some short time about $7\frac{1}{2}$ fcs., which is at the rate of 30 fcs. for a year or, on a spot rate of 75 fcs. per £, 40 per cent per annum, while, during the final few days, "short swaps," i.e.

purchases of spot and sales of forward for only a few days ahead, were being done at margins representing an interest loss to the seller of the forward at the rate of 100 per cent per annum! When exchange dealings were resumed after the passage of the necessary legislation for the devaluation of the franc, wide fluctuations from 102 fcs. to over 106 fcs. per £ took place during the first few days but the "controls" in London and Paris, working in co-operation with New York as well as with each other, gradually narrowed in the range of these fluctuations until by the beginning of November, 1936, the franc-sterling rate was held almost unaltered for weeks at a time at $105\frac{1}{8}-\frac{5}{8}$ fcs. per £. The franc-dollar and the sterling-dollar rates were allowed greater elasticity as New York was the chief centre to which fugitive funds had been and might still be sent, as well as being the only remaining centre with a legally fixed rigid gold price and as a result the demand for or offering of dollars against francs or pounds was likely to be more difficult to control, while the fluctuating price of gold in the "free" London Bullion Market necessarily meant fluctuations in the sterling-dollar rate and so in the franc-dollar rate as long as the franc-sterling rate was held rigid. The price of gold in London was also a leading factor in the Tripartite Agreement, which is dealt with later.

The French "control" broke rather new ground in not only entering the "spot" market, but also in operating in "forwards." The arrival of the event for which speculators had been waiting caused the pressure to sell forward francs to disappear for the time being and the margin narrowed in to about $\frac{3}{4}$ fc. for 3 months, or at the rate of just under 3 per cent per annum. After a few weeks, however, the opinion grew that French budgetary difficulties were by no means over and that the rising level of prices in France would to some extent offset the current level of devaluation so that even further devaluation—possibly to the extreme legal limit—would have to take place. Consequently, there was a renewed offering of "forwards" and the margins would no doubt have widened out nearly to the former exaggerated levels had not the French "control" intervened at a level representing about 5 per cent per annum and given signs of its readiness to sell sterling forward against spot in large amounts.

After a short lull, speculative pressure against the franc was resumed when it was judged that the initial force of profit-taking

at the new level and a certain repatriation of capital had spent itself. Although the Bank of France acquired considerable amounts of gold in the few months following the new devaluation, the internal financial situation of the country was still felt to be unsound and, in spite of operations of some magnitude by the new Exchange Equalization Account, the franc slowly depreciated further to about $110\frac{1}{2}$ per £. At this level it was firmly held by the authorities, but the "bear" pressure increased to such an extent that by June, 1937, the resources of the Account and of the French Treasury were almost exhausted. On 28th June, 1937, the Government, under powers granted to it the previous year, passed a law by Decree providing for the complete suspension of gold payments and for a fluctuating internal price for gold. This Decree, in effect, abrogated the Devaluation Law of September, 1936, and left the franc completely unattached to gold except in so far as the authorities were prepared to fix daily dealing prices for gold in terms of francs. Exchange dealings in francs in Paris and London were suspended for two days, and when dealings were resumed on 1st July, 1937, the franc-sterling rate fluctuated between 128 and 130, as compared with the previous quotation of $110\frac{1}{2}$.

Another lull followed, but a fresh "bear" attack, based mainly on the then state of French politics, developed in September, and the authorities bowed somewhat before the pressure and allowed the rate to break on 9th September, 1937, to about 135 and, later in the month, to 145. On 2nd October, 1937, the rate touched $152\frac{1}{2}$, but at this level the authorities took vigorous action in both the spot and forward markets, and for the next two months the rate was firmly held at 147. to 148 for spot and at about 5 fcs. (as compared with 10 to 12 fcs.) discount for the three months' forward.

Early in January, 1938, a fresh political crisis developed, the Government fell, and industrial troubles due to the obstinate attitude of both employers and workpeople seemed likely to embarrass the country. Once again, a fresh flight of capital from France commenced, accompanied as usual by a "bear" attack on the currency, and the franc weakened to 155. Political troubles in Central Europe further intensified the loss of confidence in the franc and, following another change of government, the exchange touched the low record, since 1921, of 169 per £. By March, 1938, a further devaluation of the franc, through the writing-up of the

value of the gold stock of the Bank of France, seemed imperative.¹

The theoretical gold content of the franc prior to June, 1928, was 322.58 milligrammes, nine-tenths fine, and this was then reduced to 65.5 mg. On the passing of the law of September, 1936, further reducing the content to between 49 and 43 mg., the gold stock of the Bank of France was revalued at about 47 mg. per franc, and the resulting profit formed the basis of the new Exchange Equalisation Account. In June, 1937, the gold stock was again revalued on the basis of 43 mg.; but, at the price levels in France, the U.K. and the U.S.A., which are current at the time of writing, it would appear that a further devaluation to under 30 mg. per franc will be needed to restore the exchange value of the franc to somewhere near the actual purchasing power parity.

BELGIUM. The occupation of Belgium by Germany during the War and the issues of inconvertible paper in terms of Belgian francs by the latter country, as well as the difficulties of the Belgian government, found the country with a sadly depreciated currency after the conclusion of peace. From a parity of 25.2215 fcs., the Belgian franc fluctuated, to some extent in sympathy with the French franc, until the break in the latter in 1926 caused the Belgian government also to take drastic steps for the rehabilitation of their currency. A stabilization loan was floated in London and New York, and the proceeds were used to control the exchange, which was held at about 175 fcs. per £. At the same time, a devaluation law was passed which retained the franc as the *internal* unit of account, but instituted a new unit, known as the "belga" for external purposes. A ratio of 5 paper francs per belga was fixed, and the belga itself was given a theoretical gold content which made the parity with the pound 35 belgas, and with the U.S.A. dollar, 7.19 belgas. At first a gold exchange standard was maintained, but as affairs became more settled and normal conditions of trade and finance resumed, a return to a gold bullion standard was effected, together with what was a practically free gold market. The pressure of the world depression from 1929 onwards proved too strong for such a small country and in March, 1935, the belga was devalued again to a new theoretical gold content of .150632 grammes fine.

¹ On 5th May, 1938, the French government allowed the franc to fall to 179 per £ and announced that under no circumstances would it be allowed to depreciate further. It has since shown a tendency to appreciate and is probably undervalued at over 170.

ITALY. Not only did the Italian lira depreciate owing to inflation as with other countries, but the political troubles which followed the conclusion of peace caused a loss of confidence abroad in the currency and the exchange value of the lira fluctuated wildly but with a steadily depreciating tendency. On the establishment of the Fascist government, one of the first steps taken was to control exchange dealings and banking operations with a view to stopping the activities of speculators in the currency. Also "sumptuary" laws, i.e. laws prohibiting the import and sale of articles of luxury, were passed, every effort was made to balance the national accounts by strict economy and the imposition of further taxation, and the whole country was placed under a rigid discipline. At the end of 1927, after stabilization *de facto* at about 90 lire per £ had been effected for some months, stabilization *de jure* was undertaken by de-valuing the old lira and giving it a new gold content which produced a parity with sterling of 92.46 L. per £ instead of the old parity of 25.2215 L. The exchange was controlled by means of credits in London and New York, and the Bank of Italy was given the option of cashing its notes either in gold or in gold exchange, so that the monetary standard is one of either gold bullion or gold exchange at the option of the Bank of Italy. The steady contraction of world trade, and the conquest of Abyssinia in 1935-6, forced even more drastic measures of monetary and economic control to be instituted. The further devaluation of the French franc in September, 1936, proved a mortal blow to the current theoretical gold value of the lira, although, as with Germany, various forms of "tourist" and "blocked" lire were available for certain transactions at very much lower values than the official gold lira, and, on the 5th October, 1936, a new law reduced the theoretical gold content of the unit to 46.77 milligrammes fine. This restored the exchange against sterling to about 93 L. per £ and was again a devaluation of about 40 per cent.

GERMANY. Some writers have referred to the dramatic and unprecedented collapse of the old German currency after the War as "the most gigantic swindle the world has ever known"! At the conclusion of peace her currency was heavily inflated, her resources almost at an end, her industrial organization disrupted, and her stocks of raw materials exhausted. The work of reconstruction was at once commenced with the energy characteristic of the German people, but was financed by further inflation, and the undoubtedly

bad state of the country, politically as well as financially, led to a complete loss of confidence in the currency at home and abroad. The government apparently endeavoured to control the situation by the imposition of emergency measures of control on exchange operations, limitation of imports, and prohibitions on the export of capital, but entirely neglected to take steps to balance its budget, to impose fresh taxation, or to display genuine efforts to meet the demands of its still hostile creditors. But its measures were evaded, loss of confidence proceeded further, and the depreciation of the currency both as an internal and external purchasing agent gained rapidity daily. Internal prices rose in startling fashion. An article priced at 10 marks in the morning might be 20 marks in the evening of the same day! No one could estimate the value of their income in spite of valiant attempts on the part of all to secure increases of wages and salaries to keep pace with the decreasing purchasing power of the monetary unit. From a pre-War parity of 20.43 marks per £, the currency fell in value more or less steadily to 250 marks per £ early in 1923, and then the *débacle* commenced. All owners of marks hastened to exchange them for some other currency, or for non-perishable goods, or for real estate, or for anything of intrinsic value. The rate fell to 1,000, to 5,000, to 10,000, to 100,000, to *billions* of marks to the £, and the currency was then finally useless. The owners of mark notes, largely outside Germany, found themselves in possession of something which was literally only worth the paper on which it was printed, and all the billions of marks' worth of debts represented by these notes were entirely wiped out. There was nothing to be done, however, and Germany merely pleaded that economic pressure had been too much for her, and that unless her former enemies came to her assistance she would have to declare herself to be what she was already in effect—bankrupt! With the aid of the principal Powers, a new bank was established with authority to issue new notes based on the U.S.A. dollar. This bank was known as the *Rentenbank*, and the unit in which its notes were issued was called the *Rentenmark*, and the new era commenced in November, 1923. This was only a transition stage, and in November, 1924, a Gold Discount Bank was established by the German Reich, with the help of credits in London and New York, and a new unit of currency, called the *Reichsmark*, was introduced. This unit was given a gold content producing a parity of 20.43 Reichsmarks per £, as with the

old mark, but which was said to be equal to 1 Rentenmark or to *one billion old marks*. This is the currency in use to-day, and within a reasonable period after the introduction of the new unit, a gold bullion standard was established which functioned well until the crisis of 1931. The utter collapse of the old mark, however, amounted to complete repudiation of all debts contracted in terms of the old currency, and Germany found herself with her entire internal debt wiped out and most of her old external debt as well. Even to-day her burden of debt is very little greater than in pre-War days in spite of the enormous new loans she has raised and the equally large amounts of short-term borrowings from other countries. Her industries found themselves also with only a fraction of their former capital load, and while the investor class generally has suffered severely, the major part of the population suffered no more than temporary inconvenience with an ultimate enormous benefit to the industry of the country as a whole. Whether the German government could have prevented such a complete collapse of the currency may never be known, but it may safely be said that the initial depreciation of the mark was deliberately conceived and put into effect.

The various expedients adopted by Germany from 1931 onwards in her efforts to obtain supplies of foreign exchange and to bolster up the artificial value of her currency are mentioned in the chapter on "Exchange Restrictions" and elsewhere. The "registered" mark at a discount of 48-50 per cent over the exchange value of the "free" or official reichsmark in terms of pounds, as it is at the time of writing, probably represents approximately the true purchasing power parity. Up to December, 1936, Germany had made no move to devalue further the official reichsmark so as to bring it more, if not right, into line with the "registered" or "tourist" mark, but it seems almost certain that this will have to be done when the leading world currencies are once more stabilized in terms of each other.

OTHER COUNTRIES. The exchanges between this country and Holland, Switzerland, and the Scandinavian countries followed closely the course of the sterling-dollar exchange during and after the War. Even the acute world depression from 1929 onwards, the suspension of gold payments in this country for the second time in 1931 and the devaluation of the U.S.A. dollar in 1933 and 1934 left Holland and Switzerland unaffected on the surface and these two were actually the only leading currencies which had suffered no

form of devaluation from pre-War days right up to September, 1936. The eventual defection of France from the "gold bloc" through overwhelming weight of circumstances caused both these countries at long last to abandon their former firmly declared intention not to alter the theoretical gold content of their units of currency but to maintain unimpaired their then existing systems of gold standard. The fateful announcement by France on 25th September, 1936, however, forced the governments of both countries to follow suit. On 26th September, 1936, the Dutch government announced the suspension of gold payments and of the gold standard as previously worked in that country and also the creation of an Exchange Control Fund of 100 million florins to allow the authorities to control the exchange value of the florin. No actual devaluation had taken place up to December, 1936, and the position in Holland appears at the moment to be analogous to that in this country. Switzerland followed the example of the U.S.A. and France rather more faithfully. On 28th September, 1936, the Swiss government issued a decree devaluing the Swiss franc to a variable gold content of between 190 and 215 milligrammes nine-tenths fine. No exchange control fund has so far been instituted officially but the authorities quickly announced their adherence to the Tripartite Agreement, which is referred to later in this chapter, and would appear to have taken a hand on several occasions in preventing undue fluctuations in the exchange values of the Swiss franc. In December, 1936, the current exchanges with other leading currencies showed that devaluation to the extent of about 30 per cent had taken place.

The Treaty of Versailles partitioned Europe into many new states, but subsequent experience has shown how many mistakes were made and how economic considerations were overlooked, with almost disastrous results in some cases. Austria and Hungary became separate republics instead of one kingdom; an important new republic in the shape of Czechoslovakia was created; the kingdom of Yugoslavia obtained much new territory, as did Italy and Roumania; concessions were made to Poland and the Free City of Danzig and the "Polish Corridor" came into being as intended measures for the greater security of Europe, though these latter have lately proved incitements to differences rather than to agreements. Both the remnants of the old nations and the newly-created states found themselves with heavy burdens of debt and inflated

currencies and, without exception, all of them have had to resort to devaluation of the old unit of currency, which has, of course, meant partial repudiation of old debts. Every country in Central and Southern Europe has had to face the problem of unbalanced budgets, falling trade and revenues, internal dissensions and fluctuating exchanges; some of them have received help from the League of Nations or direct from other countries and all of them have perforce resorted to successive devaluations of their currencies in view of the course of events elsewhere.

Czechoslovakia for some years maintained a gold bullion standard, but the suspension of gold payments first in this country and then in the U.S.A. forced her to indulge in a measure of devaluation of the existing value of the Cz. Crown and the French devaluation in September, 1936, once more compelled her to carry the process a stage further. On 8th October, 1936, a law similar to those in France and Switzerland was passed giving the Crown a variable gold content of between 30·21 to 32·21 milligrammes fine. In December, 1936, the theoretical gold content had been temporarily fixed at 31·31 milligrammes fine, which represents a devaluation on the former value of about 33 per cent. Austria, Poland, and several of the other Central and Southern European states have given theoretical gold contents to their units of currency, but in every case the exchange value is maintained and controlled by official action. The Scandinavian countries, owing to their close trading relations with this country, followed the pound off gold in 1931 and became the nucleus of the "sterling bloc" which later attracted many other adherents. Their currencies have been most capably managed both internally and externally, the purchasing and exchange values of the respective units having remained remarkably stable.

Russia passed through a stage of almost complete isolation, politically and economically. The past few years have seen a change in her external policy and she has shown a disposition to enter into the councils of the world, while some small return to the "capitalist" system of economics has been permitted internally. The currency has been very definitely managed, but the development of renewed international relations led to the rouble being linked by the Russian authorities to the French franc. The devaluation of the latter currency for the second time caused an adjustment of the former ratio to be made and, about the end of October,

1936, a decree was published linking the rouble to the French franc at a ratio of $4\frac{1}{4}$ frs. per rouble.

Japan is another country in which political views and ambitions have greatly affected monetary policy and the value of the currency. For some time after 1918, orthodox methods were adopted and valiant attempts were made to restore the former gold value of the yen and in spite of disastrous setbacks due to appalling earthquakes, she eventually returned partly to a gold bullion and partly to a gold exchange standard at the pre-War parity. Her war in Manchukuo and subsequently in China have led her to depart somewhat from the paths of orthodoxy, and the currency, having been allowed to depreciate or deliberately depreciated to an extent which the economic position of the country does not seem to justify, is now managed by the authorities as expediency dictates and with no apparent reference to the modern accepted technique of currency management.

The Dawes Report.

The utter collapse of the mark in 1923 caused the Allied nations to take vigorous steps to make Germany set her house in order and to ascertain the measure of her capacity to pay the amount of war debt agreed under the Treaty of Versailles (which had been fixed at a preposterous figure, and which was no doubt partly responsible for the readiness of the German government to allow the currency to become valueless). A Commission was set up under the chairmanship of the American Commander-in-Chief, General Dawes, and in 1924 this Commission rendered a report, which was shortly afterwards adopted by both the Allied and German governments.

The report advised that Germany should be given full financial and economic control of her territory so that steps could be taken to impose new taxation and balance the budget, and that, if this were done, a sum of about £60,000,000 should be available in 1926, about £87,000,000 in 1927, and about £125,000,000 per annum thereafter, for the service of reparations.¹ The report also recommended that a loan of £40,000,000 should at once be raised abroad for account of Germany, the proceeds to be spent in 1924 in paying the costs of the armies of occupation, and that such a loan should be

¹ The annual amounts payable were to vary with variations in the price level—the first official attempt to effect equilibrium between the commodity value of a debt at its inception and at its discharge.

secured by railway bonds, industrial debentures, and controlled taxes. The loan was duly raised and applied as advised, but the burden of reparations in successive years became so great that Germany pleaded her inability to pay the amounts laid down, especially as part of her Ruhr territory was still occupied.

The McKenna Report.

Another Commission under the chairmanship of Mr. Reginald McKenna sat at about the same time and reported on the exodus of German capital abroad and on the methods of preventing any further expatriation of capital and the means whereby existing assets abroad could be made available for the German government on account of reparations.

The Young Plan.

Under the Dawes Plan a Reparations Commission had been set up to supervise the payments by Germany on account of reparations and to watch the effects on the exchange of the making of such payments. In the interim, Germany had been a heavy borrower abroad, mainly of short-term loans, part of the proceeds of which had been devoted to reparation payments and part to reconstruction works in Germany. In spite of this further outside aid, however, Germany consistently pleaded for the complete evacuation of the Ruhr and for a scaling down of the Dawes Plan. This country had, in the meantime, issued the famous "Balfour Declaration," which stated that we should demand no more from our debtors, including Germany, than was demanded from us by our creditors. This was intended as a gesture towards complete debt cancellation, but the principal creditor, the U.S.A., held, and still holds, that contracts for war debts were no different in their sanctity from any other obligation, and the transfers of funds from one debtor to a creditor and from that creditor to another still proceeded, the final bulk of the payments, of course, finding its way to America.

Eventually Germany showed such signs of breaking under the strain that a new Commission was set up, under the chairmanship of Mr. Owen D. Young, a prominent American banker, to investigate the question afresh. The findings of this Commission advised a further international loan by way of capitalizing a portion of the annual sums which it was decided Germany could pay, and that

the annual payments should be divided into two categories of "unconditional" and "conditional," the latter to vary or become capable of suspension in the event of economic conditions rendering it impossible, or inadvisable, that Germany should be called upon to make such transfers. The proceeds of the loan were divided between certain of the Allies, France taking the lion's share, and a part was again handed over to Germany to relieve the internal economic situation.

The history of reparations up to the present would therefore appear to be that Germany has paid certain sums out of her own resources, but that the major portion of the sums received by the Allied governments as reparations has been provided by loans raised amongst their nationals, and that each time the full burden of reparations appears likely to fall on Germany alone in any one year, she calls for another Conference or Commission! The findings of the Young Commission were hotly debated at the Hague Conference in 1930, but the main provisions were accepted by the Allies, and the scales there agreed to were in force until the crisis of 1931.

The Bank for International Settlements.

A most important suggestion put forward by the Young Commission was that a new bank should be established, primarily for the purpose of taking over from the Reparations Commission the duties of supervising reparations payments, but with a much broader end in view. This end was nothing less than that the new bank should become an international central bank with which governments and national central banks should make deposits of funds and, eventually, gold, with the object of making the new bank a kind of clearing house for international payments.

This scheme has already proved itself the most useful suggestion of our post-1918 years. It was established in 1930, and within the first year of its life it had attracted to itself large deposits on current and deposit account from all the principal governments and central banks of the world, and had given valuable aid in smoothing out temporary differences in international debts, and so helped towards a greater stabilization of the exchanges.

As the world depression which exists at the time of writing passes, the utility of this institution, known as the Bank for International

Settlements, will undoubtedly increase, and it is likely to become what its progenitors viewed for it—the bank for central banks and the clearing house for international debts.

The Macmillan Report.

Prior to the collapse of the Stock Exchange "boom" in the U.S.A. in 1929, commodity prices generally had already shown a falling tendency from their previous high levels. The enormous loss of paper profits all over the world which followed the general heavy slump in security prices reduced world consuming power, and, production having already outstripped consuming power, commodity prices began to slump also, the fall finally reaching unprecedented proportions. It is almost impossible to separate clearly cause from effect, and many factors were at work to intensify the world depression, and which have been mentioned in earlier chapters. In this country, the trade depression gave rise to many adverse comments on our monetary and banking systems, even the Federation of British Industries being moved to publish a manifesto calling for a public inquiry into such matters. Eventually the Government set up a Commission under the chairmanship of Lord Macmillan, a prominent industrialist, banker, and economist, to inquire into the problem of how far the existing depression was due to monetary causes and with special reference to the part played by the Bank of England in our currency and credit system.

This Commission issued its report in July, 1931, and it found that, subject to certain reservations, the depression was mainly due to "a number of highly intractable non-monetary phenomena"! The Report was a document of over 300 pages, but its main recommendations were—

(a) That this country should continue to adhere to the international gold standard at the existing parity, but that our domestic currency should be "managed" by the Bank of England.

(b) That we should use our influence to lower the international value of gold in terms of wholesale commodities (i.e. that an endeavour should be made to raise the general level of prices).

(c) That, after prices had been raised sufficiently, we should aim at maintaining a stability of prices at the higher level thus reached.

(d) That the leading creditor countries should extend their loans to debtor countries, remove hindrances in the way of new capital

issues, and aim at a policy of cheap money to aid in the rise in prices.

(e) That the Bank of England should be empowered to increase the fiduciary note issue from £260,000,000 to £400,000,000, that the gold reserve should be allowed to fall, if necessary, to a minimum figure of £75,000,000 (instead of being kept at between £130,000,000 and £160,000,000 as customary), that the other banks should decrease their private holdings of notes by paying them in to the Bank, thus increasing both their deposits with the Bank and the cash holding of that institution, that the Bank should increase immediately the amount of its liquid assets, and that the principle should be accepted that our gold reserve was not required for internal purposes, but solely to preserve the international value of the pound by means of exports should the position of the exchanges demand it, so that as long as the reserve was sufficient to meet any possible foreign demands for gold it might be considered sufficient for all practical purposes. The Report also roundly condemned the practice of "window-dressing" by the banks, stating that the effect was to give a fictitious appearance of strength to the weekly "averages" and to the half-yearly statements and balance sheets, and suggested that a large increase in the capital of the Bank of England was advisable. Addenda to the Main Report gave opposing views on the imposition of import tariffs and on the question of a general reduction of wages and salaries.

World events since the publication of this report have been such as to prevent any steps from being taken.

The Crisis of 1931.

A careful perusal of the comments on current economic events given in previous chapters will have shown the precarious position into which the debtor countries of the world were thrown by the burden of reparations, the losses through the unprecedented falls in security and commodity prices, and, in the case of this country, by embarking on schemes of social improvement and relief of unemployment which the reduced income of the nation was unable to support. From the crisis of 1929 onwards, France and America, as the principal world creditors, were withdrawing funds from other centres partly to support their own internal credit positions which

had suffered under the universal shock to credit and the losses sustained by the falls in commodity and security values, and partly because a feeling of nervousness made capitalists in those countries anxious to have most of their funds under their own control, even if at a lower rate of interest. Strenuous efforts at international co-operation were made, and interest rates were everywhere reduced in the hope of stemming the fall in prices, but these two chief creditors seemed to lose sight of the fact that the debts due to them could be discharged only in the form of goods and services, securities, and gold. They hindered the import of goods by tariffs, they were unwilling to buy the securities of their debtors, and they said they did not want to add to their already enormous gold holdings—but they took gold none the less.

The gold "squeeze" fell mainly on this country, as, true to our traditional policy, we continued to lend abroad, and so gave the borrowers the right to sterling. This right was promptly transferred to the two chief creditors who, to a large extent, exercised their rights in the withdrawal of gold. But they wanted both to have their cake and to eat it, too! The object of money is to act as measure of value, and the volume of money in circulation should have a material bearing on its exchange value in terms of goods and services. While gold formed the principal form of currency, a country trading at a profit found its gold stock being increased, and the resulting increase in the volume of money caused a rise in prices which, in turn, caused a falling off in its trade until the benefit of the diverted trade was felt by those countries enjoying it and the falling off in demand for home goods caused a readjustment of home prices so that other countries could again commence purchasing. This meant that no one country could for too long prosper at the expense of its neighbours unless it was willing to return the major part of its excess income from abroad to the providers of that income, in the shape of long-term loans to such countries.

With the colossal growth of credit currency during and after the War, based, in the case of most countries, on a reduced or, at the most, an equal gold holding, but with each paper unit said to possess the same purchasing power as if it had been a gold unit (after the general return to some form of gold standard), it was more important than ever that any gold movements should be allowed to play their full part in increasing the currency and credit system of the receiving

country and reducing that of the remitting country, with a corresponding adjustment of their respective internal price levels. In 1929, America and France between them held about one-half of the visible world stock of gold. In 1931, the proportion had been altered to 75 per cent in these two countries, and only 25 per cent in all the other gold standard countries of the world. But the gold received by America and France had by no means been allowed to perform its proper function of increasing the volume of currency and credit, but was largely "sterilized" by operations in the respective money markets by the central banking authorities in these countries. They were afraid of a rise in their internal price levels which might cause internal distress and lose for them a part of their export trade, but they wanted their money back from abroad, even if they had to take it in gold. They wanted large slices of cake, but they wanted to avoid the effect of financial indigestion which would normally follow! The U.S.A. to some extent counteracted the withdrawal of funds from London by fresh investments there and elsewhere, so that the world supply of dollars was not much below the demand, but France withdrew far more than the equivalent of her fresh lendings, and a steady stream of gold flowed across the Channel.

The other debtor countries found themselves faced with a curtailment of supplies of short-term loanable credit, the steady burden of reparations payments, a decreasing yield from taxation owing to the falling off in profits, and increasing unemployment needing increasing national expenditure. The weakest financially were naturally the first to succumb. In May, 1931, a leading bank in Austria informed the Austrian government that it was unable to meet its liabilities and would have to close its doors. A main cause was that it had been practically forced, some time previously, to take over another large bank which was in difficulties owing to the fall in security and commodity values. The Austrian government was in no state itself to provide temporary assistance, but called in other leading Austrian banks and the Bank for International Settlements to help in avoiding a crisis which would have had the gravest effects in Austria. The trouble was thus minimized for the time being, but, as soon as the news became known, serious doubts were at once raised as to the liquidity of neighbouring countries, notably Germany. Austria badly needed help but, true to her traditional

policy, America tried to keep aloof from European affairs, while France, as had become her habit, delayed the taking of any decision. It was left to the Bank of England, as usual, to give a lead to the world, and within a few days the Bank announced that it had granted a loan of £4,000,000 to Austria to tide over the situation. The damage to credit generally had been done, however, and, partly owing to inexperience of international financing and partly owing to a certain lack of the calm and detached outlook which is so essential for such operations, the banks and investors in America, France, Switzerland, and Holland who had funds in Germany hastened to withdraw at least a part of their investments. Unfortunately, Germany had been borrowing largely on short-term and sinking the proceeds in fixed assets in the shape of buildings, machinery, roads, etc., and was not in a position to turn her assets into ready cash. It was as if a bank were to lock up 90 per cent of its depositors' money in fixed advances and so render itself unable to meet the normal demands for cash which it should expect from those depositors. We in this country had also been guilty of some bad banking as usually understood here. Our bankers had proceeded more or less cautiously in making direct advances to Germany and Central Europe, but, when they became "full up" on "names" there, had not hesitated to lend to other names who they knew full well were only taking such advances to re-lend to exactly the same borrowers abroad. Moreover, in order to provide the necessary liquid funds with which to make further loans at attractive rates, our banks had competed with each other for sterling deposits from foreign lenders, such as the U.S.A. and France, and London had become full of "bad" foreign money, and so even more vulnerable than usual to the effects of the sudden withdrawal of foreign-owned balances.

In consequence, the repatriation panic first hit Germany, as being a debtor practically to all the world, and during June, 1931, enormous sums were withdrawn by foreign lenders, causing heavy offerings of marks against other currencies and throwing a heavy strain on the resources of the German banks. She could only have met the demands made upon her by further borrowings, but lenders were no longer prepared to make advances to her. At length a credit was arranged jointly by the Central Authorities in London, Paris, and New York and the Bank for International Settlements, but the damage had been done and a state of minor panic ruled in

financial quarters. The Reichsbank also sent gold to Paris, Switzerland, and New York, but early in July the realization that the demands for repayment of short-term loans could not be met in full until funds had been raised against the fixed assets in which they had been sunk, caused the panic to spread to the German nationals themselves, and a new "flight from the mark" set in. At the end of the second week in July, a leading German bank was compelled to close its doors, and the German government addressed appeals for help to all the principal governments of the world. A world crisis of the first magnitude was imminent.

In the meantime, the government of the U.S.A. had abandoned, for the first time since the War, its attitude of detachment from European affairs, and, in June, 1931, President Hoover made an announcement to the world which was known as the "Hoover Plan." This was that a complete moratorium of reparations payments should be declared between all debtors and creditors on this account for one year, to give Germany, as the principal debtor, time in which to reorganize herself and to place her internal finances on a more secure basis. Unfortunately, France again proved the stumbling block. It must be admitted that America had great interests at stake in Germany, and would be badly hit by any collapse in the mark which might lead to a forced moratorium or even to the bankruptcy of Germany, so that her gesture was not entirely disinterested. The cost to this country, as regards the national exchequer alone, of a reparations moratorium of even one year was over £11,000,000, but the Government at once issued a cordial acceptance of the Hoover Plan in an endeavour to give a lead to other countries. France, however, stood out, as usual, for "safeguards," and after much valuable time had been wasted in conferences and discussions a basis of agreement suitable to her and to all the other countries concerned, including Germany, was reached on the 10th August, and all payments in respect of war debts were postponed as between all governments. South Africa alone refused to take advantage of the respite, and announced her intention of continuing her payments to this country. France had bargained for, and obtained, an assurance from Germany that the "unconditional" portion of the year's payments due by her should be made, as usual, to the Bank for International Settlements, but on the understanding that such sums should be at once re-loaned by that Bank to the

German railways so that the funds would not need to be transferred out of Germany.

In the meantime the gravity of the situation in Germany had reacted unfavourably on this country, as not only were we known to be heavily interested in that country, but the position was further complicated by the issue, first of the Macmillan Report, which disclosed the fact that London held over £250,000,000 of foreign-owned, short-term funds, and had made long-term loans, mainly to temporarily insolvent debtors, of £450,000,000, and then of the May Economy Committee Report (a committee set up under the chairmanship of Sir George May to report on the methods of decreasing national expenditure and reducing the budget), which showed an alarming increase in the cost of our social services and foreshadowed a budget deficit of £120,000,000 for the next financial year should the existing rate of expenditure continue. Uneasiness had also already been caused abroad when it became known that Australia was unable to meet obligations maturing in London on 30th June to the extent of £10,000,000.

The panic over foreign investments thus spread to London while the Powers were endeavouring to agree on the limits of the concessions they were prepared to make to each other. During the whole of July, 1931, and for the early part of August, the exchange value of the pound in terms of dollars, francs (both French and Swiss), and florins, fluctuated violently and wildly. With approximate outgoing gold points of \$4.85½ and 123.88 fcs. per £, the respective rates of exchange touched \$4.83½ and 123.25 fcs. per £. In spite of the margin of profit, the New York banks refused to take gold to swell the existing vast stocks in America, but France took enormous quantities and large amounts also went to Switzerland, Holland, and Belgium. In one day alone the Bank of England parted with over £5,000,000 in gold, and the total loss during the first three weeks in July was over £40,000,000, though about £8,000,000 was received from various sources during this period, making the net loss about £32,000,000.

Following the failure of the important German bank, the German government ordered the closing of all banks and stock exchanges for one week, and, on the reopening of the banks, only greatly restricted withdrawals and exchange operations were allowed, while stringent regulations were enforced to prevent further withdrawals of capital

and, by agreement with the chief lenders, existing credits were renewed compulsorily for a further three months. The Reichsbank raised its discount rate from 5 per cent to 10 per cent and then to 15 per cent, where it remained for nearly a month until conditions became less nervous, when it was reduced to 10 per cent again.

On 23rd July, 1931, the Bank of England raised its rate from 2½ per cent to 3½ per cent, and on 30th July to 4½ per cent, so serious had the position become. The incidence of the holiday demands for currency also coincided with the gold drain, and the note circulation increased while the reserve rapidly dwindled. Under these circumstances the Bank took advantage of the section of the Currency and Bank Notes Act, 1928, which permits a temporary increase in the fiduciary circulation under abnormal conditions, and applied to the Treasury for sanction to issue notes against securities to the extent of £15,000,000 above the stated limit of £260,000,000. This sanction was at once obtained, and the following announcement was made by the Bank on Saturday, 1st August, 1931—

“The Bank of France and the Federal Reserve Bank of New York have each placed at the disposal of the Bank of England a credit in their respective currencies for the equivalent of £25,000,000, making a total equivalent of £50,000,000.

“On the application of the Bank of England the Treasury have issued a Minute in accordance with the procedure laid down in the Currency and Bank Notes Act, 1928, authorizing an increase of £15,000,000 in the fiduciary note issue for a period of three weeks, thus raising the total of the authorized fiduciary issue to £275,000,000.”

The Increase in the Fiduciary Issue.

August Bank Holiday is normally the time when the peak of the holiday demands for currency is reached. As mentioned above, the heavy reduction in the reserve of the Banking Department of the Bank of England, due to the withdrawals of cash with which to obtain gold for export, coupled with the normal increase in demand for currency, had reduced the ratio to a dangerously low level. In the existing disturbed state of credit conditions all over the world, the Governors of the Bank evidently considered that a further increase in Bank Rate would be ineffective in attracting funds to London for investment, with a possible influx of gold or, at any rate,

a cessation of the current withdrawals, and the only other method of increasing the reserve was by transferring securities from the Banking to the Issue Department against a further issue of notes by the latter department. This meant an increase in the fiduciary issue, for the time being, and it was for this purpose that the Bank applied for, and obtained, the sanction of the Treasury for an increase in this issue of £15,000,000 for a period of three weeks. It was thus evidently intended that the increase should be of a very temporary nature, but subsequent events necessitated successive extensions of the sanction and the issue was not restored to its previous figure of £260,000,000 until 31st March, 1933.

The Return of the Bank of England made up to 5th August, 1931, shows the effect of the increase in the fiduciary issue. A copy of this return is given on page 368.

First Attempts to Support Sterling.

During 1914-18 all trade was subject to Government control, either directly or indirectly, most imports being on Government account. Consequently it was a comparatively easy matter to control the exchanges with other countries, since the gold standard was still nominally in force in all the leading countries, and debts to several could be discharged by assets in any one or more of them. The chief creditor, the U.S.A., was also the chief lender of funds, though our national holdings of American securities were mobilized and either borrowed or purchased from holders here by the official American Securities Committee to be either pledged or sold in the U.S.A. to provide cash with which to pay for our purchases there. When these resources were exhausted the Government obtained credits or raised loans to provide the cash needed to pay for purchases from the U.S.A. (and to a much lesser extent from elsewhere) for ourselves and our Allies. Exchange operations at that time were not directly controlled, but operating banks had to report periodically to the Bank of England and that institution was the sole source of supply of the most needed currency—U.S. dollars. It held the sterling-dollar rate "pegged" at the official level and operating banks could always obtain a supply of dollars at this rate, but it was left to such banks and other arbitrageurs to translate dollars into other needed currencies. The volume of market operations was extremely small as the major payments to and from other

ISSUE DEPARTMENT

	£		£
Notes Issued—		Govt. debt	11,015,100
In circulation	365,251,566	Other Govt. securities	257,315,021
In banking department	43,265,049	Other securities	2,577,424
		Silver coin	4,092,455
			Amount of fiduciary
			issue 275,000,000
			Gold coin and bullion 133,516,615
	£408,516,615		£408,516,615

BANKING DEPARTMENT

	£		£
Capital	14,553,000	Govt. securities	49,310,906
Rest	3,584,180	Other securities—	
Public deposits ¹	11,438,012	Discounts and ad-	
Other deposits—		vances	9,018,855
Bankers	63,436,883	Securities	23,282,897
Other accounts	33,175,357	Notes	43,265,049
Seven-day and other bills	1,415	Gold and silver coin	1,311,140
	£126,188,847		£126,188,847

¹Including Exchequer, Savings Banks, Commissioners of National Debt, and Dividend Accounts.

	Amount	Inc. or Dec. on Last Week	Inc. or Dec. on Last Year
	£	£	£
Rest	3,584,180	+ 33,654	+ 8,481
Public deposits	11,438,012	- 3,781,405	+ 2,572,350
Other deposits—			
Bankers	63,436,883	+ 7,638,553	+ 1,884,597
Other accounts	33,175,357	- 511,245	- 3,612,004
Govt. securities	49,310,906	- 3,250,000	- 3,834,641
Other securities—			
Discounts and advances	9,018,855	- 677,629	+ 1,058,798
Securities	23,282,897	- 3,321,252	- 331,462
Reserve	44,576,189	+ 10,628,395	+ 3,959,624
Note circulation	365,251,566	+ 5,880,697	- 7,726,708
Coin and bullion	134,827,755	+ 1,518,092	- 18,767,082
Proportion	41½%	+ 8½	+ 3½

countries were official in nature and were effected by bulk entries in the books of the Bank of England.

Payments for even vast quantities of goods, however, need only be made as and when the goods are produced, and there is usually time to prepare for the making of such payments. But colossal withdrawals of capital, such as were taking place from July to September, 1931, cannot be foreseen or provided for by any normal methods. No parallel can therefore be drawn between war-time conditions and those prevailing during the period in question, but as soon as the gravity of the situation was appreciated steps somewhat similar to those previously devised were taken by private interests. The very wealthy and powerful group of British insurance companies are normally holders of securities in all the leading centres of the world, and this group, after consultation with the authorities, decided to mobilize its American security holding to provide a fund of dollars which could be used to support the exchange value of the pound, and so, if possible, prevent the continued heavy drain on our gold reserve. The object of the group was, of course, to preserve the market value of its enormous holding of sterling securities by preventing a heavy fall in the gold value of the pound such as would naturally follow a suspension of gold payments in this country. The group commenced operations through the agency of its bankers about the middle of July, 1931, and it is estimated that by the end of that month it had disposed of an amount in the region of \$200,000,000. The general state of almost unreasoning panic was no whit allayed by these enormous sales, and many anxious foreign owners of capital would not even wait for the normal market process to provide them with transfers into other currencies, but hastened to turn their sterling into gold, so that even though demands for exchange were being satisfied up to the limit of physical capacity of the exchange market the gold withdrawals continued. Evidently the authorities were then advised that private efforts were powerless to stem the world trend against sterling, but though it is always easy to be wise after the event, the comparatively ineffective nature of the step actually taken officially seems now inexplicable. With such abundant evidence of the enormous amount of foreign-owned sterling in the shape of cash balances, short term loans and security holdings which the owners were feverishly endeavouring to turn into other currencies as rapidly

as possible, the authorities apparently did not think it necessary to call for a concerted national effort such as was requested during the War, but contented themselves with supplementing in a slightly larger way the efforts of the insurance group which had already proved unavailing.

Official Exchange Operations.

The *communiqué* of 1st August, quoted above, marked a decisive period in English banking history. For the first time the Bank of England took a real active part in the operations of the foreign exchange market, and used the proceeds of the credits raised in Paris and New York to sell francs and dollars in the market through certain other banks working on its behalf. The actual mechanism adopted has been explained in the chapter on Exchange Restrictions. Unfortunately the simultaneous action in arranging for an increase of £15 millions in the Fiduciary Issue was interpreted by our "friends" abroad as the first signs of inflation, and their anxiety to withdraw their capital became intensified. The Bank was so far successful in its efforts to keep the exchange value of the pound above the outgoing gold points to the other chief centres that there was little alteration on balance in our gold reserves during the month of August; but even this further £50 millions of foreign exchange was absorbed within four weeks by a market working to its utmost capacity. On 28th August, 1931, the Treasury itself issued the following *communiqué*—

For the purpose of strengthening still further the exchange position of sterling negotiations have been in progress with financial authorities in New York and Paris. They have been concluded on the following basis—

In the case of America the arrangement is that a financial group undertake, if called upon, to take up British Government Dollar Treasury Bills to a total not exceeding \$200,000,000.

In the case of France agreement in principle has been reached with a view to making available a sum not exceeding five milliards of francs, partly in the form of a credit from French banks and partly by an issue of British franc Bills to the French public. The sum to be borrowed in each centre will be for the term of a year.

The negotiations have been conducted in the most cordial spirit and the greatest assistance has been received from the French Ministry of Finance, the Bank of France, and the various authorities in America.

The Treasury was thus following the lead of the Bank and, in a way, of the insurance group, but for a rather larger amount. By this time, however, the full extent of our resources had become apparent. Our credit abroad had received such a series of blows

and our defensive actions must have seemed so weak to foreign observers, that our ability to raise further funds abroad was limited to the amount of acceptable security which we could offer to prospective lenders, and at such a time the only acceptable security was gold. The stock of gold in the Bank was down to about £133 millions, against which the Bank itself had already borrowed £50 millions. This left a margin of acceptable security of about £83 millions, against which the Treasury did in fact borrow £80 millions. It could not borrow more because we had no more acceptable security to offer, and with a definite limit placed on the amount of foreign exchange available for official selling, the "flight" from and speculation against the pound in foreign quarters was redoubled. As a result the credits raised by the Treasury were dispersed by the selling of exchange through the medium of the Bank and its agents in an even shorter time than those previously raised, and on the afternoon of Saturday, 19th September, 1931, the Governor of the Bank of England was forced to inform the Government that the remaining supplies of foreign exchange were quite inadequate to support even one more day's dealings on the existing terrific scale, and that he must in consequence advise the temporary suspension of gold payments.

Suspension of Gold Payments in the United Kingdom.

The unprecedented gravity of this situation necessitated unprecedented measures. On the evening of Sunday, 20th September, the following official statement was issued by the Government.

His Majesty's Government have decided, after consultation with the Bank of England, that it has become necessary to suspend for the time being the operation of subsection (2) of Section 1 of the Gold Standard Act of 1925, which requires the Bank to sell gold at a fixed price. A Bill for this purpose will be introduced immediately, and it is the intention of His Majesty's Government to ask Parliament to pass it through all its stages on Monday, 21st September. In the meantime the Bank of England have been authorized to proceed accordingly in anticipation of the action of Parliament.

The reasons which have led to this decision are as follows: Since the middle of July funds amounting to more than £200,000,000 have been withdrawn from the London market. The withdrawals have been met partly from gold and foreign currency held by the Bank of England, partly from the proceeds of a credit of £50,000,000, which shortly matures, secured by the Bank of England from New York and Paris, and partly from the proceeds of the French and American credits, amounting to £80,000,000, recently obtained by the Government. During the last few days the withdrawals of foreign balances have accelerated so sharply that His Majesty's Government have felt bound to take the decision mentioned above.

This decision will, of course, not affect obligations of His Majesty's Government or the Bank of England which are payable in foreign currencies.

The gold holding of the Bank of England amounts to some £130,000,000,

and, having regard to the contingencies which may have to be met, it is inadvisable to allow this reserve to be further reduced.

There will be no interruption of ordinary banking business. The banks will be open as usual for the convenience of their customers, and there is no reason why sterling transactions should be affected in any way.

It has been arranged that the Stock Exchange shall not be opened on Monday, the day on which Parliament is passing the necessary legislation. This will not, however, interfere with the business of the current settlement on the Stock Exchanges, which will be carried through as usual.

His Majesty's Government have no reason to believe that the present difficulties are due to any substantial extent to the export of capital by British nationals. Undoubtedly the bulk of the withdrawals have been for foreign account. They desire, however, to repeat emphatically the warning given by the Chancellor of the Exchequer that any British citizen who increases the strain on the exchanges by purchasing foreign securities himself or assisting others to do so is deliberately adding to the country's difficulties. The banks have undertaken to co-operate in restricting purchases by British citizens of foreign exchange, except those required for the actual needs of trade or for meeting existing contracts, and, should further measures prove to be advisable, his Majesty's Government will not hesitate to take them.

His Majesty's Government have arrived at their decision with the greatest reluctance. But during the last few days the international financial markets have become demoralized, and have been liquidating their sterling assets regardless of their intrinsic worth. In the circumstances there was no alternative but to protect the financial position of this country by the only means at our disposal.

His Majesty's Government are securing a balanced Budget, and the internal position of the country is sound. This position must be maintained. It is one thing to go off the gold standard with an unbalanced Budget and uncontrolled inflation; it is quite another thing to take this measure, not because of internal financial difficulties, but because of excessive withdrawals of borrowed capital. The ultimate resources of this country are enormous, and there is no doubt that the present exchange difficulties will prove only temporary.

The necessary Bill was passed on Monday, 21st September, 1931, and was as follows—

GOLD STANDARD (AMENDMENT) ACT, 1931

1.—(1) Unless and until his Majesty by Proclamation otherwise directs, subsection (2) of Section 1 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 sub-section (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 connection 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.

2. This Act may be cited as the Gold Standard (Amendment) Act, 1931.

The Inconvertible Pound.

This drastic change in the hitherto unimpeachable status of the pound was received by the people of this country with their usual

philosophic calm. No runs on the banks took place, business proceeded as usual, and in fact an atmosphere of optimism replaced the previous feeling of uneasiness and lack of confidence.

In the days immediately prior to the suspension of gold payments, the existing Government had resigned and had been superseded by a National Government, comprising the leaders of all political parties so that the responsibility for the step should be shared. During the ensuing few weeks an emergency Budget was introduced, imposing fresh taxation and introducing rigid economies so as to put the finances of the country once more on a thoroughly sound basis, and this was followed by a General Election, at which the supporters of the National Government were returned in an overwhelming majority.

In the meantime, the effect of the Act quoted above was to suspend the statutory obligation of the Bank of England to sell gold in a minimum quantity of 400 oz. at the price of £3 17s. 10½d. per standard ounce, thus rendering the pound inconvertible into gold. During the previous period of inconvertibility (from 1914 to 1925) conditions, both precedent and current, were very different and our eventual return to a gold bullion standard in 1925 had resulted in the pound and gold once more becoming synonymous terms. The effect abroad of this enforced suspension of gold payments was therefore one of consternation and dismay, since the very basis of international credit and confidence appeared to be crumbling.

With the paper pound no longer convertible into gold, the exchange value of sterling was left to be determined by the relation between the effective demand for and supply of pounds as against other currencies, i.e. the pound was left to find its real international level as a purchasing agent. There can be no doubt that the pound had been internationally over-valued since 1925, and that this had acted as a check on exports and a stimulus to imports which must have contributed largely to our adverse balance of payments. The freeing of the pound from its arbitrary gold value gave the chance of discovering its current desirability, or otherwise, in the eyes of other countries. The immediate reaction, after a brief complete cessation of exchange dealings in the London Market, was extremely adverse, the pound falling to below \$4 and Fcs. 100 soon after the resumption of dealings. Violent fluctuations followed during the ensuing days, and attempts were made to curb speculation by the

introduction of forms of declaration, to be issued by a bank to any person wishing to deal in foreign exchange and to be signed by that person, stating the purpose for which the exchange was required. The banks themselves were also required to render returns to the authorities of the state of their accounts in foreign centres and details of any other foreign assets and liabilities, and to supply bulk figures of their dealings in foreign exchange. Most of these restrictions were removed on 3rd March, 1932, but the banks still render periodical statements of their foreign assets and receive occasional official warnings against facilitating speculation in gold or exchange.

Since the other leading world currencies were still on a gold basis and so linked to each other, fluctuations in the exchanges between them were limited to a comparatively narrow range, and to show the fluctuations in the value of the pound, it will be sufficient to give its exchange rate in terms of the U.S. dollar at various times. By 25th September, 1931, the sterling-dollar rate had fallen to \$3.40 which showed a depreciation in the paper pound as against gold of about 43 per cent. This was evidently regarded abroad as too low a value and, helped by the political steps which were then being taken here, confidence in the pound became more apparent, and the rate moved up steadily to \$3.90 early in October. At this level, the Bank of England appeared as a buyer, and later in the month the first signs of a "two-way" control were seen as the authorities made tentative sales of dollars whenever the rate fell below \$3.83. Their resources were insufficient, however, to stand up against any pronounced offerings of sterling, and as the delayed effect of the usual autumnal movement against the pound made itself felt, they were compelled to allow the rate to sag away gradually to \$3.23, which low point was touched on 8th December, 1931. The seasonal movement had by then spent itself and, with a marked improvement in our trade and revenue returns, an investment and speculative demand for sterling sprang up which had carried the rate up to \$3.50 by the middle of January, 1932.

Repayment of the Credits and Definite Exchange "Control."

Although the Bank made quite heavy purchases of dollars and French francs from January, 1932, onwards for some weeks, with

the double purpose of trying to maintain a reasonably stable exchange and of accumulating funds for the repayment of its own and the Treasury's credits, the pressure from abroad to "get back into sterling" was so great that, in spite of the "Kreuger scandal," the rate had been forced up to over \$3.80 by the end of March, 1932. It must be remembered that the proceeds of the credit raised were used in the sales of francs and dollars against sterling. The sterling received for these sales remained available for the re-purchase of the foreign currencies, though, of course, such re-purchases had to be made at rates vastly more unfavourable to the pound than those at which the currencies were originally sold. The resulting "loss in exchange" item is mentioned later. The first partial repayment of the two official credits was made as early as 31st October, 1931, when the Bank repaid £20 millions of its own credit by remitting £15 millions in gold and £5 millions in foreign exchange. The balance of this credit, viz. £30 millions, was repaid by the Bank on 1st February, 1932, entirely in foreign exchange. At the end of February and the beginning of March, 1932, the Bank, on behalf of the Treasury, repaid Fcs. 1,600 millions and \$170 millions, all in foreign exchange, while a further Fcs. 900 millions and \$30 millions were repaid at the end of March, also in foreign exchange. This left only Fcs. 2,500 millions to be repaid, and as this was in the shape of bonds in the hands of the French banks and public, it could not be dealt with until maturity. This final item was actually repaid on 10th September, 1932, but there is no doubt that the Bank had acquired the necessary exchange some time previously. As the credits had been raised for a period of twelve months, such an early repayment of the major portion of them, mainly in foreign exchange, further increased the revival of confidence in the pound, and the authorities had no little difficulty in preventing the pound from appreciating to a level rather higher than they wished to see. It is assumed that while the Bank alone was engaged in exchange operations, i.e. before the establishment of the official Exchange Equalisation Account, its operations, having to be shown somewhere in its figures, were included under the heading of "Other Securities" in the Issue Department, the *contra* entries being a transfer of securities from the Issue to the Banking Department, and an increase in Deposits due to credit in sterling having been passed to other banks against the exchange bought. By the end of April, 1932,

the item of "Other Securities" in the Issue Department had risen from a normal figure of about £3 millions to over £50 millions. If we are correct in assuming that this increase represented a holding of foreign exchange by the Bank, and as the Bank had repaid over £100 millions in foreign exchange in respect of the credits, the strength of the demand for sterling can be appreciated. It was stated in the House of Commons that in the three months prior to our suspension of gold payments over £200 millions had been withdrawn from this country in the shape of gold and foreign exchange. If, therefore, during the following six months nearly £150 millions in foreign exchange had been acquired by the authorities, the very forces which pushed us off gold in 1931 would have pushed us back again in 1932 had not official action been taken!

The hand of the "control" was very apparent from April, 1932, onwards, and a movement of 1 per cent in the leading rates was sufficient to bring in the "control" as buyers or sellers, according as to whether the movement was for or against sterling, while operations were also carried out through agents in Paris, New York, and other principal centres. By the middle of May the Bank's holding of exchange had grown so large that steps were taken to exchange some of it for gold, and various amounts of bullion were purchased from time to time—chiefly from the U.S.A. In spite of this, "Other Securities" in the Issue Department had reached the record figure of over £68 millions early in June, 1932. The "control" action, however, had proved highly effective, with markets much steadier and the volume of speculation reduced to much smaller proportions. The only orthodox step taken was to reduce Bank Rate early in April so as to render investment in sterling less remunerative.

The Exchange Equalization Account.

In his Budget speech in April, 1932, the Chancellor of the Exchequer made reference to the exchange operations of the Bank of England outlined above, and stated that the Government proposed to take steps for the regulation of the exchanges. This was to be effected by the establishment of a fund to be known as the Exchange Equalization Account. The nucleus of the Account was a sum of about £25 millions in U.S. dollars, which was the balance of the Dollar Exchange Account, and represented an amount of dollars which the Treasury had accumulated in anticipation of our periodical payments to the

U.S.A. in respect of War Debt, together with an undisclosed amount in gold which the Treasury was understood to have purchased in the open market from time to time since our suspension of gold payments in 1931. The Account was authorized to raise a further sum of £150 millions by borrowing in such form as the government of the day might determine. Actually such borrowing has been carried out by means of the issue of Treasury bills. The Treasury at once issued Treasury bills to the Account to the value of £150 millions, which were discounted with the Bank of England or in the Discount Market as and when sterling was needed to finance its operations.

The Account took over from the Bank of England the latter's holding of foreign exchange, together with the liability for the loss occasioned by the initial operations. It has already been mentioned how the proceeds of the credits were sold at rates of exchange which compared very unfavourably with the rates at which the foreign currencies needed for the repayment of those credits were re-purchased. It is estimated that the loss on these credits was in the neighbourhood of £28 millions, which, of course, would fall ultimately on the taxpayer of this country. The subsequent operations of the Account, however, have been so cleverly conceived and carried out that the profits made must have reached figures of considerable magnitude; in fact, successive Chancellors of the Exchequer have stated in Parliament that the Account shows a net profit on its operations.

The actual transfer from the Bank of England to the Account took place early in July, 1932, and the Bank Return made up to 6th July, 1932, shows an increase in the Issue Department of "Other Government Securities" of nearly £32 millions, with a decrease of an equivalent amount in "Other Securities," which then showed a total of over £18½ millions. Of this latter sum probably about £15 millions represented balances abroad accumulated in anticipation of the repayment of the outstanding amount of Fcs. 2,500 millions in respect of the Treasury's French credit. The amount of £32 millions transferred to the Account must have included the original loss on repaying the credits, less any profits which had been made subsequently as, of course, the Bank had been operating on behalf of the Government and its stockholders could not be expected to sustain a loss which should properly be shouldered by the country as a whole.

Within a year of its inception, it became clear that the movements of capital with which the Account would have to cope were likely to be so sudden and of such a size that the initial resources of the Account would need strengthening. Accordingly, the Budget of 1933 increased the borrowing powers of the Account by £200 millions. This proved sufficient for some time, but the experience gained and the problems raised by the continuous flow of "funk money" to this country from abroad showed a need for yet another increase in the Account's resources, and it was given power, in the Budget of 1937, to borrow a further £200 millions. At the time of writing (February, 1938), the Account has a capital of about £575 millions, of which £550 millions is borrowed on the security of Treasury bills as and when needed. Our national figures are presented to us in so conglomerate and obscure a form that it is impossible to be definite about the inter-departmental mechanism used in this case, but it would appear that the Treasury has, on each occasion, immediately issued new Treasury bills to the Account, which the latter dates and issues according to its need for sterling resources. It would also appear that each time new bills are handed over by the Treasury, the amount is shown as an addition to the country's floating debt, so that the total of Treasury bills issued by the Treasury has been swollen by the £550 millions handed over to the Account, but the actual amount which has been issued and discounted out of this holding is a matter of the deepest secrecy. In default of other measures, this process would involve a definite inflation of our credit system, but later in this chapter it is shown how a technique has been evolved to insulate the internal credit system from the normal effects which would be produced by the working of the Account, and how the ultimate effect is to leave the Account either in the position of having acquired gold and issued Treasury bills thereagainst, or of having parted with gold and used the sterling so produced in the re-purchase of Treasury bills. The gold operations of the Account in the Bullion Market and with the Bank of England are also dealt with elsewhere.

Obviously, since the main object of the Account is to prevent sudden and extreme fluctuations in the exchange value of sterling, it is essential that its operations should be given all the secrecy possible; and, until 1937, only the vaguest references to the size of these operations and to the position of the funds at its disposal

were made officially; but in his Budget speech of 1937, the Chancellor of the Exchequer promised the House of Commons that figures showing the position of the Account would be given to the House twice a year, but would be those for three months previously, and gave the figures as at the end of March, 1937. In December, 1937, the figures were given of the position as at end September of that year, and showed that the Account held gold to the value of about 279 millions, but only a negligible amount in foreign exchange. It was also stated that the Account showed a profit to date on its working. As the gold stock of the Bank of England had been increased since September, 1931, by about £190 millions, the bulk of which has been sold to it by the Account and on which the latter must show a book loss owing to its having been bought at current market prices and sold to the Bank at the old statutory price, the Account must have immobilized its resources to the extent of this loss plus the initial loss of about £28 millions taken over from the Bank. This means that the Account is carrying book losses of about £90 to £100 millions, which must be financed by the use of "Treasuries," so that at the time these figures were given, the Account must have been using nearly £400 millions of its total resources.

The Bank's Valuation of Its Gold.

With the passing of the Currency and Bank Notes Act, 1928, the whole note issue of this country, with very minor exceptions, came under the control of the Bank of England, and the Act laid it down that the profits of the Issue Department should accrue to the Treasury. The Bank, therefore, acts in an entirely fiduciary capacity in respect of the note issue and really holds such gold as forms part of the cover for the note issue in trust for the nation.

The fixation of a statutory price for gold dates back to the Bank Charter Act, 1844. Under that Act the Bank was required to purchase all gold offered to it at the price of 77s. 9d. per standard ounce, but no obligation was laid on it to sell gold at any fixed price. The right of free coinage, however, existed, and the Royal Mint would accept gold for coinage into sovereigns, without charge, which meant that a holder of bar gold could have it converted into sovereigns containing 123·27447 grains standard. This was

equivalent to a price of 77s. 10½d. per ounce standard, but the loss of interest and the small loss of gold incurred during the process of coining reduced this out-turn to the holder to an eventual price of 77s. 9d. per standard ounce, or the same price as he could have obtained at once by a sale of bar gold to the Bank. In practice, therefore, practically all imports of bar gold were sold direct to the Bank, which itself arranged with the Mint for the coinage of gold into sovereigns as and when it thought necessary. Since the Bank would, in any case, have stocks of bar gold lying idle, it could not be regarded as losing interest on such bars as were sent to the Mint for coinage. Moreover, the Bank was frequently asked to buy sovereigns from various sources, and these it had, of course, to purchase at their face value. Its gold stocks, then, consisted partly of bar gold capable of being converted into sovereigns of a value of 77s. 10½d. per standard ounce; other gold coins purchased at their actual gold content and at the statutory buying price, but also capable of being melted down and converted into sovereigns; and actual sovereigns which had been acquired at their actual value of 77s. 10½d. per ounce standard. The entire gold holding of the Bank has, therefore, been valued at 77s. 10½d. per ounce standard since 1844.

The Gold Standard Act of 1925 restored the obligation on the Bank to buy all gold offered to it at the rate of 77s. 9d. per ounce standard, but withdrew the right of free coinage and instead required the Bank to sell bar gold in amounts of not less than 400 ounces fine at the fixed price of 77s. 10½d. per ounce standard; and it was only this latter obligation which was abrogated by the Gold Standard (Amendment) Act, 1931. The Bank has, however, consistently pursued its practice of valuing all gold held or acquired by it, from whatever source, at 77s. 10½d. per ounce standard, irrespective of the fact that its effective or legal buying price is only 77s. 9d., and doubtless will continue to do so until the legal gold content of the sovereign is altered and the existing gold stock can be written up to a new level. In proof of this, the figures of the country's gold holding given by the Chancellor of the Exchequer in connection with the working of the Exchange Equalization Account can be quoted. He stated in the House of Commons in December, 1937, that as on 30th September, 1937, the Issue Department of the Bank of England held 76,843,000 fine ounces of gold.

This quantity, valued at 77s. 10½d. per ounce standard, gives a sterling value of £326,408,106, which agrees within the value of less than one bar with the figure of £326,406,613 shown in the Bank Return dated 29th September, 1937.

With the divorcing of the pound from gold in 1931, the gold value of the paper pound, i.e. the London price of gold, has naturally varied with the international value of sterling as shown by the exchanges and, to some extent, with its internal purchasing power as shown by the general level of prices. The highest price for gold in London recorded up to date was 149s. 4d. on 6th March, 1935, and the average price during 1937 was about 139s. 7½d. The Exchange Equalization Account, whether it operates in foreign exchange or in gold, must do so at current prices; and if it transfers any of its gold holding, valued in its books at cost, to the Issue Department at the Bank's statutory buying price, or even at the value of 77s. 10½d. per ounce standard placed on it by the Bank, a book loss is shown which must be borne by the Account for the time being. Additional reference to the operations and relations between the Account and the Bank is made later in this chapter. Further, when the accumulated stock of foreign exchange acquired by the Bank between October, 1931, and July, 1932, was first taken over by the E.E.A., the sterling equivalent paid over to the Bank by means of Treasury bills was probably greatly in excess of the current value of the exchange handed over by the Bank, the difference representing the net loss on the total operations to date. If at any time it is decided to devalue the pound by adopting a new legal gold content, the fixed price of gold in terms of pounds would become adjusted in proportion to such devaluation and the current value of the Bank's gold holding would be increased accordingly. This increase in value would represent a profit, but as the profits of the Issue Department accrue to the Treasury, such profit would have to be handed over to the Treasury, by whom it would probably be applied to the funds of the E.E.A. Then, when the Exchange Equalization Account came finally to be wound up, the Treasury, and indirectly the taxpayer, would benefit not only by such profit as the Account had made during its period of operation, but also to the extent of the sum provided by the new valuation of the Bank's gold in terms of the new gold pound. This principle has been adopted in the U.S.A., New Zealand, and Canada; and while in

these cases the commercial banks, who were forced to part with their gold holdings at a value very much below the current value, may have had some cause for complaint, no such considerations would apply in the case of the Bank of England.

Further Operations of the Exchange Equalization Account.

Although responsibility for the control of the exchanges theoretically passed to the Treasury with the legal establishment of the E.E.A., the mechanism by which the necessary operations are carried out has remained the same. From July to September, 1932, a tight hold was maintained on the market, but in the autumn of that year events temporarily proved too strong for the resources of the Account, and operations were suspended for a short time. It should be noted that any "exchange control" can always prevent a *rise* in the exchange value of its own currency since it can always create a supply of that currency to sell to foreign buyers against other currencies. Where, however, the pressure is *against* the home currency, the control may possess holdings of gold or foreign currencies sufficient to enable it to use these in buying up the foreign offerings of the home currency for a time, but if the pressure is protracted, it will exhaust these reserves and be unable further to support the home currency, which must then be left to find its current level. Several references have already been made to the part played by exchange speculators in causing or accentuating exchange movements, and a speculative movement can be a most formidable force.

At the end of June, 1932, the Government announced a Conversion Scheme for a very large amount of existing debt. This debt was very widely held and as it totalled over £2,000 millions an impression gained ground abroad that, owing to the terms of the conversion, foreign holders would not convert but would demand repayment in cash. This would have led to heavy offerings of sterling and speculative interests began to operate against sterling on this basis. The actual conversion date was fixed for 30th November, 1932, and until the end of September the "control" had most successfully held the dollar rate at between \$3.45 and \$3.50. The speculative movement against the pound then began to gather force, and this was intensified by the usual autumnal offering of

sterling on trade account. The authorities found the pressure too great for their slender resources in the shape of accumulated foreign balances, and had to content themselves with allowing the rate to fall by easy stages to \$3.28 by the end of October. The proximity of the conversion date then seemed to induce a further wave of speculation against the pound and the "control," either of set purpose or because of a lack of foreign currency or gold, retired from the market altogether for some days, leaving the rate to touch the record low level of \$3.14½ on 29th November, 1932. Note the significance of this date in view of the assumed withdrawals of sterling by non-assenting foreign holders of the existing debt on 1st December. When, however, this critical date passed without the slightest disturbance to either the Money or Exchange Markets in London, a reaction in favour of sterling set in, and most of those who had previously been so anxious to sell pounds became equally anxious to buy them, only to find that the seasonal commercial offering of sterling had practically finished and that there was consequently no source of supply of pounds unless and until the "control" resumed operations. So far from assisting these speculators to make a profit at the existing low level for sterling, the "control" very cleverly used its remaining foreign resources in also bidding for pounds and, as a result of the combined factors, the rate quickly rebounded to over \$3.30. At this stage the "two-way control" was once more reimposed, and the speculators found themselves faced with the necessity of buying back in the "thirties" pounds which they had sold in the "twenties" and under.

For the next few months the "control" had no difficulty in holding the rate at any desired level, though it allowed sterling gradually to appreciate in accordance with the usual seasonal trend, but in early March, 1933, the development of banking troubles in the U.S.A. created an entirely new situation. The U.S.A. crisis is briefly treated in a subsequent paragraph, and it is sufficient to say here that the suspension of gold payments in that country left the dollar a "free" currency and, not being convertible into gold at a stable price, an unsuitable currency to be held or dealt in by our E.E.A. which, after all, is a trustee on behalf of the nation of the funds at its disposal. As a result, from March, 1933, to September, 1936, the "control" was forced to operate exclusively in French

francs as being the only currency remaining on a real Gold Bullion Standard, and even then its operations were sporadic owing to the impossibility of calculating with any degree of accuracy the probable effects of the various steps taken by the U.S.A. in the course of the "great experiment" in managed national economy. The activities of the Account appear to have been devoted to watching carefully for any signs of an outbreak of speculative activity for or against the pound and of then taking usually most efficient steps to "cane the speculator" by allowing the movement to proceed a little way and then suddenly and forcibly pushing the rate to a level which shows a loss to the speculators and holding it there! The proof of the pudding is in the eating, and the efficiency of the "management" of our national currency is best measured by the results in the shape of stability of value of the currency. That the internal purchasing power of the pound only varied from 132.7 in June, 1933, to 132.6 in June, 1934 (September 18th, 1931 = 100), in spite of exchange movements of 60 per cent in U.S. dollars and 20 per cent in French francs during that period, is sufficient proof of the care and ability brought to bear on the problem. Even though it seems probable that differences of opinion and ideas have shown themselves from time to time between the French authorities and our own, there has always been a close association between the Bank of France and our E.E.A., while the American authorities also kept in reasonable touch with and assisted in our aims and ideas. With the introduction of the Tripartite Agreement in 1936 (*supra*), this co-operation increased greatly in closeness and efficiency, and the authorities in Belgium, Holland, and Switzerland have also done their share. The joint operations must have been of the greatest benefit to both countries in "ironing out" what would otherwise have been very violent fluctuations, not only in the franc-sterling rate, but in the rates with and between those other countries which are still linked to gold. Money being only a purchasing agent, the stability of its purchasing power is the most important consideration, and an "exchange control" which can secure this stability is rendering invaluable service to its nationals.

The E. E. A. and our Domestic Credit System.

One of the most startling changes introduced into our internal currency and credit system by the establishment of the Exchange

Equalization Account is the technique which has been developed with the object of insulating that system from the effects which would normally have been produced on it by the enormous movements of capital and gold in bulk which have been such an international feature during the past seven years. In the first place, there has been a calculated attempt on the part of financial authorities in all the principal countries of the world to maintain a long period of "cheap" money, i.e. low interest rates, with the primary object of promoting a rise in basic commodity prices from the very unprofitable low levels to which they had fallen in 1932; and, secondly, in the hope of discouraging movements of idle capital from low interest centres to those where higher rates temporarily prevailed. These aims would have been swamped completely had the panic-induced capital movements, resulting in transfers of gold to and from the leading centres in amounts of unprecedented size, been allowed to set in motion the economic and financial effects which would have occurred under international working of free gold standards.

A brief example will make this clear. Under our gold bullion standard system, an import of gold meant that some member of our commercial banking system received the gold for the credit of a client. The gold would be handed over to the Issue Department of the Bank of England, which would automatically issue notes in exchange, and these would be paid in by the bank concerned to the Banking Department for its credit there. This meant (a) that the Issue Department had an increased note circulation covered by a similar increase in its gold holding, thus somewhat improving the total convertibility of the whole issue; (b) that the Banking Department had its "Bankers' Deposits" increased, while its "Cash Reserve" increased similarly, thus raising the "proportion of cash to liabilities and providing a basis for an expansion of credit; and (c) that the commercial bank concerned also had its deposits and its cash increased by similar amounts, which again increased the proportion of cash to liabilities and provided a basis for an expansion of credit. Normally, the Bank of England maintained a ratio of cash to liabilities of about $33\frac{1}{3}$ per cent, while the commercial banks were content with a proportion of only 10 per cent. An influx of gold of, say, £10 millions, therefore, would mean that the Bank itself could create a further £20 millions of new credit, while

the commercial banking system could create £90 millions. The influx of gold, moreover, would almost certainly be accompanied by a reduction in Bank Rate, which would mean a reduction in all other interest rates (thus stimulating borrowing and the promotion of new enterprises), a rise in security prices, and so an increase in paper profits and the general setting of the stage for a mild commercial and financial "boom." The Bank itself could create credit by buying bills and securities, and making advances to its customers and to the Money Market until the volume of its deposits had risen to the extent needed to restore the former ratio of 33½ per cent based on the new level of cash. This increase in deposits at the Bank must, of necessity, increase the cash reserves of the commercial banks, since the funds paid out by the Bank would eventually be paid in again to one or other of the commercial banks for which it would take credit in its account with the Bank. This would mean a further addition of £20 millions to the cash resources of the banking system as a whole, which could form the basis for an expansion of credit of £180 millions. In the absence of any controlling steps, therefore, an influx of gold of only £10 millions could form the basis for the creation of new credit to the extent of £20 plus £90 plus £180 millions—a total of £290 millions! Needless to say, such a drastic effect was never allowed to be produced. The Bank would accept as part of its public duty the increase in its ratio of cash, however unprofitable to its proprietors, and, further, would take immediate steps to absorb as much of the commercial banks' surplus cash as it thought necessary by selling some of its own holdings of bills and securities to the Money Market. With lower money rates and the consequent scramble for bills and high-class securities, there was usually no difficulty in taking money off the market by this means, and the eventual payment for these purchases meant that, in the long run, the commercial banks' deposits *and* their cash reserves at the Bank were depleted to a level which the Bank considered desirable. But a certain amount of new credit was bound to be created and, in any event, the change in Bank Rate caused an economic disturbance to the whole monetary system of the country, affecting alike the 25 per cent of the commercial community interested in foreign trade and finance and the 75 per cent whose interests were purely domestic.

Conversely, when the reverse swing of the pendulum came and

gold began to leave the country, the whole process had laboriously to be reversed. The high security prices due to low interest rates usually induced sales of foreign-owned stocks and the withdrawal of floating funds; the rise in commodity prices which followed shortly on these conditions caused a falling off in foreign buying and a lessening of the demand for sterling; while the very dearness of sterling which caused the import of gold usually provoked speculative sales and, in any case, stimulated imports, owing to the relative cheapness of foreign currencies, and so led to offerings of sterling. The cumulative effect of these factors in due course turned the tide and sterling fell in value until gold exports became necessary. The Issue Department took in notes and gave out gold. The Banking Department had supplied the notes to the debit of a commercial bank's account and so suffered a more than proportionate diminution of its cash to the fall in its deposits. The same thing applied with even greater force to the commercial banking system. Deposits fell through the withdrawal of funds, but cash fell to the same extent through the need to take cash from the Bank, so that the ratio was heavily reduced. In the same way that an influx of gold of £10 millions could have formed the basis for an expansion of credit of £290 millions, so the efflux of a similar amount of gold could be the cause of a deflationary movement to the same extent. Again, the authorities had to take steps to prevent such a disastrous happening. Bank Rate would be raised, borrowing discouraged, enterprise lose confidence, security prices fall, commodity prices start to fall in due course, and all the factors needed to produce a "slump" would be present. These effects were minimized by money being doled out to the Market by purchases of bills and securities by the Bank, resulting in an increase of deposits at the Bank and so in the cash reserves of the banking system, until the level of such reserves has been adjusted to the new level of deposits, while the Bank itself was left with increased deposits and increased holdings of bills and securities, but a depleted cash reserve. There can be little doubt, too, that these successive potential "booms" and "slumps" had a direct bearing on the employment figures and most certainly on the general level of prices. It may further be remarked that, from 1925 to 1931 under our gold bullion standard, Bank Rate was changed no fewer than sixteen times and that the average rate during that time was about $4\frac{9}{16}$ per cent. Since our

suspension of gold payments in 1931 and the introduction of a scientifically "managed" currency, Bank Rate was reduced to 2 per cent in June, 1932, and has remained at that figure without change up to the time of writing!

The new and still developing technique of "managing" our currency and credit system has been directed towards the elimination of the disturbances caused by gold movements under a gold standard, and has been remarkably successful in insulating our internal economy from the effects of unprecedentedly large movements of gold both into and out of the country. It has been shown how, in the course of its operations in exchange to counteract demands for or offerings of sterling in exchange for other currencies due to capital movements or speculation, the Exchange Equalization Account either creates sterling and acquires some other currency, which is eventually turned into gold, or has to supply other currencies, which it provides by parting with some of its gold stock, and acquires sterling in exchange. Under the Tripartite Agreement (*supra*), the parties thereto agree to exchange for gold at the close of each business day any amounts of each currency held by other parties, so that, in effect, each "control" is now operating in its own currency against gold. When our Account is being asked to supply sterling, it has to allow its account at the Bank of England to be debited for the credit of the accounts of those members of the commercial banking system with whom the foreign buyers of the sterling require the funds to be placed. This means that Government accounts with the Bank are reduced or overdrawn, while "Bankers' Accounts" are increased and the cash reserves remain unchanged, thus weakening the Bank's own position. The commercial banks have an increase in deposits against which they have acquired an increase in cash of the same amount. The Account has created sterling against which it has acquired some foreign currency which will, at the end of the day, be turned into gold at the current price. This is equivalent to an import of gold as under the gold standard, but, at this point, the difference is that instead of the gold having been turned into notes, which are paid into the Banking Department and so increase the Bank's reserve, it has been turned direct into an increase in the commercial banking system's cash reserve. The potential credit inflation by the Bank itself is, therefore, eliminated, but the potential of a nine to one

increase by the commercial banks still remains. Now, however, the Account has to put itself in funds to restore its account with the Bank. This it does by utilizing some of its capital stock of Treasury bills and discounting them either in the Money Market or direct with those banks which have received the benefit of the cash credit at the Bank. In either case the result is the same. The purchasers of the bills must pay for them by drawing on the Bank or on some commercial bank, which, in turn, must use some of its balance at the Bank to effect the transfer. This means that the total of commercial banks' cash is reduced, and either their deposit accounts are reduced in the same amount (where the purchaser of the bills draws on his banking account in payment) or their holdings of bills increase (where the banks themselves are the purchasers of the bills). The net result is that the Banking Department finds its "Bankers' Accounts" and its cash reserve unchanged, a small change in "Public Accounts" equal to the discount on the bills, and little difference in its "ratio." The commercial banks find themselves with increased deposits (since only a small proportion of the bills issued will be bought by firms or persons not being bankers) and an increased holding of bills to approximately the same amount, while their cash reserves remain unchanged. If this process continues, deposits will continue to mount against increasing bill portfolios and with no proportionate increase in cash; this would eventually lead to an enforced deflationary movement on the part of the banks to restore the normal 10 per cent of cash to deposits! Compare this with the potential inflationary movement provided by an influx of gold under a gold standard.

In order to rectify this undesirable position, the Account developed its technique a stage further. Whenever a persistent demand for sterling has required the creation of such a sum as to swell bank deposits to a level where cash reserves have fallen below the recognized 10 per cent ratio, the Account will have acquired gold as a result of its operations, and it then proceeds to sell a portion of this gold to the Issue Department of the Bank in exchange for notes. It then pays in the notes for the credit of its account in the Banking Department, and so has ready cash to pay out when next it is asked to sell sterling. When such sales take place, the Bank, as usual, debits the Account's account and credits that of some commercial bank or banks, which thereupon receives an increase in cash

reserves; but as the Account will not need to discount Treasury bills to cover the sales of sterling in question, the cash reserves of the banking system remain augmented, and this offsets the previously disproportionate increase in deposits and restores the ratio of cash to deposits.

Another development of this new technique is to be seen in the use which has been made by the Account of the Fiduciary Issue. As has been explained, the sterling resources of the Account are limited, and a protracted heavy demand for sterling has, on occasion, meant that the greater part of these resources is held in the shape of gold acquired ultimately through purchases of foreign currency against sales of sterling. At such times, the Account has sold gold to the Issue Department, but, instead of taking notes in exchange, it has obtained Treasury authority for a reduction in the Fiduciary Issue, and so is able to take from the Department the equivalent in Treasury bills which it promptly cancels, and so is in a position to issue new bills to that amount when further sales of sterling make this necessary. An outstanding example of this action took place in December, 1936. The continuous "flight" from other currencies into sterling was only temporarily interrupted after the devaluation of several Continental currencies in the September of that year, while extensive hoarding of Bank of England notes was also present. As a result and in spite of several small sales of gold by the Account to the Bank, commercial bank deposits had steadily increased, while cash reserves had not fully responded to the amounts of cash released by the Account owing to the hoarding of notes, and the Account itself evidently found that far too much of its capital was locked up in gold. It, therefore, obtained Treasury sanction for the Fiduciary Issue to be reduced from £260 to £200 millions, paid into the Issue Department gold valued at the Bank's statutory buying price at £65,000,313 (though, of course, it was valued in the books of the Account at approximately current prices), took only £5 millions in notes to feed the cash reserves of the banking system, and took the balance in the shape of some of the Treasury bills held by the Department as part of the cover for the Fiduciary Issue. This resulted in a small increase in the note circulation, a reduction in the interest-bearing securities held by the Issue Department and in the legal Fiduciary Issue, and a large increase in the Bank's gold holding. Three points are worthy of

notice in this connection. The Account must shoulder the loss shown by selling gold, purchased at market prices, to the Bank at its statutory price equal to about 84s. 9 $\frac{3}{8}$ d. per fine ounce, or even at the price of 77s. 10 $\frac{1}{2}$ d. per standard ounce at which the Bank's gold holding is apparently valued. The Issue Department is, to all intents and purposes, a sub-department of the Treasury. The book loss on gold sales shown by the Account will be merged in the profit shown on the gold holding of the Department when, if ever, this is revalued. If notes had been issued against such a sale of gold, a dangerous potentiality of inflation would have arisen, while if securities had been taken from the Banking Department, a loss of profit to the proprietors of the Bank would have been incurred which they could not properly be asked to bear; whereas the loss of interest suffered by the Issue Department is, in effect, a loss to the Treasury which again will eventually be absorbed when the accounts are merged and which, in the meantime, is offset by the gain to the Account of having fewer Treasury bills under discount for the time being. Finally, if the Account is able so to utilize the Fiduciary Issue, its resources are, in effect, increased by the total of that issue, since it is possible to visualize continual sales of gold to the Bank by the Account against the delivery up of securities from the cover for the Fiduciary Issue until these are exhausted and the Issue replaced entirely by gold.

Other movements can take place in the legal amount of the Fiduciary Issue without any direct connection with the operations of the Account. For example, towards the end of 1937, foreign hoarding of our notes was again in evidence, while the usual seasonal demand for currency had to be expected. On 16th November, 1937, the Chancellor of the Exchequer announced that he had authorized an increase of £20 millions in the Fiduciary Issue, against a corresponding increase in the Note Circulation, to provide for the normal increased demand for currency over the Christmas season, but that it should be possible to restore the Issue to its former total when the usual return of currency from circulation took place in the New Year. Actually, the Issue was again reduced to £200 millions on 19th January, 1938. This was an entirely normal operation and was carried out simply to increase the Bank Reserve by a transfer of securities from the Banking to the Issue Department against which the latter issued new notes. The former department

lost securities and gained cash which was available to the commercial banks when they had to meet the demands for cash made on them by their customers. These demands resulted temporarily in a reduction of commercial banks' deposits, in their cash balances at the Bank and in the Bank Reserve, owing to the increased amount in notes circulating in the country; but as soon as these notes found their way back to the banks, they were paid in again to the Central Institution, bank deposits rose, bank cash in the shape of balances at the Bank rose and also the Bank Reserve, until the position allowed of the return of notes by the Banking to the Issue Department against the re-delivery of securities and the restoration of the Fiduciary Issue to its former figure.

As and when confidence in various foreign currencies is gradually regained by their own nationals and repatriation of exported capital commences in real earnest, we must expect a world offering of sterling as heavy and persistent as has been the world demand during recent years. Under such conditions, our Exchange Account will be obliged to take over sterling and to supply foreign currencies, which latter can be provided only by shipments of gold from London to the various centres abroad. This, of course, will be an efflux of gold which, under a gold standard, would demand a greater or lesser deflation of credit (with its concomitant disadvantages) according to the measures taken by the authorities. Under the new technique, however, we need expect no more disturbance of our internal economy than we have seen over the period during which gold has been coming into the country in very large quantities. The present operations of the Account will merely need to be reversed. Sales of sterling to the Account by foreign owners will mean a reduction of commercial banks' deposits and of their cash at the Bank—a deflationary potential, since the ratio of cash to deposits will fall—and an increase of the cash balance of the Account with the Bank. The Bank's own Cash Reserve and ratio will not be affected. The Account will then proceed to use its liquid cash in the re-purchase of Treasury bills from the banks, which it will then cancel and so leave itself with reduced liabilities against the reduction in its gold holding. This action will increase the commercial banks' cash balances at the Bank and is inflationary in trend, owing to the higher ratio of cash to deposits; and to counteract this tendency the Account, from time to time, will have to use

part of its liquid cash in the re-purchase of gold from the Issue Department instead of Treasury bills from the banks. This will leave the banks with a loss of cash equal to a certain loss in deposits, which will reduce the former abnormally high cash ratio to normal, but the Bank itself will lose cash in the Banking Department of an amount equal to the reduction in Public Deposits and so will find itself with a lower "Ratio." This it will have to remedy by selling bills and securities to reduce "Other Deposits," through payments made to it by purchasers, until the normal "Ratio" is restored, and this process will have to be carried out in step with the operations of the Account so as to sterilize or prevent any marked fluctuations in the commercial banks' cash ratio. Further, when it finds its own stock of gold running low, the Account will have to make use of the Fiduciary Issue in reverse fashion. Instead of cancelling all the Treasury bills which it re-purchases out of its sales of sterling, it will have to hand some of them over to the Issue Department as cover for an increase in the Fiduciary Issue (under Treasury sanction) and take out gold so released. Presumably it will be able to obtain such gold at the same price as it was originally sold by it to the Department, and so wipe out a part of its present book loss.

In addition, any withdrawal of funds in bulk from this country would naturally be accompanied by a demand for gold in the London Bullion Market. Were this demand to be allowed to raise the price unduly, some of the effects of an inflationary movement would be experienced in the shape of a fall in the purchasing power of money, i.e. a rise in prices, with the usual subsequent results. In order to counter this tendency, the Account will have to meet the market demand for gold by offering supplies out of its own holdings in quantities sufficient to prevent the price from rising more than a few pence per ounce. Since the "flight" of "hot" or "funk" money to this country has only been made possible by the action of the Account in accepting gold and creating sterling thereagainst, the ultimate withdrawal of such "hot" money can only be accomplished by a reversal of this process, and any persistent loss of gold by this country due to such a cause must be regarded merely as restoring the *status quo* and not as in any way detrimental to or disparaging of our trading or financial position.

The "Gold Bloc" and "Sterlingaria."

In view of the leading part played by this country in world trade, our suspension of gold payments and the subsequent depreciation of the exchange value of the pound resulted in a definite orientation of countries into two main groups. Many of the Continental nations had already experienced the transient benefits of a depreciating exchange, and the much more lasting and often costly effects of eventual forced devaluation of their currencies. Many of them dared not cause further loss to the "small investor" class of their nationals and, under the lead of France, announced that they would endeavour at all costs to preserve a gold standard as between themselves. This group consisted of France, Belgium, Holland, Switzerland, Czechoslovakia, Poland, Germany (with distinct limitations in the case of the latter), and other countries with "managed" currencies, such as Spain and the Southern European nations, and Russia also linked themselves to the French franc. This group became known as the "gold bloc," and as far as possible took concerted action in monetary affairs.

On the other hand, several other countries were more closely linked to this country by trading and financial relations, and they automatically followed us off gold and linked the fortunes of their respective currencies to those of the pound. This group comprised the Dominions and Colonies (with the important exception of Canada, whose proximity to and close trading and financial relationships with the U.S.A. made it imperative for her to steer a middle course between the pound and the dollar), the Scandinavian countries, and Portugal.¹ This area over which sterling was almost an international unit became known as "Sterlingaria"—a kind of international monetary state.

Since the suspension of gold payments in the U.S.A. a small group remains attached to the dollar, and can be said to form a "dollar group," while silver still rules in part of the Far East. What eventual international money system will emerge from this melting-pot it is at present impossible to gauge.

The German "Standstill Agreements."

Germany having become the world's chief debtor owing to the demands on her for Reparations and her financial troubles in 1931

¹ And for some time, the Argentine Republic.

having been largely responsible for the precipitation of the world crisis, it is necessary to touch briefly on subsequent events there. In July, 1931, a Conference of seven of the creditor governments agreed, on behalf of individual debtors as well as themselves, that transfers of exchange from Germany in respect of payments on account of interest on and amortization of short, medium, and long-term debt should be suspended for six months. The Young Plan Advisory Committee sat in Basle at the same time and issued a set of recommendations which were supplemented at a further meeting in December, 1931. During this preliminary period small reductions of not more than 10 per cent were made by Germany on certain short-term loans and credit lines, and in February, 1932, a further conference by bankers representative of the creditors was held in Berlin, and the existing arrangements were somewhat improved upon and embodied in an agreement to remain in force until February, 1933. This agreement covered mainly the short-term indebtedness of Germany, as the bulk of her medium and long-term debt consisted of the Dawes and Young loans, which were supposed to be inviolate and the service for which was a first charge on the assets of the Reich. These "standstill" arrangements operated fairly successfully, and were again renewed for one year in February, 1933, but by that time the increasing burden on a dwindling volume of foreign trade had caused a steady diminution in the reserves of gold and foreign exchange held by the Reichsbank. Much has been written of the way in which German exchange holdings abroad were used in the purchase of her own securities in foreign centres at prices artificially depressed by her own partial default, but the fact remains that payments in respect of unproductive debt can only be made out of the proceeds of successful trading, and the depreciation of first the pound and then the dollar in terms of gold while the mark remained on a nominal gold basis must have proved a grave handicap to German trade.

In an apparent great effort to provide, out of her decreasing trade balance, the foreign exchange needed for payments on account of guaranteed debt and "standstill" agreements, Germany imposed more and more restrictions on trade and exchange dealings. Some of her creditors, notably Holland and Switzerland, instituted "exchange clearing houses," into which the proceeds of all imports by those countries from Germany had to be paid, and out of which the

"first charges" on debts had to be paid before any payments in respect of sales to Germany were made. Part payments under the "standstill" agreements were made in "blocked" marks and reference has already been made to the manner in which these were used to subsidize German exports. In spite of all these artificial and really uneconomic aids, German trade, in common with that of the rest of the world, continued to dwindle and the balance of exchange available for meeting her debt obligations grew smaller and smaller, while the reserves of the Reichsbank also decreased steadily under the constant drain. The exchange "quota" for German importers was maintained at 50 per cent of their 1930-31 requirements for two years, but in February, 1934, it was reduced to 45 per cent, in early May to 25 per cent, and on 28th May, 1934, to only 10 per cent of the basic "quota." At the same time the President of the Reichsbank announced that the exchange position had become so serious that it would shortly be impossible to make any further transfers on debt account, and a meeting of Germany's creditors was hastily summoned in Berlin. After much acrimonious discussion only a partial agreement was reached, and in June, 1934, the President of the Reichsbank announced that he would be forced to declare a moratorium on all debt transfers, including those in respect of the guaranteed Dawes and Young loans and the commercially guaranteed Potash loan, as from 1st July, 1934.

This grave step was, of course, very badly received in the creditor countries, and in this country a Bill was at once passed by Parliament authorizing the Government to take certain steps to prevent imports from defaulting countries, and to establish "exchange clearing houses" in respect of such countries, as and to an extent which might be found necessary. On 4th July, 1934, an agreement was reached between the British and German Governments under which the latter agreed to pay interest in full, during the ensuing six months, on the sterling issues of the Dawes and Young loans which were in the ownership of British nationals on 15th June, 1934, while the former agreed not to exercise for the same period the powers conferred on it by the new Debts Clearing Offices Act. It may once more be emphasized, however, that all restrictions on the free passage of goods and services between countries must necessarily impair the ability of even the most willing debtor to effect payments since such payments depend on the volume of

exchange available from trading, and a seller prevented from selling becomes a buyer robbed of his purchasing power.

The Crisis in the U.S.A.

A whole book could be written on the causes of the American crisis, the results arising therefrom, and President Roosevelt's "great experiment," and it is only proposed here to touch lightly on the outstanding features. Several references have been made earlier in this book to the unprecedented wave of gambling in securities and real estate which swept over the U.S.A. in 1928 and 1929, and which collapsed in the autumn of the latter year, bringing ruin to thousands. The complexity of the American banking system and the facilities offered by the banks for security operations resulted in an enormous amount of loans becoming "frozen" to the detriment of depositors. At the end of 1929 an amendment to the banking Acts was passed permitting banks to value their security holdings at over the current market prices, and other emergency measures were taken to bolster up the system. Matters were slowly improving until the crisis in Europe in 1931, but the subsequent spread of distrust and the general depression of trade naturally had repercussions in the U.S.A. The finances of several large cities there were very badly managed; "graft" was rife and office went by favour or to the highest bidder. Eventually, the Governor of the State of Michigan felt it imperative to declare a banking moratorium in the last days of February, 1932, and this example was speedily followed by the Governors of other States of the Union, culminating in the State of New York, the financial centre of the country, and leaving only South Carolina with a banking system still working.

On 4th March, 1933, President Roosevelt was elected, and his first act was to ask for the powers of a war-time dictator and to summon Congress. Within a few hours the banking moratorium had been made general throughout the U.S.A., and actually remained in force for nine days. Exchange dealings in the dollar perforce remained suspended during that time as an embargo had been placed on gold exports from the U.S.A., and only small amounts in currency for actual personal needs were allowed to be withdrawn from the banks. The moratorium was lifted and gold exports under licence only were permitted on 13th March, 1933, but only those

banks which could demonstrate a certain amount of liquidity were allowed to reopen, the others being placed under control of the Federal Reserve Inspectors. Some thousands of small banks were found to be hopelessly insolvent owing to unwise lending or direct speculation, and even to-day there are many which have never been allowed to reopen.

Efforts to withdraw or export capital from the U.S.A. at once commenced, and on 19th April, 1933, the President announced that the embargo on the export of gold would be reimposed, and that the dollar would be left to find its own level as a purchasing agent both at home and abroad. He also sent a message to Congress asking for power to be given to the Government to issue Treasury notes up to \$3,000 millions, to devalue the dollar to the extent of 50 cents as and when it thought desirable, to fix a definite relationship between the values of gold and silver and to purchase up to \$200 millions of silver at a price not exceeding 50 cents per fine ounce. The latter clause was doubtless forced upon him by the "silver interests" of the States of Nevada and New Mexico, but in a country where self-interest is paramount it is surprising that he was strong enough to resist the many other strong claims for preference which must have been put before him. These powers were legally given to him by the end of the month, and he proceeded to implement them first by means of a body created in 1931, known as the Reconstruction Finance Corporation, and, later, of a new body known as the National Industrial Recovery Association. The first of these was responsible for the planning of a "managed" monetary system and for the injection into the finances of the country of inflation in successive doses, and the latter for the development of "planned economy" in industry. Unfortunately for the rapid success of these plans, the heterogeneous nature of the American people and their volatile national temperament make them most difficult subjects for such experiments and, for a long time, although the devaluation of the dollar caused a partial rise in commodity prices, the fall in the internal purchasing power of the currency lagged very much behind the artificially depreciated exchange value.

President Roosevelt's avowed aim was to raise prices at least to the 1926 level and to establish a "commodity dollar" the purchasing power of which should remain entirely stable in terms of commodities.

This would presumably be attained by "managing" the currency on the basis of index numbers according to the theory of Professor Irving Fisher. As a first step, inflation was undertaken by means of the issue of treasury notes, relief works, and loans to banks through the Federal Reserve System. The first wave of optimism carried up prices far ahead of the plans, and a halt had to be called. The resulting check caused a serious reaction in the other direction, and his advisers suggested to the President that the time had come to begin the devaluation of the dollar by raising the price of gold. In September, 1933, the President accordingly announced that the Reconstruction Finance Corporation would purchase domestic mined gold at prices above the world level, to be fixed from day to day. As the U.S.A. is not a large producer of gold this step had little effect beyond giving a bonus to home gold interests, and it was soon decided to make the policy more international in scope. The R.F.C. accordingly was authorized to buy foreign gold and the first purchase was made on 23rd October, 1933, at the price of \$31.36 per fine ounce as against a statutory price of \$20.67183. The official buying price of the R.F.C. was raised by easy stages until it had reached \$34.06 by the end of 1933, and a fund of \$50,000,000 (later increased to \$75,000,000) had been sanctioned by Congress for this purpose. The dollar-sterling exchange, which had been steady around \$3.55 prior to the banking moratorium, jumped to \$3.93 on 20th April, 1933, to \$4.55 by 28th July (having touched the former parity figure of \$4.86½ on 19th July), and ranged from \$4.40 to \$5.53 between October and December. The record high level of \$5.53 was touched on 16th November, 1933. It can thus be seen that the exchange value of the dollar bore little relation to the official gold price ruling in the U.S.A. as no sales of gold were permitted, and the export of capital and heavy speculation against the dollar overwhelmed all the normal demands for that currency.

The next stage was reached on 15th January, 1934, when the President asked Congress to sanction the transfer to the Government of all monetary gold in the country, to reaffirm his authority to devalue the dollar to between 60 and 50 cents at his discretion, and to permit the gold holding to be revalued at the new level for the dollar, while, out of the profit on this revaluation, a fund of \$2,000,000,000 should be established to support the exchange value

of the dollar and the market value of Government securities. These powers were at once granted, and the buying price for gold was at once raised to \$34.45 per fine ounce, which gave the dollar a theoretical gold value of 60 cents. This seemed likely to stabilize the position for the time being but the response of commodity and security prices was evidently less than had been hoped, and on 31st January, 1934, the President signed a Proclamation fixing the weight of the gold dollar at $15\frac{5}{16}$ grains of gold nine-tenths fine, which was the equivalent of 59.06 per cent of its former weight of $25\frac{8}{10}$ grains. Simultaneously the Secretary of State announced that the Federal Reserve Bank of New York had been authorized by him to buy and sell all gold offered to or demanded from it at the fixed price of \$35 per fine ounce Troy, less the usual Minting charges when buying, and with a charge of one-quarter of 1 per cent for handling both on purchases and sales. This meant that the dollar was definitely devalued to 59.06 cents, and up to the present it has remained at this level, though the President still has power to devalue further up to a maximum of 50 cents.

The existence of both buying and selling prices for gold once more put the dollar amongst the gold group, and its exchanges with the other gold countries have since only fluctuated between the assumed gold points, though the natural strength of the dollar as the currency of the world's chief creditor nation has prevented any lasting test of the willingness of the U.S.A. to part with gold under the new conditions. The American internal price level index figure has shown much greater variations than has our own, and the original conception of a "stable commodity dollar" appears to have undergone considerable modifications.

Another important measure passed by Congress in June, 1934, was the Silver Purchase Bill which empowered the State to hold both gold and silver as cover for the legal note issue in the proportion of three parts gold to one part silver. To this end, it empowered the Treasury to purchase silver in the open market until the world price of silver should equal \$1.29 per ounce or until the desired ratio is reached, while domestic silver was required to be nationalized and purchased from holders at not exceeding 50 cents per fine ounce.¹ At the end of 1934, gold stocks in the U.S.A. were over \$8,000 millions and by the end of 1936 she had acquired a further \$3,000 millions. Failing any loss of gold, this means that about 2,900 million ounces

¹ Revoked in April, 1938.

of fine silver must be acquired to bring about the desired proportion, unless the price should meanwhile rise to the set figure.¹ By the end of 1937, the total holding, including purchases of hoarded, home-mined and foreign silver, was over 1,900 million ounces, or about two-thirds of the total needed, on the basis of the current gold holding. The first result of this policy on the silver market was to cause such a rise in price as to have most serious effects on China. Where a country has a currency linked to gold, the effect of an artificial rise in the world price of gold is to cause an overvaluation of that currency with a consequent deflationary effect owing to the fall in prices induced by the unduly high value of the currency. This also causes a decrease in exports and an increase in imports until the internal price level is adjusted to the gold value of the currency, but if the latter is far out of economic equilibrium, the former may entail too drastic adjustments in the internal price structure. The same applies to a silver-using country where the world price of silver is forced to an uneconomically high level. From a fair stability of about 18d. per ounce, the silver buying policy of the U.S.A. forced the price of silver steadily upwards until the high level of 36½d. was reached on 26th April, 1935. This meant that the external cost of Chinese exports was doubled, while the cost of imports was halved. No internal monetary manipulation could cope with such a factor, and in November, 1935, the Chinese Government in effect abandoned the silver standard, nationalized the internal stocks of silver, made the notes of the leading home banks legal tender and undertook the management of the exchanges. Similar action was taken by Hong Kong. This evidently caused some change of policy on the part of the American authorities and they withdrew their support from the London market a few days later. The entire artificiality of the existing price was quickly disclosed and the market became disorganized; for the first time in its history, the market was unable to fix any price at all on the 10th December, 1935, in spite of frenzied appeals to the U.S. authorities to come to the rescue. During the next few days, America took a small proportion of the offerings, but the price

¹ All purchases of silver are re-valued at \$1.29 per ounce by the U.S. Treasury. The price for internal newly-mined silver was first fixed at 64.5 cents per ounce (\$1.29 less 50 per cent seignorage); was raised in May, 1935, first to 71.11 and then to 77.57 cents per ounce (40 per cent seignorage); and lowered in January, 1938, to 64.64 cents per ounce or exactly 50 per cent seignorage.

steadily sagged until it varied between 18d. and 20d. per ounce early in 1936. This appears to show that silver can never regain its old status as a currency basis in Occidental countries and is even becoming *démodé* in the Far East. If, in the course of twelve months, purchases to the extent of something over twice the normal annual world production could not permanently lift the world price of the metal, it would seem hopeless to expect the efforts of a lone purchaser, needing not much more than twice the amount, to have any lasting effect. Beyond giving speculators in the metal an unexampled chance of making (or losing) money, giving a temporary bonus to home producers of silver, and forcing China and Mexico into "managed" currencies, it is hard to see what results this further American "experiment" has attained!

The World Economic Conference, 1933.

Following the suspension of gold payments in this country in September, 1931, with which most of the Dominions and Colonies and other countries closely associated with Great Britain were practically forced to conform, a meeting of Empire statesmen was held at Ottawa in July, 1932, to discuss the possibilities of closer trading and financial relations within the Empire. This Conference was known as the "Ottawa Conference," and it eventually arrived at certain arrangements for the supposed betterment of Empire trade (which have since been the subject of no little discussion) and issued a Report on monetary aims which conformed entirely to the theoretical economic views of a higher price level, stable exchanges, cheap money, and a reduction of tariff barriers.

The partial success of this Conference led to more ambitious aims. Under the lead of this country, a canvass was taken of the leading nations and consent was obtained to the principle of a World Economic Conference. A preliminary assembly of "experts" was convened in Geneva late in 1932, and they issued a Report in January, 1933. This Report again followed strictly orthodox lines.

A full World Economic Conference assembled in London in June, 1933, at the expense of the British Government. It was almost entirely abortive, as even the opening speeches of the delegates displayed an entirely nationalistic, as against the hoped-for internationalistic, spirit. Each came prepared to take as much as possible in return for as little as could be forced out of them. The

main hope of arriving at an agreement for at least the temporary stabilization of exchanges was shattered at a very early stage by a message from President Roosevelt to the effect that he proposed to continue his experiment in "managed" currency and industry, that he was by no means prepared to agree to the stabilization of the dollar at its current level, and that other nations had better follow his example in depreciating their currencies by inflation and devaluation, and so attain a higher price level. Strenuous efforts were made to prevent the Conference from being an absolute failure, and minor agreements on wheat prices and a silver policy were eventually signed, but the labour of this much talked of mountain brought forth only a mouse!

The Conference lasted from 12th June to 27th July, 1933, and in its concluding stages a statement on Empire Currency Policy was issued over the signatures of the principal plenipotentiaries of the chief countries in the British Commonwealth of Nations. This statement was again full of pious hopes and aspirations and was, in the main, a repetition of the findings of the Ottawa Conference. It affirmed the decisions regarding the promotion of trade within the Empire and as to the abolition of tariff barriers and trade restrictions. It agreed that a rise in the general level of wholesale prices was eminently desirable, but stated that this could not be achieved by monetary measures alone, though a revival of short and long term lending and the continuance of a cheap money policy would be of material assistance. It re-asserted that the ultimate aim of any monetary policy should be the restoration of a satisfactory international gold standard, with international co-operation to avoid undue fluctuations in the purchasing power of gold. It stated that the main problem was to reconcile stability of exchange rates with a reasonable stability in world prices, and that the definite immediate objective of the signatories was inter-Imperial stability of exchange rates.

The reader has only to consider the course of world events since July, 1933, to appreciate the amount of international co-operation which has been secured. The policy of the U.S.A. has been openly stated as one of inflation and a rising price level. The policy of France, on the other hand, has been equally openly stated as one of rigid adherence to orthodox monetary policy as prescribed by the working of a gold bullion standard, combined with national economy

and a falling price level. The policy of this country is partially stated below. In the multitude of counsellors there is supposed to be wisdom. On the other hand, too many cooks spoil the broth!

Collapse of European "Gold Bloc" in 1936.

As has been described earlier in this chapter, the suspension of gold payments first in this country in 1931 and then in the U.S.A. in 1933, followed in each case by a substantial rise in the price of gold and a partial rise in commodity prices in each country, caused considerable financial and commercial embarrassment to those European countries, headed by France, who were endeavouring to preserve their existing gold standards and the current theoretical gold content of their respective units of currency. Had the rise in general internal prices in both this country and the U.S.A. followed exactly and immediately the rise in the internal price of gold and the fall in the exchange values of the two currencies, the economic pressure on the countries of the "gold bloc" would have been far less severe. As it was, the relative external cheapness of British and American goods *and securities* forced the other countries to attempt to impose further measures of internal deflation in the hope of counteracting the comparative dearness of the exchange value of their currencies (due to their high theoretical gold value) by depressing internal prices. But so many of the items composing production costs cannot be forced below a certain minimum and the contraction of incomes and profits, together with the universal contraction of trade, caused a serious reduction of the taxable national income in each case. The resulting budgetary difficulties and the evident economic weakness of the whole group, particularly France, induced an ever increasing emigration of capital. Gold moved steadily to London and New York and national reserves of the metal rapidly dwindled. By March, 1935, Belgium, as the weakest of the group, decided on a measure of further devaluation and so was the first to admit economic facts and to recede from the uncompromising attitude of the other members of the "bloc."

Although a distinct improvement in internal conditions in the U.S.A. and this country took place during 1935 and early 1936, general world conditions showed little improvement, while in France the deflationary measures had caused widespread social unrest. In spite of increasing measures of control by the French authorities,

both by direct intervention and by enlisting the co-operation of the commercial banks, the export of capital from France continued and the strain on all the members of the "gold bloc" was intensified by the world-wide speculation against their currencies. After a long series of emphatic denials that any departure from the existing form of gold standard would be permitted by any of the governments concerned, the French government announced, late on Friday, 25th September, 1936, that it was forced to suspend gold payments forthwith and that it would ask for legal power to devalue the franc to a then undisclosed extent. It was afterwards made known that for at least three months previously, negotiations had been taking place with the other leading powers to ensure that such a step would not lead to a "war" of currency depreciation so that the eventual decision to devalue was not as sudden as the previous persistent denials of any such intention made it appear. Within a few hours of this announcement the governments of Holland and Switzerland proclaimed their determination not to devalue and to maintain their existing gold standards, but only a few hours later still both of them issued decrees suspending gold payments and, in the case of Switzerland, stating that power would be taken to devalue the Swiss franc.

The repercussions of these events were, of course, tremendous. A good deal of fugitive capital had been turned into gold and hoarded abroad, but there was a vast "open position" all over the world as a "bear" of gold currencies. In London, the Foreign Exchange Market was closed down by official orders on the morning of Saturday, 26th September, 1936. On the following Monday, dealings were allowed to recommence in all currencies other than French and Swiss francs and Dutch florins. Dealings in these two latter currencies were resumed on the Tuesday, but it was not until Friday, 2nd October, 1936, that dealings in French francs were again permitted in the London Market. This delay gave rise to several anomalies. London is normally the most active exchange market in the world, and with such a large speculative position in being, especially against the French franc, a very large amount of covering had to be done. In many cases, operators had commitments falling due on the working days immediately following the announcements and, with the arrival of the event on which they had speculated, were prepared to cover in and take their profits.

With exchange dealings in French francs suspended both in Paris and London, the initial rush of covering orders went to other centres and business was reported from New York and Zürich at rates equivalent to 96 fcs. and 97 fcs. per £ as against the last quoted rate in London of just over 76 fcs. per £. The Bank of France in Paris and the Bank of England in London both announced on the Tuesday that they would supply francs against sterling at this last quoted rate but, naturally, operators took no notice of these offers in view of the very different rates being quoted elsewhere. The following day, francs were "on tap" at both Central Institutions at 96 fcs. per £! On the resumption of dealings in Swiss francs and Dutch florins on the Tuesday, wide fluctuations in rates followed, but these exchanges eventually settled down a few days later to about 21·20 Sw. fcs. and 9·20 fl. per £. Dealings in French francs when the market re-opened on the Friday were not as frenzied as might have been expected, owing to the amount of covering which had already been carried out on speculative account and to the reluctance of fugitive capital to return. Fluctuations in the rate of from under 102 fcs. to over 106 fcs. per £ were seen, but within a few days the "controls" had steadied matters considerably and a month later the rate was being rigidly held. The lack of major disturbance was remarkable, and is a great testimony to the self control of exchange dealers and the efficiency of exchange controls. The subsequent course of the franc has already been dealt with on page 348.

The Tripartite Agreement, 1936.

With the suspension of gold payments by the "gold bloc," no official buying and selling prices for gold existed, and the problem arose of how the various "controls" could operate in currencies which were inconvertible into something of international value. Both the U.S.A. and Holland had, for some long time previously, instituted regulations prohibiting the export of gold to countries from which gold was not freely obtainable, i.e. countries in which the gold bullion standard was in suspense. With the general suspension, save for Belgium, of gold standards in the leading European countries, this regulation in the U.S.A. prevented the authorities there from allowing their Exchange Control Fund to operate in the currencies of those countries while, even between themselves, the European group found it almost impossible to control exchanges

efficiently and safely with no means of settling accounts between each other on some definite basis such as is provided by gold at legally fixed prices. Any Exchange Control Fund must be regarded as a trust account on behalf of the nation, and those responsible for its working must take every care to prevent capital loss even if operating losses are incurred from time to time. If a Fund, in the course of operations to regulate its exchanges, has to buy large quantities of another currency against sales of its own, it must be sure that such other currency has a basic value which can be immediately established in terms of the international standard of value—gold. If such other currency has no fixed gold value and cannot at once be turned into gold at a current equivalent corresponding roughly to the rate of exchange at which the operations were carried out, a capital loss is shown should the foreign currency depreciate from that level. While official gold prices existed in the countries of the "gold bloc," co-operation between their Central Banks, the Bank of England and the U.S. Treasury allowed all holdings of their currencies to be translated at once into gold at the official price. No risk of capital loss therefore existed until the change in conditions prevented this process from being carried out.

After the first few days of experiment, rates between all the leading nations showed signs of settling down and becoming amenable to the new technique of official control. To render control operations possible it was necessary to agree on some basis for the conversion into gold of any official holdings of another currency. After comparatively brief negotiations the U.S.A. rescinded her regulations as against France and this country, and on the 13th October, 1936, the Secretary of the U.S. Treasury announced that a Tripartite Agreement had been arrived at between the U.S.A., France, and Great Britain under which any operations by the respective Exchange Control Funds in the currencies of either of the other parties would be held covered by gold at the price ruling on the day in question. This at once gave a basis on which official exchange operations could be conducted without risk of capital loss, and within a few days Belgium, Holland, and Switzerland announced their willingness to join this Agreement and to operate in similar fashion.

As the price of gold in London from 26th September, 1936, onwards has been based on the U.S. official gold price and as the

franc-sterling, franc-dollar and sterling-dollar exchanges have been largely held stable by "control" operations, the actual effect has been to make the U.S. gold price a world gold price.¹ In practice, it would appear that francs acquired by the British Exchange Fund in the course of any day's operations are at once converted into gold at the parity value produced by the London price of gold and the exchange rate at the "control" level on that day. Francs acquired similarly by the U.S. Exchange Fund are converted into gold at the fixed U.S. gold price on the basis of the "controlled" exchange rate. Dollars acquired by the British Fund are converted at the U.S. gold price and pounds and dollars acquired by the French Fund are converted at the London gold price on that day or at the official U.S. price respectively. The other adherent countries work on the same lines and, in most cases, the gold is merely "earmarked" in each centre and does not necessarily pass into the physical possession of the creditor centre, thus saving the costs of transport.

In effect, therefore, the principal countries in the world are on a new form of gold standard which can be made more or less elastic at the discretion of the authorities. The gold price in centres other than New York can be varied by allowing variations in the respective exchange rates, while the more closely and rigidly the latter are held by the "controls," the less the price of gold will vary in European centres. No doubt the ultimate object will be such control over the exchanges as will reduce daily fluctuations to a minimum while allowing a seasonal or an economic trend gradually to become effective and, at the same time, to fix official buying and selling prices for gold with a much wider margin than formerly to allow the market prices of both gold and exchanges an ample elasticity.

Our Conditions for a General Return to Gold.

Mr. McKenna, of the Midland Bank, Ltd., once stated publicly that a gold standard must be the best standard since the majority of mankind believed it to be the best. Majority rule is not always the best, but if man has pinned his faith to gold as a measure of value, mankind would undoubtedly be more content if that measure of value came once more into general use. In theory it should be perfectly easy to play the gold standard game according to certain

¹ The U.S. Mint will still *buy* gold from anyone at its fixed price, but will *only sell* to parties to the Agreement and then only to Central Banks.

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