

BANK FOR INTERNATIONAL SETTLEMENTS

NINTH ANNUAL REPORT

1st APRIL 1938 — 31st MARCH 1939

BASLE

8th May 1939

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NINTH ANNUAL REPORT

TO THE ANNUAL GENERAL MEETING OF THE BANK FOR INTERNATIONAL SETTLEMENTS

Basle, 8th May 1939.

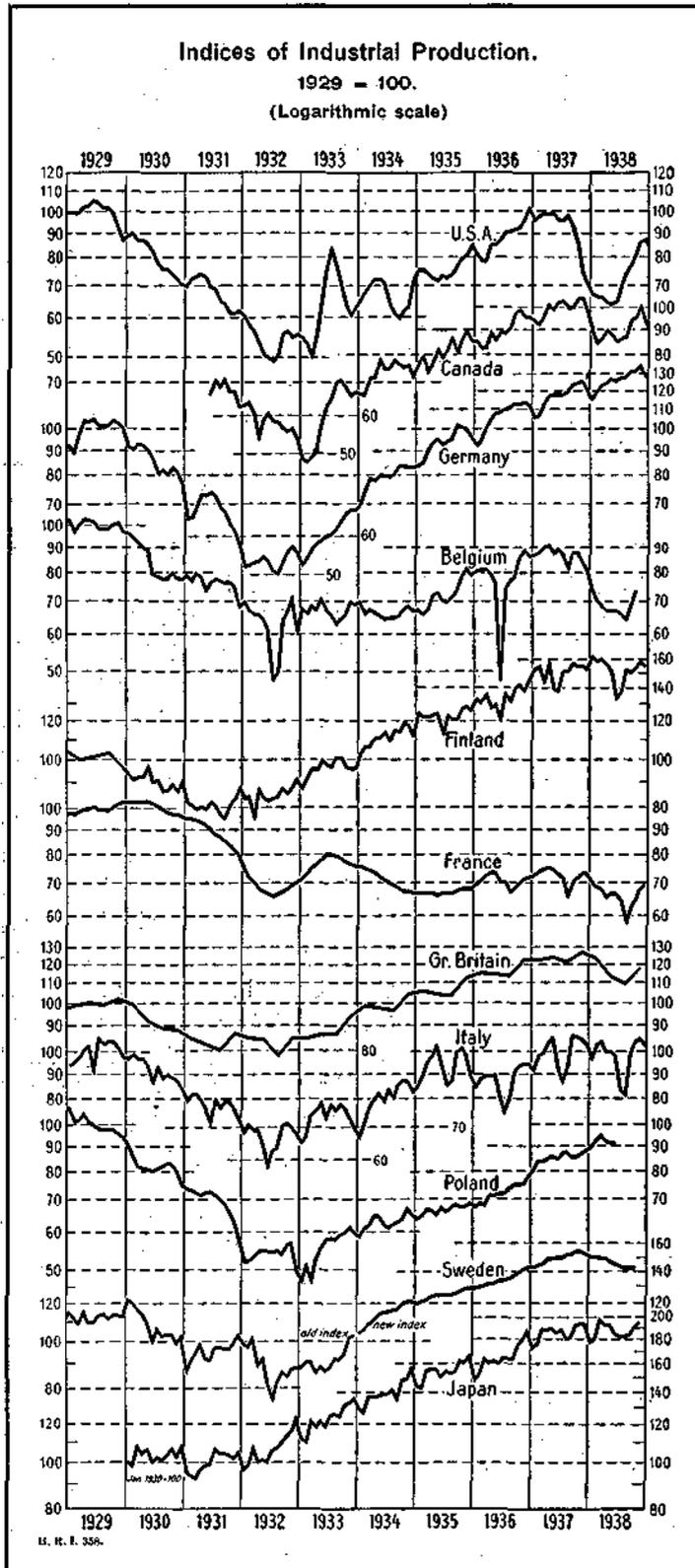
Gentlemen, .

I have the honour to submit to you the Annual Report of the Bank for International Settlements for the ninth financial year, beginning 1st April 1938 and ending 31st March 1939. The results of the year's business operations are set out in detail in chapter VII. After careful provision for contingencies, the Board recommends to this General Meeting an annual dividend of 6 per cent. and the statutory allocation to reserves.

It is not difficult to indicate the reasons why business last year passed through periods of great anxiety. In the opening months of 1938 repercussions of the abrupt decline in American industrial activity that had begun in the previous autumn were felt all over the world, particularly in the export trade. This decline proved the more depressing as it came at a time when there were high hopes of more sustained prosperity in the United States. The general weakness in prices of primary products, a consequence of reduced American demand, and the downward tendency of many other prices called for reductions in costs and other adjustments, which generally met with resistance from interested parties. In countries of the sterling area, which had experienced almost uninterrupted expansion since the autumn of 1932, conditions were ripe for a slackening of internal activity.

To this situation were added exceptional events of a political character, which dealt rude shocks to business and left in their wake a level of armaments and military preparation never before witnessed in times of peace. Among the most striking signs of the political uncertainty was the pressure on sterling caused by mass movements of funds which, with other factors, added \$1,500 million to the American gold stocks in the five months from August to December 1938. More harmful effects were found in the restraints suffered by ordinary business, as initiative was cramped and the will to make new investment weakened. Filling the gap by government orders for armaments and other purposes for the time being helped to sustain employment but necessarily diverted productive power from the pursuit of normal trade and especially tended to impair the export capacity of the countries most deeply involved.

Under the strain of almost uninterrupted political tension, bringing with it general uncertainty as to the business outlook, continuous capital flight from Europe and growing armament expenditure in all countries, the economic development of the world does not, however, show the picture of colourless gloom that one would expect. It lacks, of course, stability and nowhere inspires confidence in the strength of the more favourable tendencies that are at work. The state of the world is feverish rather than healthy; and whatever recovery may be seen is anything but steadfast, since it is dependent on the



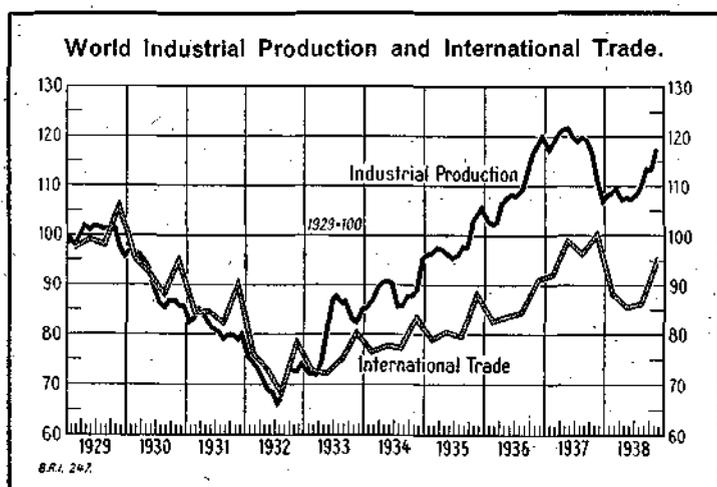
use of stimulants on the one hand and interrupted by grave disturbances on the other.

In the face of grim reality in Europe there is decidedly less belief in experimentation with new methods of economic policy. Too many measures that in former years were discussed as the outcome of economic wisdom were in fact forced on governments by dire necessity. When a violent storm blows up the first task is to avert disaster and to steer as well as possible in face of contrary winds and currents. But on the whole the weather in the past year, although stormy, was not altogether unkind and not all the winds were unfavourable.

First there was the recovery in the United States, which was shown in June 1938 by a sharp rise of security prices and a swift improvement in the volume of production. The abrupt fall in American industrial activity from the autumn of 1937 through the early part of 1938 was suddenly reversed into a rapid rise. From the lowest point the gain amounted to 35 per cent. by December 1938; the volume of production was then, however, still

10 per cent. below the high point in the spring of 1937, when for a short time the level of 1929 had been attained. The recovery in the United States was followed by Canada and Belgium in the course of the summer of 1938. In the last-mentioned country the decline in industrial activity from the autumn of 1937 to the middle of 1938 was particularly sharp, Belgium being very sensitive to changes in the trend of world trade. In Great Britain industrial activity fell by about 7½ per cent. during 1938, but a comparison of quarterly indices shows a revival of activity in the last three months of the year beyond the usual seasonal rise. The Italian volume of production was as high in 1938 as in 1937. In the northern countries — Denmark, Norway, Sweden and Finland — rates of profit were reduced in many lines of business, but the level of industrial production in 1938 was only slightly below that of the previous year. In France, developments from the summer of 1936 influenced the whole country's monetary, economic and social structure — but recently a stage of new equilibrium seems to have been reached. Since the franc was devalued to about Fr. fcs 179 to the pound in the spring and the Reynaud recovery plan put into effect in the autumn, the conviction grew that no further devaluation of the franc need be feared and returning confidence revealed itself most significantly in a steady reflux of capital. In the winter of 1938-39 industrial production began to show distinct signs of revival, the average working week exceeding forty hours early in 1939.

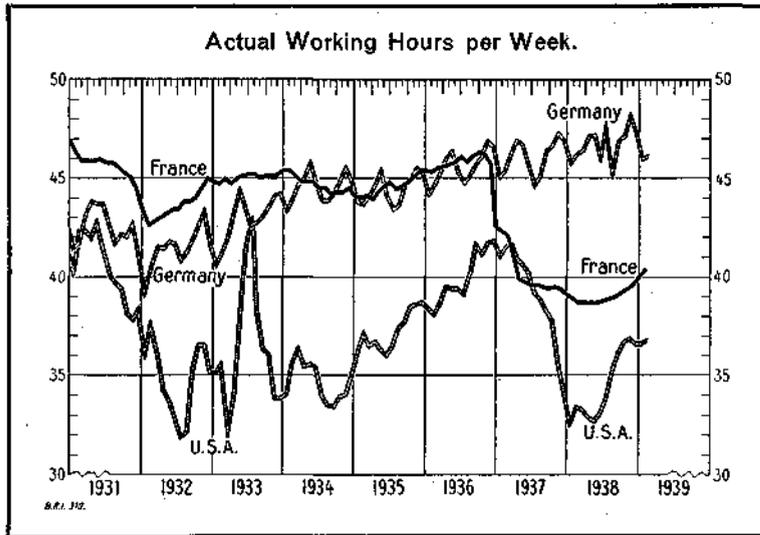
The improvement found in various national economies in the latter half of 1938 is also reflected in the sphere of international trade. While the fall in



the volume of trade during the first quarter of 1938 was definitely sharper than the usual winter decline and the reduced basis reached in the spring continued all through the summer, the upturn in the late autumn was impressive. In the last quarter of the year the volume of international trade was barely 6 per cent. below that of the cor-

responding period in 1937, when — it should be noted — for a single quarter the 1929 level, after an interval of eight years, had again been attained. To realise the significance of this recovery it must be remembered that in 1929 international trade in volume was higher than ever before in the history of the world, reaching a magnitude of 30 per cent. above 1913. Despite the setback on balance in 1938, the volume of the current exchange of goods between different countries still stands, if not quite at a record level, at 15 per cent. higher than the maximum reached in any year before 1914.

The economic development of central Europe continued to show a character of its own under the growing influence of Germany, where the whole of economic life came more and more under the centralised guidance of the government. German industrial production rose by 8 per cent. from 1937 to 1938, thereby setting up a new record of industrial output for the country, about 30 per cent. above 1929. In Germany, the economy of its greater territory being moulded to a centrally planned scheme, the stage of full employment has been passed and whilst many countries are still faced with the problem of unemployment the policy of huge and increasing investment makes Greater Germany the one country in the world with an actual shortage of all the factors of production. In these circumstances average hours worked in industry have continued to increase. Indeed, everywhere business activity, employment and average working hours tend to rise and fall together. In this connection the accompanying graph, showing actual hours worked in France,



Germany and the United States for the period 1932-39, is particularly interesting. Caution is, of course, necessary in making international comparisons of this sort; the German figures, for example, rather understate hours actually worked, but the general impression of the trends given by the graph is correct.

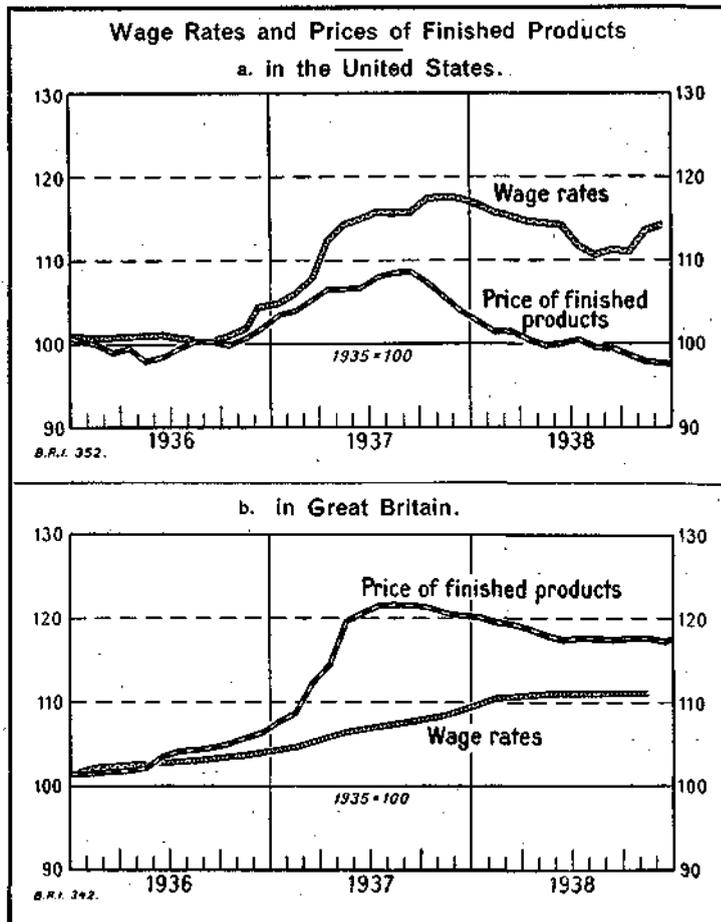
Productivity or efficiency per worker has increased considerably in the past fifty years (largely owing to new inventions and the greater use of machinery) and this increment of production has allowed a rising standard of living, both by increasing the quantity and quality of goods and services available and by permitting more leisure to the worker. During the past fifty years the average length of the full-time week of factory employees in the United States declined by 30 per cent., from 60 to about 42 hours. Similar but less marked declines occurred in other countries, recently, however, interrupted by the exigencies of increased armaments production. At present the full-time week in Japan is close to 60 hours; in the United Kingdom, Germany and many other countries the 48-hour week is the most common; the average full-time week is estimated for the United States at 42 hours and in France the previous limit of 40 hours has, under recently issued decrees, been superseded by the normal week of 45 hours.

Although increased efficiency has enabled industry to stand a secular decline of working hours accompanied by rising wages, yet experience has

demonstrated that abruptly forced decreases of hours or increases of wages may, by their dislocating effects on the cost structure, be extremely unfavourable to a continued upswing of the business cycle. Reductions of hours of work made in some countries to "spread employment" have notably failed to achieve their object. At most it has been possible to stem the tide, as is often the case with measures of government interference. Exchange restrictions, import duties and export premiums may prevent conditions from getting worse in the country where they are employed, but they rarely help to make them better. And it is doubtful how far their influence even on the internal economy of a country is really as effective as it appears, though account must be taken of a particular combination of circumstances in some countries, which explains their special policy. As to the fostering of employment, it may be said, on the basis of the experience of recent years, that all experiments have failed except those that lead to increased production either by direct government management of the whole economic system or by creating the one condition necessary for increased investment by private enterprise, i. e. a just equilibrium between cost and prices.

It was a feature of the boom in the United States during the winter of 1936-37 that costs of production rose at an unusually rapid rate. Prices of

primary products increased by fully 30 per cent. from the autumn of 1936 to March 1937; the dangerous effects of so sudden a rise were fully recognised by the authorities; in February 1937 President Roosevelt uttered a warning "that prices were too high". But there does not appear to have been, at the time, the same realisation of the danger involved in the sudden rise in wage costs, although the advance in hourly wage rates of the leading industries in the United States was unusually rapid, amounting to no less than 15 per cent. within a period of



seven months and exceeding the simultaneous rise in the prices of finished articles.

There can be no doubt that the rise in costs of production was one of the main causes of the precipitous decline in industrial activity of the United States during the second half of 1937. With a more gradual advance in wage rates the chances were that a greater number of unemployed would have been absorbed by industry, increasing the purchasing power in the hands of the public without the same risk of an early setback. Not even the most extensive distribution of purchasing power by the government nor the persistent pursuit of a cheap-money policy succeeded in bringing about a lasting recovery when costs rose so much as to be out of line with current prices of finished articles.

In France before the devaluation in 1936 commodity prices had fallen more than wages, though in each of the years 1930-36 "purchasing power" was distributed from budgets balanced only by means of large public borrowing. French industrial activity continued to decline. Under the régime of far-reaching price control established in Germany, industrial and commercial businesses were allowed an appropriate margin of profit to enable them to carry out their economic tasks; to prevent a general rise in prices the principle was adopted that wage rates should be maintained unchanged but at such a level that an adequate minimum income would be secured for the workers.

For a policy of public works to be helpful as a stimulus to trade, it must be framed not as a substitute for but as part of a general endeavour to bring about a return to equilibrium in the economic system; the individual methods of application should be governed by this overriding consideration. Care must be taken particularly lest the carrying-out of an extensive policy of public works intensifies a disequilibrium already existing. The inauguration of such a policy usually involves starting publicly-financed construction on a large scale; and the consequent demand for labour may easily lead to a rise in wages. As a natural recovery in the building trade has proved to be a most reliable — not to say indispensable — element in a general revival of business, an increase in building costs may be very detrimental in that it may more than offset the beneficial effects of the immediate extra employment in the trade.

Much attention has been devoted to the Swedish public-works policy in the years 1932-35 when, in order to stimulate business and give some temporary work to the unemployed, fairly substantial provisions were made in the budget for increased spending of public money, the charges being met by a temporary increase in the national debt. It is of some interest to note that, notwithstanding the inauguration of this policy (and the depreciation of the Swedish crown in 1931), the wages of Swedish workers, including those in the building trade, were reduced by 4 to 10 per cent. in the period 1931-34. A Swedish Royal Commission reporting in 1938 on conditions in the building industry ascribed the intense development of building in Stockholm during the years 1934-37 largely to the reduction in building costs and to the low interest rates at which money had been readily available for house financing. With the improvement in

Swedish business from 1934 to 1937, not only was the cut in wages which had been conceded during the depression fully restored but additional increases were obtained in most branches of industry. The policy thus pursued, which has led to a remarkable reduction in the number of unemployed, has been as much in the interests of labour as of the employers.

Equilibrium in the Swedish cost and price structure was thus re-established, on the one hand, by a reduction of costs (decrease in wage rates, etc.) and, on the other, by a series of expansionist measures including the inauguration of a public-works policy and the gradual application of cheaper money rates, which in a measure also served to reduce the cost of production. If Swedish experience be compared with that of other countries, it may be concluded that one-sided reliance on expansionist measures is a dangerous line of policy; neither cheap money nor the spreading of purchasing power through the budget or by increases of wages has anywhere brought about a sustained revival of business so long as the re-establishment of a real equilibrium within the cost and price structure has been impeded by internal or external causes.

It cannot be overemphasised that the establishment of those conditions which make for a more lasting recovery of industry is indispensable for a general improvement in the standard of living. All available evidence shows that in times of rising output labour receives proportionately as large an increment as capital and absolutely a bigger gain, since labour's share of the national income is by far the larger. The attainment of equilibrium in the cost and price structure should not be regarded only as a question between labour and capital; it directly affects the general question of increasing the volume of employment. For after all the absorption of the unemployed must depend upon the attraction of labour to expanding activities, producing goods and rendering services for which the demand is growing, from other activities (and among them in many countries agriculture) in which there is relative overproduction. A sharp rise in wage costs in the go-ahead industries must increase the cost of the finished products and thus limit sales; it will also stimulate the use of more labour-saving machinery and in that way further reduce the demand for labour. Less labour will thus be employable in these industries, which usually are those already paying the highest wage rates, and conditions in other occupations will be pro tanto adversely affected.

There is no doubt that the problem of transfer of labour from one occupation to another has become more difficult to solve in recent years and especially in comparison with conditions ruling before the world war when the leading industrial countries in Europe and America, thanks to a great natural increase in population and great freedom of migration, were expanding more rapidly than at present. If, for example, in the first decade of the present century the number of workers in a given industry became excessive, it sufficed, as a rule, to abstain for a few years from engaging new workers in that industry, leaving the young people entering the labour market to seek their first employment in other industries. The natural ex-

pansion of demand from a growing population could be relied upon to bring about equilibrium almost by itself. Only by way of exception was the progress of rationalisation so rapid as to upset the functioning of this mechanism. At present conditions are in many respects different. As far as the increase in demand is concerned, it will not be brought about in the same degree as previously by an increase in population but will rather be the result of a rise in the standard of living. One important effect of this change is that a gradual increase in the demand for more or less the same kind of goods can no longer be expected but there will be considerable shifts in the direction of the demand. Furthermore, account must be taken of changes in technique affecting the number of workers required in different industries. As a consequence, the leading industrial countries are increasingly faced with the most difficult problems of transferring workers who have already become qualified in some particular industry to other occupations. Coal-mining is a case in point. From 1901 to 1911 the number of coal miners in Great Britain increased by 36 per cent. from 752,000 to 1,021,000; from 1924 to 1938, on the other hand, the number fell by the same proportion from 1,214,000 to 777,000, while output declined by 15 per cent. only. The demand for coal, it is true, has been affected not only by the more stationary character of the population but also by competition from oil and electricity; but for that very reason it illustrates well the difficulties which have arisen.

The expansion in the boom years 1927-29 was most marked in a number of relatively new industries — artificial silk, automobiles — while many older industries in the United States as in the United Kingdom and Germany hardly took part at all in the expansion; the 1927-29 boom was, in other words, much less "all-round" than the upward swings in earlier times. Thus the various countries are confronted by a series of problems which did not arise in the same intensity before the world war. Conscious efforts are the more needed to overcome the many causes of friction which a more complicated organisation of society necessarily involves and to facilitate the entrance of workers into other trades than those in which they have been originally employed. The importance of finding a solution to these problems extends far beyond the particular sphere of the labour market; for upon mobility of labour and a fair distribution of costs between different occupations depend the attainment of a healthy development of industry and a more even dispersion of income between different employments. No monetary policy can by itself mend the mistakes which arise from an unbalanced direction and remuneration of a country's productive forces.

Be it said at once, however, that it is not intended to minimise the part played by cheap money in overcoming the depression of 1930-33. In the active post-war decade the capital loss suffered during the war was quickly repaired in many countries and important additions were made to capital equipment all over the world. As a result it became an indispensable condition for the maintenance of economic and financial equilibrium that interest should be brought down from the relatively high post-war level to rates more in conformity with those ruling before the world war. In fact, it was necessary, at least in some countries, to reduce rates below the pre-war level in view of the more

stationary character of the post-war population in the western world and the downward tendency of commodity prices from 1924 onwards (as compared with the rise of about 30 per cent. in the price level from 1900 to 1914). In the United Kingdom the conversion of the huge block of War Loan from 5 to $3\frac{1}{2}$ per cent. in 1932 paved the way for a general reduction in long-term rates. In the United States, a debtor country before the war with interest rates well above the standard in the richer European countries, the transformation to a creditor as well endowed with capital equipment as any other country necessitated a downward adjustment in the interest structure the more difficult to achieve as there was no precedent for really low rates, or, rather, none outside the short-term market in New York; and, moreover, the important field of mortgage financing suffered from a serious lack of organisation, impeding the necessary adjustment.

It seems, however, as if in wide circles the conclusion had somewhat hastily been drawn that the cheap-money policy, having proved beneficial as a means of overcoming the 1930-33 depression, should be maintained unchanged in future to serve as a basis for business prosperity and, as a consequence, that no increase should be made in the official discount rate of the central bank. As strict adherence to a cheap-money policy would deprive the central banks concerned of one of the most important means at their disposal to influence credit conditions in the country, it may be well to consider the main stages of evolution through which the principles governing the credit policy of central banks have passed.

(i) Under the régime of the pre-war gold standard any relatively important flow of gold to or from a market had its effect on bank rate. Before the war movements of short-term funds, such as are now called "flight of money", were exceedingly rare, and movements of gold were therefore more often than now the reflex of some change in the current account of the balance of payments and also, as a rule, in the rhythm of business activity in the various countries. The result was that a rise in the official discount rate would normally be applied to check an undue expansion of business activity; in that way the pre-war "automatic" gold standard worked perhaps more intelligently than some now believe.

(ii) After the war gold movements unconnected with changes in the current account of the balances of payments became frequent and were a source of embarrassment to monetary authorities. It was soon obvious that these gold movements could not be allowed to influence credit conditions in the markets without harmful effects on ordinary commercial transactions; the English Macmillan Committee, in its Report in 1931, dealt with these problems and made certain recommendations, which more in theory than in substance differed from what had been customary before the war. The Committee pointed out (on page 152 of its Report) that "the exchanges may prove adverse to us either on account of a trade or investment expansion at home of an inflationary character or on account of the movement of capital items resulting from the performance of our function as a centre of international finance", and it continued:

"We recommend an increase in the Bank's resources and a free use of these increased resources in appropriate circumstances, because our business of international banking on a great scale may prove incompatible with the reasonable stability of domestic business and enterprise if we cannot afford to allow a movement of even ten per cent. in our liquid international liabilities without taking steps most upsetting and sometimes highly injurious to our domestic trade. But it must not be inferred from this that we are in favour of any hesitation in the use of bank rate and credit contraction when the immediate problem of management is to check boom conditions or rising prices at home and is not primarily concerned with movements of foreign capital."

(iii) There has now developed a body of opinion which does not admit the need of raising the official discount rate simply because there is a deficit in the current account of the balance of payments but recommends that an increase in the discount rate should be limited to those cases where business activity is expanding unduly, it being emphasised that a deficit may occur in the balance of payments even when the domestic economy is on the whole in a depressed condition. It is argued that a country which is no longer on the gold standard may remedy a disequilibrium in the current account of the balance of payments by altering the rates of exchange instead of enforcing a restrictive credit policy.

The example is often given of conditions in Great Britain after 1925, it being argued that the difficulties through which the British economy then passed were the result of an overvaluation of sterling. Here, it is thought, was a case in which a relatively high bank rate had to be maintained as the exchange was out of touch with the "purchasing power parity"; and thus British economy had to suffer. Reviewed in conjunction with later developments, the effects of a return to the gold standard and of the somewhat restrictive credit policy of the following years appear less formidable than they were often said to be. It must not be forgotten that in the years 1925-30 unemployment was on an average well below 1½ million and that the current account of the balance of payments was on the whole in equilibrium; that the volume of world trade reached a figure some 30 per cent. above the pre-war level, which would have been unlikely without stable exchanges; finally, that the depression which began in 1929 became most acute in the United States, notwithstanding the fact that the dollar was certainly not overvalued, considering the great export surplus and lending capacity of the United States in the post-war decade. This may all be past history, but such views still play a rôle since the intensity of the depression in 1930-33 is often thought to have been due to the re-establishment of the gold standard in the post-war decade and the maintenance of stable rates of exchange. If on the contrary the experience of the years 1925-30 can rather be quoted in favour of stable exchange rates, the ground will be cleared for a more rational consideration of the whole problem of exchange relationship and credit policy.

The reliance upon alterations in the rates of exchange in relation to other currencies has its obvious limits. The depreciation which would be required may upset commercial relationships, or involve a break with an exchange stability of proved value as a means of promoting trade and general confidence

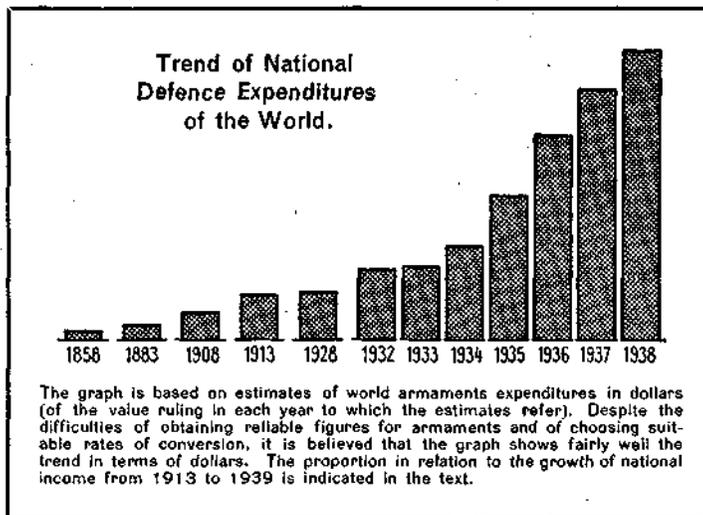
(as e.g. within the sterling area). If, in a situation where an alteration of the rates of exchange seems undesirable, a country finds that its costs and prices are unduly high (whether or not this leads to a disequilibrium in the balance of payments) and no general measures of credit restriction are allowed, the result may be that the economy of that country remains in an unadjusted position; and this is certainly one of the most effective means of perpetuating a high degree of unemployment.

Looking back on developments in recent years, there can be little doubt that if in the late autumn of 1936 a warning had been given by an increase in bank rate business people would have become more hesitant and as a result avoided the unduly large purchases of stocks, the raising of prices and the substantial increases in wages. By this hesitation a more balanced position would have been maintained and a great decline in industry and employment would have been avoided.

There are thus some obvious dangers involved in a policy of abstaining from increasing bank rate as a means of preventing the emergence of disequilibrium in the cost and price structure, especially when there is often little reason to expect that such a rise will lead to any serious restriction in the use of credit. The purely mechanical effect of a rise in bank rate is generally of less importance than the psychological effect, i. e. the warning signal given by the monetary authority. An increase of one per cent. in bank rate does not as a rule materially increase costs for the users of credit and certainly not much for the holders of commodity stocks. The psychological effect, on the other hand, can be very great and in many instances sufficient to check a tendency to undue expansion. One danger is indeed that the warning may be too much heeded. It seems as if the general public and the political and business worlds had become so used to cheap money and so persuaded as to its beneficial effects that an increase in bank rate (intended simply as an admonition to caution) might be taken as a sign of grave times to come. That being the case, the idea has to be stressed that the use of the bank rate can only partially, if at all, be replaced by other means of action. Other kinds of warning can easily cause a "scare" with highly undesirable and unforeseeable effects; and the imposition of official and unofficial embargos seems to suffer from the disadvantage that a reversal of policy when conditions have changed may be difficult to ensure, while a reduction in bank rate may be made at the earliest appropriate moment. It is possible that only after changes in bank rate have been made will the business public and others emancipate themselves from the tendency to overrate cheap short-term money and appreciate the true significance of the changes. The Macmillan Committee (page 132) urged that central banks should not be afraid of small and frequent changes in bank rate. "Such small and frequent changes", continues the Report, "would also have the advantage of accustoming the public not to attach undue importance to every necessary adjustment."

In 1938 only one European country — Belgium — had recourse to an increase of bank rate when confronted with a violent outflow of funds.

Generally, however, short-term rates remain very low or are still declining. In London the rate of discount on Treasury bills was hardly affected by the efflux of funds. Long-term rates have, however, been rising in London for the past four years. The increase in the second half of 1938 is to be associated with the capital outflow but the first sharp rise came in the spring of 1937 at the time when the armaments programme and the consequent heavy borrowing were announced. It may be recalled that in the period from 1900 to 1914, under the influence of increasing armaments expenditure and rising gold production, long-term interest rates rose on the London market from approximately 2½ to 3½ per cent. The amounts spent for armaments are now incomparably greater both absolutely and relatively than they were before 1914.



In the ten years from 1903 to 1913 armaments expenditure of all countries about doubled, while in the ten-year period from 1928 to 1938 the increase was not less than sixfold, as shown in the accompanying graph.

If this expenditure is compared with the national income the following proportions are obtained: in 1913 the total army and

navy votes in the United Kingdom amounted to about £77 million, say, 3½ per cent. of the national income; in 1939-40 the amounts to be devoted to armaments are budgeted at £630 million, representing about 14 per cent. of the national income or fully four times as much as the pre-war percentage. Similar proportions are found in some other countries as well and give an indication of the exceptional magnitude of current armaments expenditure. Moreover, the permanent burden threatens to be higher, for one aspect of present armaments is the rising amount required for maintenance and replacement, modern material — aeroplanes, guns, ships — being very expensive while, in addition, the running costs are high and much of the material soon becomes obsolete.

It is, of course, inevitable that an outlay on such a scale must exert a strain on finance and productive effort, impairing the possibilities of social improvement and even directly reducing the standard of living. From a financial point of view the immediate problem of the Ministries of Finance is to provide the necessary cash, whether through taxes or loans, in such a way as neither to endanger the purchasing power of the national currency at home nor to upset the balance of payments in relation to countries abroad. The safest policy

is doubtless to cover as much as possible of the expenditure from taxation, but on such a scale the hundred-per-cent. application of this policy is hardly possible, meeting as it does with obvious psychological resistance and being in some ways technically harmful to the development of maximum production. The aggregate of budget deficits in the world today covered by borrowing exceeds \$1,000 million per month.

To limit the burden of armament financing the governments will naturally be anxious to borrow on the cheapest terms. That does not mean, however, that the Ministries of Finance need be opposed to an increase in bank rate when required by market conditions. An advance in short-term rates may be only partially reflected on the long-term markets and not cause an addition to the burden on the budget such as might at first be expected. But no budgetary consideration can equal in importance the predominant interest of maintaining equilibrium in the cost and price structure so as to prevent a setback in trade and industry. The somewhat higher cost of the floating debt is trivial compared with the cost to society as a whole (and therefore also to the government finances) of a serious setback in business of the kind which occurred in the recent recession when industrial production in the United States fell by one-third from September 1937 to May 1938. The adoption of a flexible policy would, of course, in no way interfere with the working of the modern technique of preventing international movements of funds from exerting an undue influence on credit conditions in the markets affected.

One of the anomalies of the present situation is that the abundant gold production has been absorbed in relatively few centres, the consequences being that in these centres a very high degree of liquidity is found, based on the large gold reserves of the central banks and high cash reserves in the hands of the commercial banks. In so far as previous experiences may serve as a guide, it may be recalled that the first result of the new gold obtained from the Transvaal in the 'nineties of the last century was to create a large measure of liquidity and very low interest rates on the short and long-term markets. As, however, under the influence of the large gold production, commodity prices began to rise — with a lag of perhaps five to ten years — manufacturers and merchants needed more working capital to finance the holding of stocks; at the same time profit rates began to rise, stimulating the investment of long-term capital; and soon interest rates stiffened. If, with the abundant gold production of to-day, a definite rise in commodity prices takes place, interest rates should again begin to move upwards. An artificial insistence on cheap money would then most certainly have a disturbing effect on the credit system, with untoward repercussions on economic life generally.

In the international field normal credit relations for commercial purposes are maintained between those countries which have free and relatively stable currencies, and the exchange of goods between these countries still represents two-thirds of world trade. In relation to countries with exchange restrictions the normal international credit mechanism can function only in a limited measure, though efforts are being made through the granting of special export credits and the purchase by central banks of export bills to provide as much as possible

of the ordinary facilities. It cannot, however, be expected that settlements resulting from purely commercial transactions will offset each other completely either in amounts or in time; there will always be — in the cash and still more in the forward markets — debit or credit balances to be taken care of by other than commercial transactions. The normal functioning of the credit system presupposes a certain amount of financial credits; therefore when attempts are made to distinguish between desirable and undesirable credit transactions in order to eliminate speculation, what is to be regarded as "desirable" cannot possibly be restricted to purely commercial transactions, for such a restriction would interfere with the proper working of the markets. Before 1931 differences in pressure between the different money markets were speedily evened out by an inflow or outflow of banking funds. When there was an increase in the flow of financial funds from one market to another beyond the normal requirements of seasonal and similar changes, the fault was not in the credit system, which continued to pursue its function of equalising the pressure of credit, but in underlying disturbances affecting the whole range of international capital movements. The crisis which developed in 1931 has, more effectively than even the war of 1914-18, put out of action the system of banking credits from one market to another. It is particularly when an attempt is made to restore the old facilities that the advantages of the previous sensitive mechanism functioning in a world of stable exchanges are best realised.

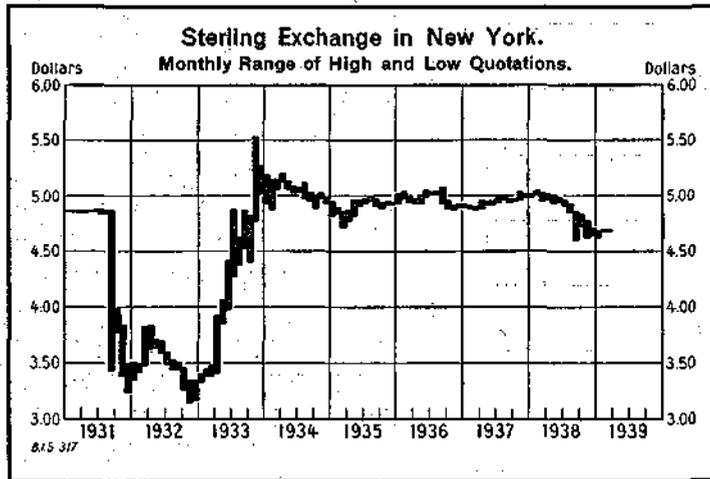
The Bank for International Settlements closely follows the working of the various credit measures taken to promote foreign trade and has itself assisted in providing certain facilities for the financing of commercial transactions. In this way some useful credits have been given, though the scale has necessarily been limited, and, in addition, an increased understanding has been obtained regarding the part that banking funds may play in the restoration of the world's credit system. The Bank for International Settlements seeks to continue the work it has started and is glad to be able to do so in close contact with the various central banks. For though in a period of great international tension its daily business consists mainly of purchases and sales of foreign exchange and gold for central banks, the attention of the Bank must still be devoted to the purpose of promoting, as far as may be possible, the regular intercourse in currency, credit and trade between the nations of the world.

II. EXCHANGE RATES, FOREIGN TRADE AND PRICE MOVEMENTS.

1. EXCHANGE RATES.

Under the influence of an expanding volume of world trade, the year 1937 witnessed the re-establishment of exchange stability in a higher degree than in any year since 1931. Unfortunately this achievement was not consolidated in 1938 when, on the contrary, a distinct setback occurred, caused by the fall in raw material prices, which adversely affected the balance of payments of the primary producers, and by the international political situation, which caused a heavy outflow of nervous funds from London and some other European centres primarily towards New York.

During certain periods of intense political unrest the foreign exchange markets displayed unusually great activity: but the extent to which the world's exchange position deteriorated during the year should not be exaggerated. Over the year 1938

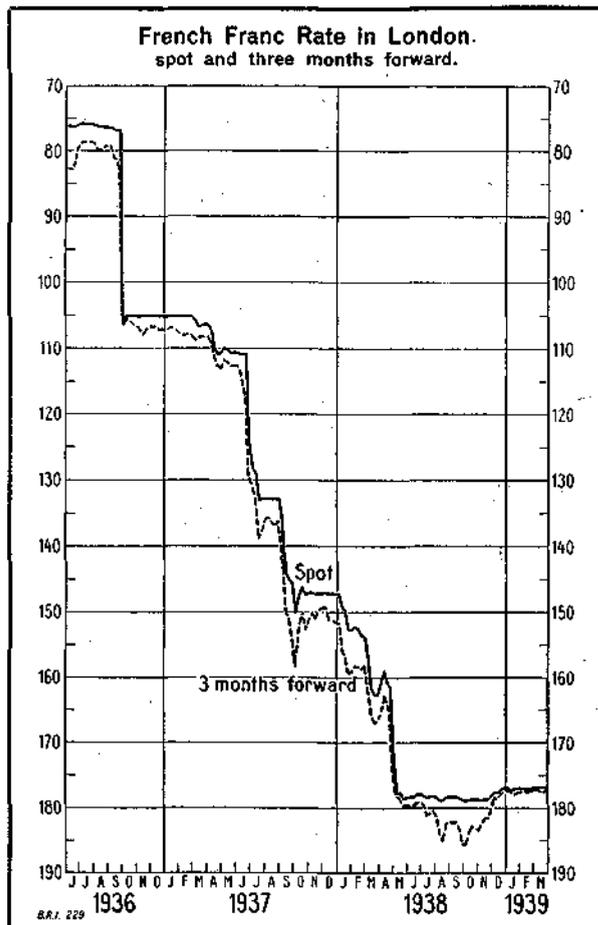


the exchange value of sterling declined by 6½ per cent., but even so the sterling-dollar rate was kept generally within about 4 per cent. of the old par, while inside the sterling area itself no single defection occurred. The raw material producing countries which suffered from the fall in the prices of their products kept, as a

rule, a strict supervision over the declines of their exchange rates and, in some cases, lost only whatever improvement they had made in the previous year. Moreover, the French franc, which in the first four months of 1938 fell by 18 per cent., was held from May onwards and, towards the end of the year, attracted a measure of confidence, which found its expression in a substantial repatriation of funds.

The fate of the French franc since the devaluation in the autumn of 1936 has been dominated by domestic rather than by world developments, i. e. the determining factors have been the movements of French costs and prices, the volume of French production, the methods of financing the budget deficits and, finally, the attitude of the French public as to the probable future value of the currency. As, in recent years, there has been practically no foreign money in the French market, foreign transactions have had little influence on the value of the franc.

Following the increase in French costs and prices in the latter half of 1936 and the beginning of 1937, the advantage which had been obtained by the devaluation of the franc to 105 to the pound in September 1936 was soon



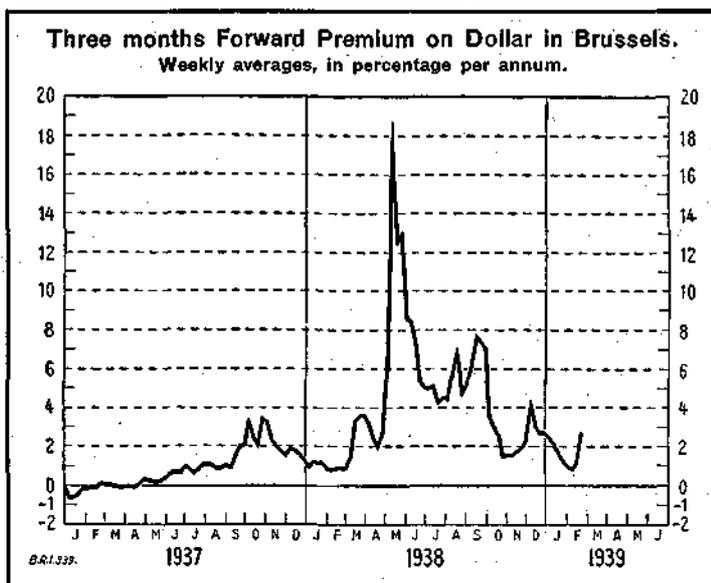
lost. The downward adjustment of the rate in June 1937 to about 133 francs was helpful in bringing about a better balance in relation to foreign countries but no real confidence was restored and further declines occurred in rapid succession during the latter half of 1937 and the beginning of 1938.

On 5th May 1938 the franc was established at 179 francs to the pound, a rate which the President of the Council in a radio communication of the previous day had declared to be the low limit for the future. As it was felt that this was a rate at which the franc could be effectually defended, forward commitments began to be liquidated and this was the main cause of the substantial and rapid influx of capital, estimated at Fr. fcs 16-18 milliard, which followed. In July and August, however, the market turned against the franc; the franc-sterling rate was held

within the announced limit, though only with the help of the greater part of the exchange fund's resources. During the crisis in September the Bank of France extended considerable credit facilities to the commercial banks and other credit institutions, to industrial and commercial firms and to the government, the note circulation increasing by Fr. fcs 22½ milliard from 1st to 29th September. The pegging of the franc at between 178 and 179 to the pound, however, became easier since the outflow of capital from France ceased altogether during the height of the crisis. On 5th October 1938 the government received increased powers from parliament and issued, in the course of the following month, a number of decrees designed to re-establish equilibrium in the ordinary budget, to make the application of the 40-hour week more elastic and to revalue the gold holdings of the Bank of France. A proposal for the introduction of exchange control was rejected on the grounds that such a measure would be difficult to apply; that it would lead to profound modifications in the domestic economic situation and also alter the relations

to foreign countries (determined in the currency field by the Tripartite Agreement); finally that it represented a negative attitude, being merely an attempt to prevent a further outflow of capital, while the real objective should be to ensure a reflux. Under the influence of the measures taken by the government, increased confidence was established and in the winter of 1938-39 Fr. fcs 16 to 20 milliard are estimated to have been gradually repatriated, representing mostly, it would seem, funds belonging to commercial and industrial enterprises in need of increased working capital as prices stiffened and production rose. Simultaneously the three-months forward rate on sterling, which in the early months of 1938 had been quoted at a discount equivalent to an interest rate of 10 per cent. and more per annum, was reduced to much more normal proportions, indeed, at times brought back to par. Contrary to previous experience, notably in October 1936 and May 1938, the favourable tendency of the franc showed itself durable and continued throughout the winter, notwithstanding the uncertainty in the international political situation. Thanks to the return flow of funds during the last quarter of 1938, capital movements over the year as a whole appear to have been substantially in equilibrium. The current items in the balance of payments also showed some improvement: the combined trade balance of the home country and the colonies was adverse to the extent of Fr. fcs 15 milliard in 1938 as compared with 18 milliard in the previous year. An increase in the domestic coal production from 45 million tons in 1937 to 48 million in 1938 made it possible to reduce imports of coal, a fact which brings out one aspect of the close connection between the volume of domestic production and the state of the balance of payments.

The decline in the value of the French franc in the spring of 1938 had its repercussions on the currencies of other countries and particularly on the Belgian franc, which in the first half of May sustained an attack of extreme intensity. At first the Belgian commercial banks were able to finance the demand for foreign currencies from their own liquid resources, but on Monday, 9th May, heavy demands were made for credit facilities to the National Bank, which was thus in a position to make its influence strongly felt. On Tuesday, 10th May, bank rate was raised from 2 to 4 per cent. and on the same day the President of the Banking Commission (at that time also Governor of the National Bank) conferred with representatives of a number of the most important banks and secured their co-operation in a programme designed to restrict to a minimum the granting of new credits and to prevent credits already granted from being used for other than normal commercial purposes. Moreover, the National Bank itself, before lending to a commercial bank, made sure that the bank in question had fully utilised its own resources and that none of its cash in Belgian currency was used for swap transactions. While maintaining the spot rate of the franc at the gold export point, the National Bank did not intervene to support the rates in the forward market but allowed these rates to depreciate sharply. The primary object of this policy was to make speculative selling difficult and expensive; and, in fact, forward rates widened on certain days to discounts corresponding at times to 30 per cent. and more per annum — these rates being, however, largely nominal. If the National Bank had supported the forward rates it would have been easier



for those desiring to sell Belgian francs forward to find a counterpart for their transactions. Moreover, the amount of domestic currency that could be presented to the National Bank as cash payment for gold was necessarily limited, while the amounts which could be utilised to buy foreign exchange in a forward market wide enough to provide sufficient counterparts would

have been very considerable. Intervention in the forward market would have been equivalent to a direct extension of credit, thus running counter to the principles of defence through restriction of the domestic credit volume.

This attitude of the National Bank in refraining from supporting the forward market while the franc was under pressure and when intervention would have aided speculation (rates charged would in any case probably have been too high to enable commercial firms to enter into their normal commitments) does not exclude a policy of assistance in more ordinary circumstances or by special methods. In its Annual Report for 1938 the National Bank of Belgium explains that it has intervened from time to time on the forward rate in order to ensure a wide and regular market and adds: "To the extent to which the activity on the forward market corresponds to the cover of normal exchange requirements, such an initiative is justified by the close relations which exist between this market and that for short-term money."

Already in the second half of May the outflow of funds was largely arrested, and in the first week of June gold began to return and continued to do so with insignificant interruptions to the end of the year. From 28th April to 1st June 1938 the gold efflux amounted to B. fcs 4,540 million, of which over one-quarter may be considered to correspond to withdrawals of foreign-owned funds (in the form of deposits, notes, etc.); of the remainder about one-half represented flight of Belgian capital, speculation, etc., and the other half the deferred covering of commercial debts in Belgian francs and anticipated payment of debts in foreign currencies. It is of interest to underline the magnitude of this last item, for the importance of a shift in the dates and terms of purely commercial payments is generally greatly underestimated. In the case of Belgium the effect was, however, of only a temporary nature and hardly affected the yearly figures of gold losses. For the whole year 1938 the

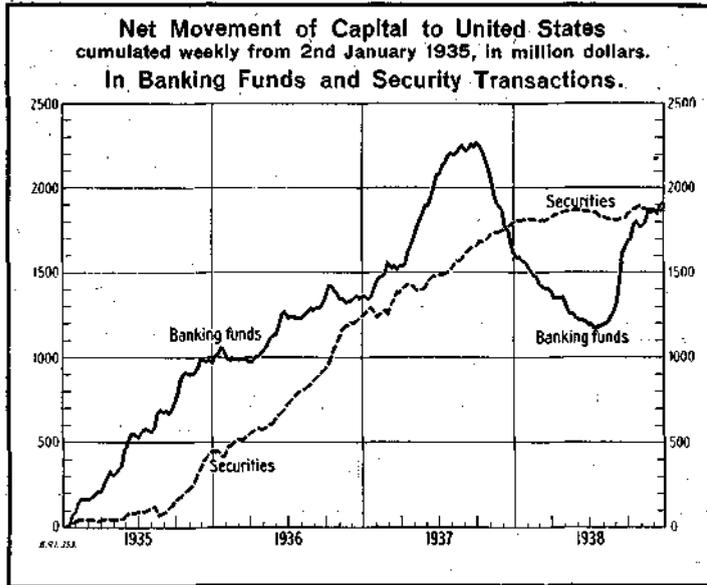
net gold losses of the National Bank and the Treasury amounted to about B.fcs 3,000 million and represented the counterpart of withdrawals of foreign money and some other capital movements such as repayments of foreign debt in excess of new borrowing abroad. No deficit would appear to have been incurred on the current account of the balance of payments; exports fell off sharply but imports even more so (as raw material prices slumped). Some readjustment in the domestic cost and price level was probably required, since Belgium, naturally very sensitive to changes in world business conditions, was much affected by the precipitous fall in industrial production in the United States and the abrupt decline in the purchasing power of primary producing countries. When the attack against the franc was repelled in May 1938 the National Bank applied the classical principles of defence: unrestricted supply of gold against cash but restriction of the amount of cash available, thereby making it difficult and expensive for those who did not hold cash to obtain it. Care was taken, however, not to restrict credit facilities normally needed by commercial and industrial firms. The discount rate of the National Bank was increased largely for psychological reasons: to make it clear that the currency would be most energetically defended. As the attack on the franc was overcome within the space of a few weeks, the restrictive credit policy and the high rates which for a few weeks were quoted on the forward market involved only temporary disturbances causing no real harm to the internal economy or the foreign trade of the country.

The changes in the value of the French franc and the capital movements to and from Paris and Brussels had their effects on the London market, but a more important influence on the exchange value of sterling was the relationship to the United States. The different phases of recent developments are clearly seen from an examination of net movements of merchandise, gold and capital to and from the United States.

Quarterly figures	Net movements to and from U. S. A.			Percentage increase (+) or decrease (-) in 348 indus- trial stocks on N. Y. Stock Market	Sterling- dollar rate
	Foreign trade balance	Net receipts of gold from abroad	Reported capital influx (+) or efflux (-)		
	in millions of dollars			in %	average
1936 Fourth quarter	+ 67	+ 352	+ 327	+ 10	4.90
1937 First ..	- 114	+ 396	+ 323	+ 7	4.89
Second ..	- 34	+ 633	+ 630	- 12	4.93
Third ..	+ 98	+ 426	+ 350	- 6	4.97
Fourth ..	+ 311	+ 131	- 502	- 25	4.98
1938 First ..	+ 321	+ 63	- 203	- 3	5.00
Second ..	+ 310	+ 179	- 161	- 8	4.97
Third ..	+ 231	+ 751	+ 407	+ 21	4.87
Fourth ..	+ 273	+ 981	+ 326	+ 7	4.72

A correlation is found between the trend of quotations on the New York Stock Exchange and the direction of capital movements affecting the sterling-dollar rate. When the Stock Exchange was strong, capital flowed to the

United States; when, on the other hand, the Stock Exchange was depressed, capital returned to Europe. Paradoxically the net total of security transactions reveal an even trend, variations in the movements of capital to the United States affecting almost wholly the amount held as "banking funds".



Not even in the period of stock exchange weakness from August 1937 to June 1938, when large amounts of short-term balances were withdrawn, did foreign investors as a group reduce their holdings of American securities.

Thus the striking connection between the trend on the New York Stock Exchange and the flow of capital to and from the United States can only be

indirect in character, reflecting, it would seem, changes in confidence felt as to the future of the American economy and the value of the dollar. In times of depressed business in the United States it is more or less widely believed that the authorities in Washington — notwithstanding declarations to the contrary — may further devalue the dollar, and thus a "dollar scare" develops, driving funds from the country. When business again shows signs of improvement these fears subside and apprehensions as to the permanence of the present gold equivalent of the dollar are forgotten. The coincidence in the latter half of 1938 of an upturn in business in the United States and a severe political crisis in Europe created a situation which set capital rushing to the New York market.

While these movements of capital, caused by a variety of monetary and political fears, have dominated the exchange markets at different periods of the year, other factors have been by no means negligible.

(i) Relative developments of wage rates and prices of finished products in the United Kingdom and the United States over the last two years have been shown in the graph on page 9 of the Introduction. The widening discrepancy found in the United States between the prices of finished products and wage rates has no parallel in the United Kingdom, a difference which is of importance not only for domestic business in the two countries but also for their exchange relationship. Irrespective of what indices are chosen for comparison, commodity prices in the United States fell about 10 per cent. more than British prices from the middle of 1937 to the end of the year. This improvement in

the purchasing power of the dollar in relation to sterling should, according to the doctrine of "purchasing power parities", strengthen the exchange value of the dollar vis-à-vis sterling (which, in fact, was what happened in the course of 1938). If, however, the calculation of the intrinsic value of the two currencies were made on the comparison of relative cost (instead of price) changes, the result would be exactly the opposite: the intrinsic value of the pound would have risen, American costs as measured by wage rates per hour having increased more than British costs. It is only too often assumed that changes in relative costs and prices of two countries must point to a corresponding change in the intrinsic value of their currencies. When such drastic depreciations occur as those of sterling and other currencies in 1931 and of the dollar in 1933, such a conclusion is, as a rule, justified, but it would be a mistake to think that the same is true of those limited changes which occur in the different phases of the business cycle. The experiences of many countries would seem to have shown that production costs tend to be more sticky than prices and therefore in the long run of greater importance.

(ii) Another factor which added strength to the exchange value of the dollar was the appearance of an increased surplus in the balance of payments of the United States at a time when current items in the British balance showed a substantial deficit.

Yearly figures	U. S. A.			United Kingdom		
	Trade balance	Net balance of other current items	Total balance on current account	Trade balance	Net balance of other current items	Total balance on current account
	in million dollars			in millions sterling		
1936	+ 33	- 186	- 153 *	- 345	+ 327	- 18
1937	+ 265	- 289	- 24 *	- 442	+ 386	- 56
1938	+ 1,134	- 169	+ 965 *	- 377	+ 322	- 55

* The estimate of the U. S. balance of payments contains an item "other transactions and residuals" which in the years 1936 and 1937 amounted to + \$170 and + \$676 million respectively. It is believed that at least part of the amounts thus received represents income on current account and that therefore the "total balance on current account" for the United States is less negative or more positive than appears from the figures in the table.

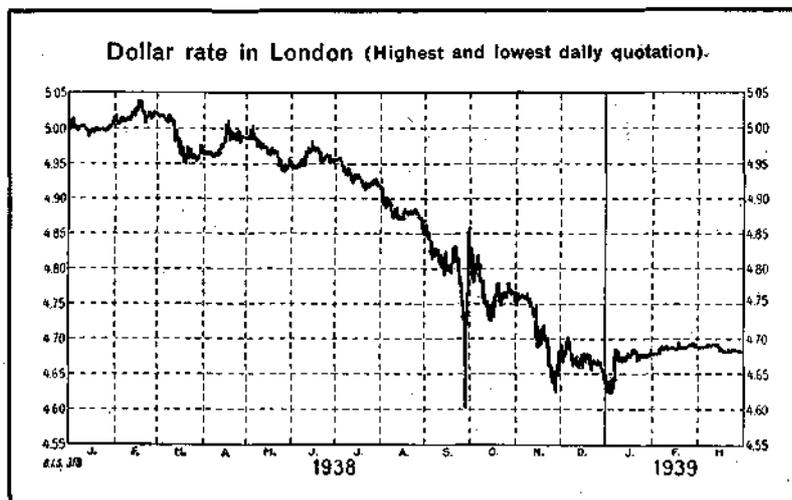
The adverse balance of the United Kingdom in both 1937 and 1938 was, however, offset by an excess of sinking-fund and other repayments over and above the amount of new overseas issues and had therefore little direct influence on the exchange value of sterling.

(iii) A much more important factor was the use made of funds held by sterling-area countries, which habitually keep their monetary and other banking reserves in London. In the boom period from the autumn of 1936 to the summer of 1937 these countries accumulated about \$100 million sterling assets, of which a substantial part must have been obtained from exports to the United States. After the heavy fall in raw-material prices in the autumn of 1937, these countries drew on their reserves in London to cover

their balances of payments (and also, to some extent, to buy gold and dollars). The aggregate amount so disposed of exceeded the accumulation mentioned above (see Chapter IV).

(iv) The repatriation of funds to France in May and again in the autumn of 1938 also exerted a certain pressure on sterling. As the gold which in previous years came from France was acquired by the Exchange Equalisation Account, it was only natural that the Account should provide the gold needed when the tide turned. The amount repatriated to France from October 1938 to the end of March 1939 was about £100 million, the greater part of which came from London. Of greater importance, however, was the amount transferred from London to New York, representing to a certain extent funds belonging to business firms, which could be held almost as easily in other centres. Little transfer of capital would seem to have been made by the British public, by far the greater part being funds owned by foreign individuals and institutions, which, before they were transferred, had been held in London partly in the form of bank deposits, partly as securities, including Treasury bills, and partly in gold. From the end of 1937 to the end of 1938 total deposits of the London big five banks fell by £75 million, a decline to be associated with the withdrawal of foreign deposits. The amount by which the deposits of other London banks (including branches of foreign banks) were reduced is not known, but was certainly substantial. Nor is it possible to indicate the net reduction in the amount of stock exchange securities and Treasury bills held on foreign account. During certain periods speculative transactions increased for the time being the outflow of funds but by March 1939 most speculative positions were probably already liquidated.

The Exchange Equalisation Account, given the task of ironing out fluctuations in exchange rates, appears to have adopted the policy of reacting against, but not wholly preventing, a modification of rates indicated by a persistent trend in the market position. The sterling-dollar rate was allowed to depreciate very gradually from \$5.00-5.04 in January-February 1938 to \$4.65-4.70 in December.



As a preponderant motive for the flow of capital to the United States was nervousness with regard to the political situation in Europe, the movement was in a measure irresistible; but, even so, evidence of resolute defence of sterling by the monetary author-

ities in the United Kingdom would be of great assistance in combating an excess of speculation accompanied by all kinds of more or less unfounded rumours. To that end the following measures were taken in London:

(i) On 20th December 1938 the Chancellor of the Exchequer announced that the relaxation of the embargo on issues of capital for transfer abroad, which had been conceded in the previous February, was withdrawn. As foreign lending had shrunk to a minimum, this measure was only of limited importance. It affected, however, block purchases of securities abroad for sale in the London market, a possible form of flight of capital.

(ii) On 6th January 1939 the Chancellor announced that gold to the value of £350 million at the current price was to be transferred from the Bank of England to the Exchange Equalisation Account. The purpose of this measure was to replenish the resources of the Account, which by 30th September 1938 had fallen to £152 million and thereafter been subject to further drain. Indeed, it was commonly believed that the amount of gold held by the Account had fallen below the £100 million mark; but the gold reserves of the Bank of England had a market value of some £570 million. The transfer of gold to the Account, besides releasing the gold for active defence, served the useful purpose of drawing attention to the magnitude of the combined reserves.

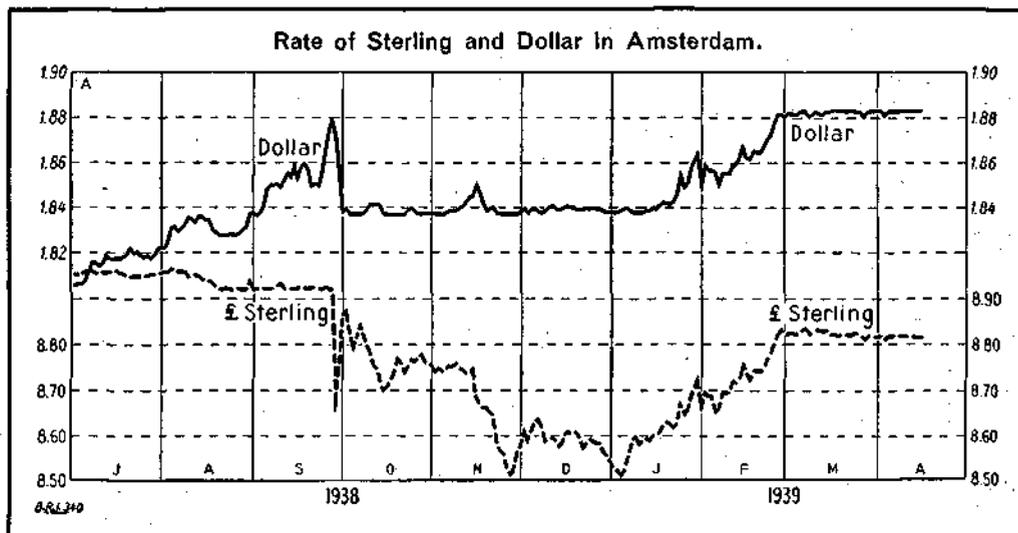
(iii) At the beginning of January 1939, the Chancellor, in a letter to the Governor of the Bank of England, asked that the unofficial embargo on forward dealings in gold and on the granting of credit facilities against private holdings of gold, lifted in the spring, should again be applied in full. He added that there was "more reason than ever why the market should continue to submit all foreign exchange operations to the closest scrutiny with a view to eliminating undesirable transactions". The banks and the bullion market agreed to carry out the Chancellor's wishes and the London Foreign Exchange Committee drew up a circular to guide the market in the application of the embargo on speculation against sterling. As the objective of the embargo was "to curb speculation in both gold and currencies, but in no way to hamper normal trade requirements", the indications were kept sufficiently elastic to allow for marginal cases. For, while it is difficult to frame detailed instructions, the banks in the market are as a rule capable of telling, in the light of their past experience, whether a particular transaction does or does not come within the ordinary business of a customer.

As regards foreign exchange operations, the circular laid down that no scrutiny of spot operations was necessary but that in the case of forward operations "the banker must be satisfied that his client is covering a normal trade requirement", with the additional proviso that forward transactions merely in an endeavour to protect one's capital would not be permitted.

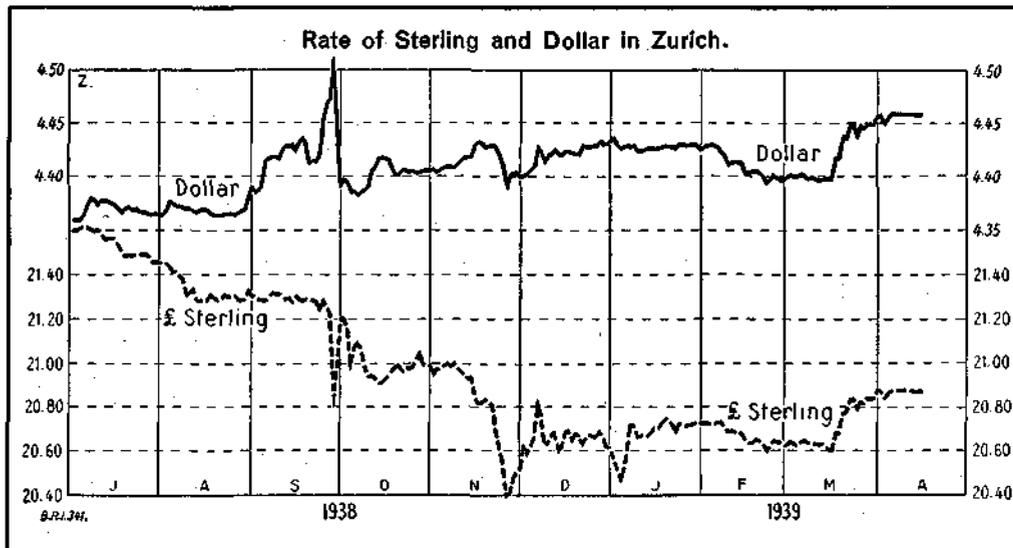
The measures taken in London to combat speculation were directed against an unhealthy growth of activity in the exchange market, the multiplication of rumours and the fostering of a state of nervousness which was harmful to the pursuit of ordinary business. With regard to the forward market, it should

be mentioned that fairly considerable movements of banking funds occurred in 1938, caused by the varying relations between forward rates and the rates of interest obtainable by foreign funds in London (further described in the chapter on Capital Movements). It is a necessary corollary to the position held by the United States and the United Kingdom in world trade and by sterling and the dollar as key currencies that even a moderate alteration in the sterling-dollar rate is apt to cause great apprehension. It did not matter that the decline in sterling's exchange value in the latter half of 1938 was small compared with the great changes in the years 1931 to 1934; as long as a downward movement continued it raised monetary problems of great moment in different countries of the world.

The question came to a head when sterling fell sharply at the end of September; interesting movements were shown especially by the Dutch florin and the Swiss franc, two currencies which are divided in their allegiance between gold (i.e. the dollar) and sterling. The significance of the gold link is largely due to the importance of trade with Germany, which in both cases passes through official clearing accounts. The following graphs show daily quotations (at 11 a. m.) of sterling and the dollar in Amsterdam and Zurich:



The Dutch florin followed sterling closely during the latter half of August and the greater part of September, and only on 28th September, when sterling fell sharply, did the florin break away, steering a middle course between sterling and the dollar on this and the following day. On Friday, 30th September, the dollar rate of 1.84 was reached, which was maintained practically unchanged until near the end of January 1939 when, under the pressure of an outflow of funds from the Dutch market, the florin again yielded a little, reaching a depreciation of slightly over 22 per cent. from the old gold value, i.e. the same depreciation as when the florin followed sterling up to 27th September 1938. In March and April 1939 the florin was again stable on the dollar at about 1.88.



The Swiss franc maintained a practically stable rate of 21.30 to the pound during the greater part of August and September 1938; but from 23rd September onwards it followed a middle course between sterling and dollar, with, however, a tendency to a somewhat closer link with the dollar. According to an instruction of 27th September 1936 given by the Federal Council to the Swiss National Bank, the Bank has to maintain the value of the Swiss franc at a level corresponding to a depreciation of about 30 per cent. from the old gold value. Immediately after the depreciation the National Bank fixed a gold price of 4,869.80 francs per kilo fine, involving a depreciation of about 29¼ per cent. In the autumn of 1938 when the Swiss franc up to a point followed sterling, the theoretical gold price of the National Bank resulting from the current gold price in London and the position of the franc-sterling rate rose to 4,973.15, involving a maximum depreciation of 30¾ per cent.

It may be mentioned that in the autumn of 1938 in France also the question arose whether the franc should follow the downward movement of the pound. The authorities adopted a somewhat elastic policy, maintaining the fluctuations in the sterling-franc rate within narrow limits, while still taking some account of the position towards the dollar, the policy thus adopted being, so to say, ratified by the market as the repatriation of capital continued.

Some important decisions had to be taken when the relationship was fixed between the Reichsmark and the currencies in Austria, the Sudeten territory, Czecho-Slovakia and Memel.

The rates adopted were in each case calculated with regard to relative price conditions. When, in March 1939, another rate was adopted for the crown than in October 1938 the reason is understood to have been that in the meantime commodity prices in Czecho-Slovakia had risen proportionately.

Conversion rates	Units of currency per Reichsmark			Reichsmarks per unit of currency at the new rate
	Old par rate (1929)	Latest market quotation	Conversion rate adopted	
Austria Sch.	1.693	2.04	1.50	0.67
Sudeten territory K	8.04	11.63	8.33	0.12
Czecho-Slovakia K	8.04	11.63	10.00	0.10
Memel territory Litas	2.382	2.382	2.50	0.40

Except in the case of Memel, the rate adopted gave a higher value to the old currency than the quotation ruling in the market immediately before the change in the position of the different areas.

Germany's clearings with the various countries in the Danubian basin and the Balkans are, in their currency arrangements, generally based on the old par rates or rates near to them, notwithstanding the fact that the free currencies are quoted in these countries at rates implying a considerable measure of de facto depreciation. Germany's clearings and payments agreements with countries in which the depreciation of the national currency is fully accepted (as, e.g., in the United Kingdom, France, Italy, Holland, Switzerland, Sweden) are everywhere run on the basis of the par value in gold of the Reichsmark. During 1938 the possibility of using "Aski" marks for transactions arising out of so-called additional exports became more narrowly circumscribed; Aski marks are, however, allowed in settlements with certain South American countries with which no payments or clearing agreements have been concluded, the quotations of these marks varying from time to time according to the character of the trade with each of the countries concerned. The value of the registered mark has shown greater fluctuations than in previous years; at the end of 1938 it was quoted at RM 27 to the pound, as compared with the official rate of about RM 11.70. The exchange value of Italian lire, strictly controlled by the monetary authorities, was rigidly pegged to the dollar throughout the year.

In Bulgaria, Hungary, Roumania and Yugoslavia a tendency has been noticeable to increase the field of so-called "compensations" by which exports and imports of particular goods and also by particular firms are linked together. It may be said that in several ways official rates have been adapted to levels more in conformity with the relation between supply of and demand for exchange in the market. The countries in south-eastern Europe not only apply exchange restrictions but often in their various clearing arrangements work with rates involving a different degree of depreciation vis-à-vis different countries (the question of the rate being, as a rule, an important object of negotiation). Moreover, the percentages fixed for the compulsory delivery of exchange at the official rate, and for transfers at compensation rates on the more or less free markets, vary as a rule according to the destination and the character of the goods exported. The fixing of the percentages in question constitutes an application of the monetary policy of these countries. Consequently, they cannot be said to belong to any particular currency group.

Within the sterling area there has been no defection during the year, the Scandinavian currencies and those of Portugal, Egypt, India, etc. having been maintained without change at their fixed relation to sterling.

The Japanese yen has also been held on sterling at 1s. 2d. through the year. In 1937 some Yen 400 million was taken from the revaluation profits of the gold reserves to form a special exchange fund; and in August 1938 a further amount of Yen 300 million was released from the gold reserve of the Bank of Japan to establish a foreign exchange fund in that Bank, the gold to be gradually converted into foreign currencies and the fund worked in a revolving manner for the import of raw materials needed for the manufacture of articles for export. Such amounts as were advanced to the exchange banks specially designated would be refunded in foreign currencies within four months, the banks being bound to earmark a part of their export bills for this purpose. At the same time the exchange restrictions imposed during the previous year were made more stringent; the exchange banks must report purchases and sales of exchange bills every ten days to the Bank of Japan which, when purchases exceed sales, acquires a certain part of the balance. In 1938 further steps were taken to mobilise Japanese-owned funds and securities in foreign currencies, the government having acquired large blocks of such securities from insurance companies and similar holders.

When in 1937 hostilities began between Japan and China there were in the East four currencies subsidiary to and maintained at par with the Japanese yen: the yen of the Bank of Formosa, the yen of the Bank of Corea, the yuan of the Central Bank of Manchukuo and the yuan of the Central Bank of Inner Mongolia. In March 1938 a fifth currency was added to this group: the Chinese yuan issued by the newly-formed Federal Reserve Bank of Peiping. This new monetary unit is also to be held at par with the Japanese yen, but it has proved difficult at times to prevent depreciated rates from being quoted for it. Regulations have been issued to ensure a concentration of export bills from the northern districts at the Tientsin branch of the new Federal Reserve Bank.

The Hong Kong dollar has been maintained at its full exchange value against sterling, but difficulties have been experienced with the Chinese dollar introduced at the end of 1935 when China gave up the silver standard and made arrangements for supporting her currency by being ready to buy Chinese dollars for sterling at about 1s. 2½d. In February 1938 the Chinese dollar began to depreciate, being quoted as low as 77/8d. early in August, but recovering afterwards to around 8½d. Since the autumn the latter rate has kept reasonably steady and by the end of the year the flight from the currency had ceased and there were even signs of some repatriation of funds. In December 1938 a Chinese-owned trading corporation in New York obtained from the United States Export-Import Bank credits up to \$25 million, the proceeds to be used for the financing of the export of American agricultural and manufactured products to China and the import of wood oil from China, the credits which mature in five years being guaranteed by the Bank of China. Further, the Secretary of the U. S. Treasury stated on 20th December 1938 that the arrangement announced on 8th July 1938, under which the Central Bank of China has been enabled, under conditions which safeguard the interests of

both countries, to obtain dollar exchange for stabilisation purposes, has been extended for a further period beyond 31st December 1938. In March 1939 an exchange fund for China was created, amounting to £10 million, half of which was contributed by the two Chinese government banks (the Bank of China and the Bank of Communications) and the other half by the Hongkong and Shanghai Banking Corporation and the Chartered Bank of India, Australia and China. The contribution by the British banks to the fund and the interest payable to them at 2¾ per cent. per annum were guaranteed by the British Government. The management of the fund will be vested in a committee of five: the Chinese banks will jointly appoint two members; the Hongkong Bank and the Chartered Bank will each appoint one; and the fifth will be a British expert appointed by the Chinese Government in agreement with the British Treasury and with the approval of the British banks. The duty of the committee will be to determine the day-to-day policy best suited to achieve the purpose of checking undue fluctuations in the value of the Chinese dollar and to give instructions to the banks concerned as to the operations of the fund.

By an Order in Council of 5th December 1938 the New Zealand Government suspended the Reserve Bank's obligation to exchange New Zealand currency for sterling at its quoted rates and also imposed a system of control over external trade and the funds held overseas by the trading banks. The imposition of these measures was related to the reduction in the export surplus and the rapid depletion of overseas funds, as shown by the following table:

New Zealand — Trade balance and London funds.

Year	Foreign Trade			Net overseas assets held by banks at end of year		
	Exports	Imports	Balance	Reserve Bank	Trading Banks	Total
in £ N. Z. millions						
1934	47.3	31.3	+ 16.0	22.1	18.4	40.5
1935	46.5	36.3	+ 10.2	21.4	14.7	36.1
1936	56.8	44.3	+ 12.5	16.5	11.5	28.1
1937	66.7	56.2	+ 10.5	17.0	6.7	23.7
1938	58.4	55.4	+ 3.0	4.7	2.1	6.8

Exports fell in 1938 but only in comparison with the exceptionally favourable year 1937, remaining higher than in any previous year. Imports in 1938 were, on the contrary, almost as high as in 1937, with the result that the active balance was reduced from £ N. Z. 10½ million to £ N. Z. 3 million (while £ N. Z. 10 to 12 million were needed to meet the service of the overseas debt). As usual, there was a time lag of half a year to a year between the previous increase in exports and the rise in imports. The buying power of the public in New Zealand was, however, also swollen by the government policy of public works and other expansionist measures, which undoubtedly tended to increase the deficit on the current account of the balance of payments. To this was added some flight of capital up to the introduction of the exchange restrictions in December 1938. It is still too early to tell whether

the government's policy will reduce the domestic income level to the requirements of the balance of payments or whether there will simply be an attempt to restore equilibrium by the cutting-down of imports through prohibitions and a strict application of foreign trade control.

It has been a common experience of most countries producing primary products that the value of their exports fell rapidly in 1938 as a result of lower prices and in response to a smaller demand, while the value of their imports tended to remain relatively high. Some typical instances are shown in the following table:

Foreign trade of some different areas in 1937 and 1938.

In million dollars	Imports			Exports		
	1937	1938	Percentage change	1937	1938	Percentage change
Europe *	15,037	13,480	- 10	11,484	10,335	- 10
U. S. A.	3,084	1,960	- 36	3,349	3,094	- 8
Argentine	482	443	- 8	758	438	- 42
Chile	88	103	+ 17	192	139	- 28
India	614	550	- 10	740	593	- 20
Netherlands India .	276	267	- 3	527	383	- 27
Br. Malaya	398	319	- 20	521	332	- 36
Australia	502	516	+ 3	589	518	- 12

* Excluding U. S. S. R. and Spain.

While the United States, notwithstanding the shrinkage of its imports, was able to maintain exports at almost the 1937 level, for Europe as a whole exports and imports declined at about the same rate. All the other areas included in the table show a heavy fall in exports, contrasting sharply with sustained imports; in some cases practically as high as in 1937, the result being a strain on the balance of payments which ate into the accumulated monetary reserves. In the case of Australia the position was partially relieved by the receipt of £5 million from the proceeds of a loan on the London market, although London funds were lower on the year: the Argentine raised a long-term loan in New York and placed some two-year bills in European centres, but otherwise access to foreign money and capital markets was not an important factor.

In the Argentine a period of great prosperity in 1936 and the first half of 1937 was followed by more difficult times, when prices dropped and crops were meagre. Developments in this country are particularly interesting, as in the period of high exports and an active balance of payments the inflow of funds was offset by the repayment of over 400 million pesos of external liabilities from domestic issues and also by the restrictive policy of the central bank. To reduce the plethora of money on the domestic market, the Banco Central sold to the banks certificates and Treasury bills specially issued for the purpose and also in other ways absorbed cash from the banks, thereby limiting the credit expansion to figures which were moderate in

comparison with the amounts in foreign exchange which had been turned over to the banks. It is, however, necessary to realise the limits to which the measures of the Banco Central were subject. Exporters who sold their export bills to the banks obviously retained disposal of the amounts obtained without being affected by the central bank's open market operations. The buying power of the public was furthermore sustained by increased outlay for improvements and other purposes by many local authorities and particularly by the city of Buenos Aires, the works being financed partly by bank credit. The Banco Central reports that, from the middle of 1937 onwards, bank loans were continually expanding and that this was not in response to a larger demand for normal credit due to the economic activities of the country but rather the result of the application of the Agrarian Credit Law and the financing of purchases by the Cereals Regulation Board. "Owing to this fact", continues the Report, "the cyclical decline in the quantity of means of payment (i. e. in 1938) was less than would have corresponded to outgoings of foreign exchange. This undoubtedly helped to keep internal economic activity at a level which was comparatively high in relation to the considerable shrinkage of exports. As was natural, it also tended to keep the volume of imports at a high level — so much so that high imports have come to represent one of the chief factors of disequilibrium in the balance of payments." In view of the course taken by imports, the National Government made it obligatory to obtain an exchange authorisation previous to the import of even those goods paid for through the free market, amounting to 335 million pesos in 1938. Moreover, the official selling rate for sterling was altered in November 1938 from 16 to 17 pesos, while the free market rate of the pound, which at the beginning of the year stood at 17.00 pesos, rose at one time as high as 20.75; and only the intervention of the central bank kept it from rising higher.

The exchange position of Uruguay was influenced by developments in the Argentine as well as by the difficulties in the balance of payments. In order to restrain imports the official selling rate applicable to commercial transactions was raised at the beginning of 1939 from 8.58 to 9.50 pesos to the pound sterling. In Chile, on the other hand, the official rate for exports remained unchanged at 25 pesos to the U. S. dollar, but the market rate depreciated at one time to 32.50 pesos. Chilean exports tended to fall and in the month of September 1938 an import surplus appeared for the first time in any month since 1932. Some flight of capital would also seem to have taken place in connection with the presidential election in October 1938.

The Brazilian milreis has continued to be linked to the U. S. dollar and, though no depreciation occurred, measures were taken to reinforce the exchange control through the Bank of Brazil. Shipments of coffee and cotton rose by 47 and 10 per cent. respectively in 1938 as compared with the previous year. The increased coffee shipments were a result of the new policy announced in November 1937 according to which the export tax on coffee was lowered from 45 to 12 milreis per bag in an effort to recapture lost markets, and at the same time the export price of coffee was reduced by 25 per cent.

Thanks to increased sales Brazilian exports in 1938 represented a little over 60 per cent. of the world trade in coffee, after having fallen in previous years to about 50 per cent. Total imports into Brazil remained practically as high as in 1937, special interest attaching to high imports of machinery, reflecting the policy of greater industrial self-sufficiency inaugurated by the government. In November 1937 all sinking-fund and interest payments of the external debt (which after the arrangements in 1934 would amount to about £8.7 million per annum) were suspended. In the course of negotiations with the government of the United States in the early months of 1939 the question of a resumption of foreign debt payments was raised in connection with the conclusion of a new loan. An important change of system was introduced in April 1939, by which the foreign exchange monopoly of the Bank of Brazil was abolished. Exporters have still to deliver 30 per cent. of their exchange to the Bank (at a rate which at the end of April was equivalent to 77.24 milreis for the pound) but are allowed to sell the remaining 70 per cent. on the free market where the rate has risen to about 88 milreis (also end of April), the average rate working out at 83½ milreis, compared with an official buying rate of about 81 milreis before the change in the system was made. Importers, on the other hand, have now to purchase exchange in the free market (i. e. at about 88 milreis for the pound) paying in addition a 5 per cent. tax as compared with a previous rate of about 83 milreis plus a 3 per cent. tax. Special rates are applied for tourists, transfers of dividends, etc.

The two north-western neighbours of Brazil — Colombia and Venezuela — have maintained their exchange positions unimpaired in 1938, both being helped in particular by the export of oil. In Venezuela the gold value of the currency is within 4 per cent. of the par value in force in 1929; and Colombia has been able to restore a measure of freedom to its exchange market, its currency showing a tendency to appreciate. In Peru the exchange market has remained unrestricted, but the currency fell about 17 per cent. in the course of the year under the influence of a reduced trade surplus.

A currency depreciation of 40 per cent. was experienced by Bolivia in the first five months of 1938 where, however, since June, the exchange has been held at 140 bolivianos to the pound sterling, at which rate the currency retained barely 5.3 per cent. of its 1929 value. In the first half of 1938 the Mexican peso fell by 28 per cent. but has been kept at about 20 U. S. cents since July 1938.

The only other currencies which during 1938 suffered a loss in value of the same magnitude were the Spanish peseta and the Chinese (Shanghai) dollar, both being affected by the hostilities which occurred within the borders of their respective countries. The Nationalist Government in Spain maintained a strict exchange control; in its clearing with the United Kingdom an exchange rate of Pesetas 42.45 to the pound was applied. And, as mentioned earlier in this chapter, an exchange fund was established in China in March 1938, so that even in the two countries where actual warfare has been waged measures were taken to prevent exaggerated movements of the exchanges. Notwithstanding the nervousness and other difficulties with which exchange markets have had to cope in 1938, there was an improvement in the volume of world trade in the latter half of the year.

2. FOREIGN TRADE.

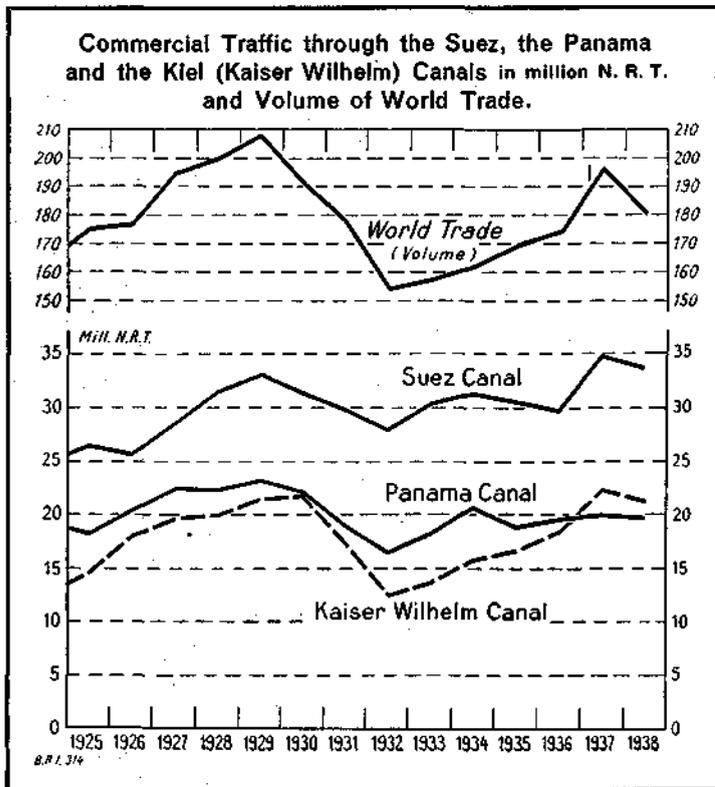
In 1937 the volume of world trade approached the 1929 level after a gradual recovery over five years from the depth of the great depression in 1932. This favourable trend was, however, reversed in 1938 when in the first half of the year world trade dropped by 10 per cent. more than the usual seasonal decline. This fall was in sympathy with and very much of the same proportion as the setback in world industrial production which began in the autumn of 1937. In contrast to developments in 1930, the first full year of the previous depression, there was already a marked recovery in the latter half of 1938 both in industrial production and in world trade. This may be taken as a sign of greater resistance to depressing forces at the present time than in the difficult years following the break of the boom in the autumn of 1929.

The improvement in the latter half of 1938 would appear to be barely maintained in the early months of 1939. The import figures for a number of countries in 1939 show a decline in comparison with the corresponding months of the previous year, but the difference is partly explained by lower prices and the general tendency seems to be one of temporarily marking time.

The index of the volume of world trade is calculated by adjusting the value figures (as obtained from the trade returns of the various countries) for fluctuations in commodity prices, the resultant being necessarily subject to a certain margin of error. It is, therefore, interesting to find that the main tendencies revealed by the trade figures are also found in the movement of

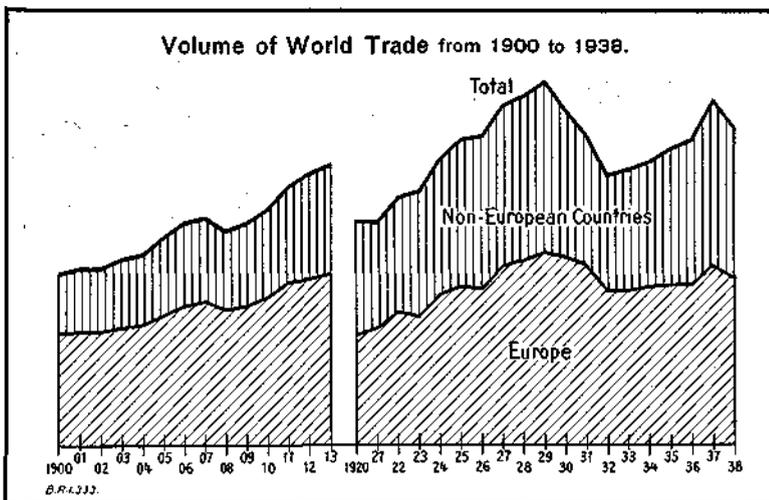
merchandise traffic through the Suez, the Panama and the Kaiser Wilhelm (Kiel) Canals, a correspondence which helps to confirm that these calculations of the magnitude of world trade are substantially correct.

The different phases of the dominant business trend since 1925 are well illustrated by the graph: the improvement up to 1929, the violent setback to 1932, the gradual recovery in the following years to the new peak in 1937, followed by a certain setback in 1938. While the 1937



traffic both for the Suez and for the Kiel Canal exceeded the 1929 figures, the opposite was the case with regard to the Panama Canal. The failure of industrial production in the United States to recover to the 1929 level would thus appear to be reflected in this graph.

Different commodities pass through the three canals; different areas of the world are served by them; still the rise or fall of traffic, which is recorded by the returns from these canals, reflects in a striking manner a common world trend of business. The volume of shipping which passed through the Suez Canal in 1938 was 5.7 per cent. below the 1937 record, but it was still 70 per cent. larger than in the best pre-war year, 1912. In 1938, despite the decline from the previous year, the volume of world trade as a whole was fully 15 per cent. above the pre-war level; but the increase was due to the growth of trade in countries outside Europe, for the foreign trade of European countries in 1938 was barely as large as in 1913.



Europe's share in world trade fell from 66 per cent. in 1900 to 61 per cent. in 1913 and was about 52 per cent. in 1938. In the main this fall must be regarded as an unavoidable consequence of structural developments — the increase in population and production in overseas countries.

The more industry is built up in relatively undeveloped areas the less need there will be for an exchange of particular kinds of goods with the old industrial countries in Europe. This growing preponderance of home production is reflected in a decline of the percentage relation between world trade and world industrial production.

Indices based on 1913 figures	World industrial production	Volume of world trade	Percentage relation between world trade and world industrial production
1913	100	100	100
1929	139	130	94
1937	152	123	81
1938	144	113	78

Technical progress, such as the perfection of automatic machinery which can be used almost anywhere, has made possible the establishment of indus-

tries in new countries, which are now able to work in many lines of business with little additional cost compared with the old countries. Moreover, the new countries show a strong desire for a more varied economic life and this tendency is intensified by the small profits derived from agricultural and other primary production, while raw material prices remain low. It should also be added that for many reasons the recovery after 1932 came at first in the internal economy of a number of countries and thus home trade developed relatively more than foreign trade. But the volume of world trade nevertheless has risen considerably above the 1913 figure.

There are, of course, important structural changes in process the whole time but these changes do not all lead to a restriction of world trade. Higher production in the old industrialised countries will necessitate more import of raw materials; and an increase in the standard of living whether in old or new countries usually raises demand for many articles produced abroad, as, for example, the desire for variety grows more pronounced. There is, moreover, the possibility of a real extension in the volume of world trade when the vast populations of countries with a low standard of living are enabled to buy cheap consumption goods, which previously were unknown to them (watches, bicycles, etc.). In that way some of the export of Japan has not "stolen" trade from other countries but added to the sum total of world trade.

Technical progress in general means that highly specialised articles (machinery, tools, instruments, etc.) will be more needed; and these articles are as a rule produced by a fairly limited number of countries. So even if there comes a decline in foreign trade in the more ordinary goods (textiles, shoes, furniture, etc.), a vast field will still be open for foreign sales. The development of overseas countries provides opportunities for the export of capital goods and these exports would still further increase if foreign lending were to recover. Such foreign investments as have continued to be made in recent years have largely taken the form of direct investments in commercial and industrial enterprises and in a large measure they lead to exports of machinery and other articles by the mother company.

Evidence of these tendencies is found in the trade returns of most countries. In the boom period in the first half of 1937 the United States failed to recover the ground lost in the export of such consumption goods as textiles, leather and rubber goods, but at no time in the past have United States exports consisted of such a large proportion of industrial, semi-manufactured and finished goods. At \$1,093 million in the first six months of 1937 (against \$766 million in the corresponding period of the previous year) these industrial exports accounted for 73 per cent. of total exports, while in 1926-30 the percentage was around 60 and in 1910-14 about 46. For Germany, the Institute for Business Research has calculated that the share of capital investment goods in total German exports rose between 1929 and 1937 from 32½ to 42½ per cent., while the share of ordinary manufactures fell during the same period from 32½ to 22½ per cent. Total British exports were reduced from £521 million in 1937 to £471 million in 1938, but at the same time exports of electrical goods and apparatus and of machinery rose from £62 million

to £71 million, after steady increases in the preceding years. Naturally a corresponding shift is found in the composition of imports in other countries, a particular feature being an increase in the imports of machinery, as e. g. in the Argentine, New Zealand, Finland, Poland, Roumania and the U.S.S.R.

The setback of production and the decline in world trade which began in the latter half of 1937 tended to increase competition on foreign markets. Overseas countries had less purchasing power at their disposal; exchange and import restrictions were intensified; and, as the highly industrialised countries were less able to utilise their productive capacity to the full, they vied more keenly in sales on foreign markets. Greater attention has been given by the governments to the need for foreign trade; in that respect a marked change has taken place compared with the years 1931-33 when particular stress was laid on internal recovery by means of public works, protective measures, etc. It begins to be felt that the fostering of a country's production for domestic needs with little consideration for exports may impair the capacity of paying for necessary imports, reduce the country's relative position in world affairs and also in some cases make it more difficult to solve the problem of unemployment. In the final analysis it is realised that an improvement in the standard of living presupposes, as it has done during the last hundred years, a development of foreign trade; and the essence of the problem is largely to find the appropriate forms for the desired advance in the exchange of goods.

In many countries efforts have been directed towards increased aid to exports by the granting of credits under government guarantees (e. g. in the United Kingdom, Switzerland and the United States). Moreover, some central banks, as, for instance, the Reichsbank, have arranged to take over export bills at favourable discount rates. In countries where forward exchange markets were lacking, or were active only for particular currencies, central banks have in many cases made arrangements under which exporters could cover themselves against certain exchange risks. These various measures may on the whole be said to aim at a partial restoration of the credit and exchange facilities which were ordinarily provided by the banking machinery before the disruption caused by the monetary crisis in 1931.

Other measures to promote exports took the form of trade agreements between particular governments. Raw material producing countries in 1938 were more than usually anxious to sell, as their shipments to some important industrial countries, hit by the setback, declined sharply. These countries continued to find in Germany — whose requirements of raw materials tended to increase — a customer to whom they were able to sell and from whom they could receive payments in so far as they would take German goods in exchange. In the bilateral arrangements which were concluded, difficult points of negotiation often arose with regard to rates of exchange and the settlement of outstanding balances; under the influence of these agreements German purchases from the other parties to the arrangements, however, increased. As a result German foreign trade shifted more and more

from the main industrial countries to certain groups of primary producers. Still the magnitude of the shift should not be exaggerated. The share of south-eastern Europe in German imports more than doubled from 1929 to 1938; but in 1938 it amounted only to 10 per cent. The share of Latin America rose from 11½ per cent. in 1929 to 15 per cent. in 1938. On the other hand, the continental industrial countries in central, southern and western Europe, Great Britain, the British Empire countries and the United States together still delivered about 40 per cent. of German imports in 1938.

Bilateral trade policy is as a rule connected with the existence of exchange control in the countries concerned, but there are also examples of purely bilateral agreements entered into by countries with free exchange markets, as, for instance, the coal arrangements between the United Kingdom and certain Baltic and Scandinavian countries. Such arrangements, which cover only particular commodities, are usually constructed in such a form as to interfere as little as possible with normal trade practices. The danger to guard against is, of course, that attempts to equalise trade between two countries may lead to the attainment of a greater degree of equalisation on a lower level.

The contractual policy pursued in recent years by the United States also takes the form of bilateral agreements, but the objective is to achieve tariff concessions and to extend the benefits to other countries by application of the most-favoured-nation clause. The United States, in fact, withholds the concessions from third countries which are held to discriminate against American commerce; as, however, no provision to that effect is contained in the agreements, the other parties are not bound to adopt a similar policy. The agreements take account of the existence of import and exchange restrictions and the principle is laid down that in the administration of such restrictions each signatory government shall ensure that the nationals and commerce of the other country will be granted a fair and equitable share in the allotment of exchange and import permits. Provision is also made for the resumption of negotiations while the agreement is still in force in the event of any appreciable variation in the value of the currencies of the contracting parties or of any changes in the conditions under which their mutual trade is conducted. By the beginning of 1939 the United States had concluded trade agreements with 20 countries, the Anglo-American Agreement signed in November 1938 attracting special attention.

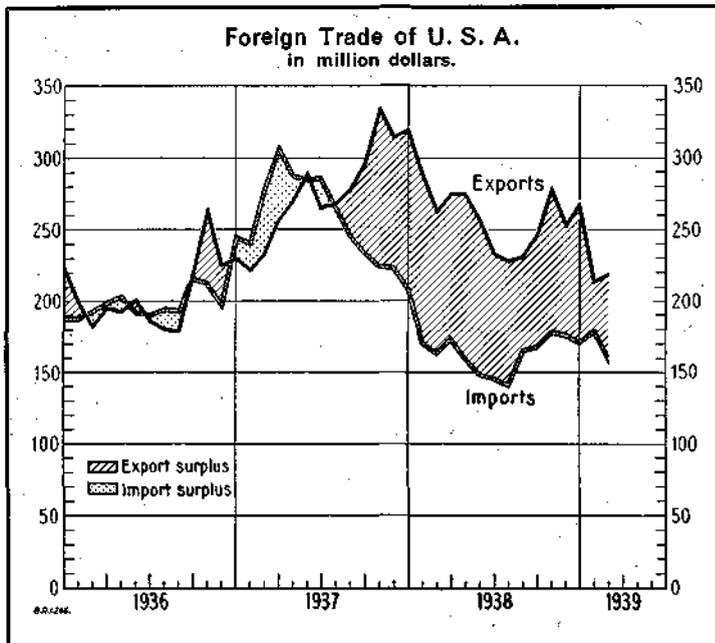
It is not easy to get the statistical measure of the results of the trade agreements concluded by the United States, for a number of factors must be taken into account, e. g. the general growth in world trade since the depth of the depression, the fluctuations in harvest yields, etc. It has, however, been calculated by the Intelligence Service of the League of Nations that the share in United States imports provided by the principal primary producing countries having trade agreements with the United States rose from 28 per cent. in 1929 to an average of over 32 per cent. in 1936-37 and to 35½ per cent. in the first ten months of 1938. Some other comparisons appear to be less conclusive; but it may be mentioned that United States exports to the "industrial agreement group" rose from 11½ per cent. in 1929 to 12½ per cent. in 1937

and 13½ per cent. in the first ten months of 1938 (the United Kingdom not yet being included in this group as the trade agreement entered into force on 1st January 1939).

As far as the United States is concerned a typical example has been provided in recent years of the connection between the domestic business trend and foreign trade. In the boom period in the first half of 1937 the United States had an import surplus; in the autumn of that year when, with the recession, the need for industrial raw materials fell (and also the need for foreign foodstuffs since the American harvest was abundant), an export surplus developed and this surplus was maintained up to the end of 1938 at the rate of nearly \$100 million per month. Not since 1921 has the United States had an export surplus of such magnitude. There can be little doubt that in 1938 the maintenance

of foreign demand for American goods was a steadying factor in the United States business situation.

The increase in the export surplus of the United States and the decline on a gold basis by over 40 per cent. in the import surpluses of two other creditor countries — France and Switzerland — seriously reduced the net import balances of the eight main creditor countries of the world from 1937 to 1938.



Trade Balance of principal creditor countries.

In millions of dollars	1936	1937	1938
Belgium	- 60	- 77	- 41
Eire	- 86	- 104	- 83
France	- 594	- 744	- 450
Netherlands	- 175	- 221	- 207
Sweden	- 30	- 31	- 58
Switzerland	- 108	- 119	- 63
United Kingdom	- 1,720	- 2,136	- 1,897
United States	+ 33	+ 265	+ 1,134
	- 2,740	- 3,167	- 1,665

In terms of the franc the import surplus of France was Fr. fcs 15,400 million in 1938 compared with Fr. fcs 18,450 million in 1937, the reduction in the adverse balance reflecting an increase in the competitive power of French industry, not to be regarded merely as the result of currency depreciation but to be associated with the stability of the franc from May onwards, favouring a repatriation of working capital as well as increased stability in production costs and greater elasticity in the employment of labour towards the end of the year. Particularly noticeable is an increase of 22 per cent. from the beginning of 1938 to the beginning of 1939 in the volume of export of manufactured articles.

Swiss exports in 1938 were slightly higher than in 1937, but imports declined, especially from those countries with which clearing arrangements had been concluded. The Swiss National Bank mentions in its Annual Report that the reduced imports from Germany made it more difficult to maintain in full the payments to different categories of Swiss creditors. Although Switzerland maintains a free currency, the importance of clearings in its foreign trade is shown by the fact that of Swiss imports nearly 40 per cent. and of exports about 60 per cent. are with countries tied to Switzerland with clearings and compensation agreements.

The reduction from 1937 to 1938 in the adverse trade balance of the United Kingdom amounted to £43½ million (excluding purchases and sales of silver); this reduction was due primarily to differential price changes, average values of retained imports falling by 6 per cent., while average values of exports rose by 2 per cent. In volume retained imports were 4½ per cent. and exports 11 per cent. smaller than in 1937. The reduction in the import surplus of Eire is in particular connected with the conclusion in April 1938 of an agreement with the United Kingdom whereby the financial and economic dispute which began in 1932 was terminated.

The decline in the net balance of the eight creditor countries from \$3,167 million in 1937 to \$1,665 million in 1938 naturally put a great strain on the debtor countries. But by drawing on their accumulated foreign resources these countries maintained their imports at a high level in 1938. It is still too early to tell whether recovery in the industrial countries will be sufficiently pronounced to increase substantially their imports of raw materials and, in a measure, restore the current purchasing power of the primary producing countries.

The change which occurred from 1937 to 1938 in relative values of raw materials and foodstuffs, on the one hand, and finished articles, on the other, has had a marked influence also on Germany's foreign trade, for 80 per cent. of German exports but only 7 per cent. of her imports consist of finished articles other than foodstuffs. The amount of German exports of finished goods fell by 9.2 per cent. from 1937 to 1938, but export prices rose by 2.2 per cent., so that the decline in volume was 11.1 per cent. Total imports were 1.4 per cent. higher, but prices fell by 8.4 per cent., so that the increase

in the import volume was 10.6 per cent. These figures refer to the former German territory; the net result for the year was the appearance of an import surplus of RM 192 million, as compared with an export surplus of RM 413 million in 1937 (excluding all trade with Austria for the two years) with a total change of RM 605 million in the trade balance. The Secretary of State for the Four-Year Plan explained at the beginning of 1939 that it had been decided to have recourse to the available foreign exchange reserve, the determining factor being the consideration that the expansion of German production of raw materials and substitutes under the Four-Year Plan would open up new sources of supply which might one day take the place of foreign exchange reserves or even contribute to the formation of new reserves. In addition, the decision was prompted by a realisation of the fact that only the employment of the foreign exchange reserves would make it possible to proceed swiftly with the reinforcement of the defence preparations. The measures for the enlistment of foreign exchange reserves, which had been directed in particular towards foreign balances in respect of exports, foreign capital claims, foreign securities in German hands and stocks of minted and un-minted gold still held in German private ownership, produced more than RM 1 milliard, a figure corresponding to nearly 20 per cent. of total German imports for 1937. The special allocation of exchange from these reserves was used in the first place to increase the food supply by additional imports of cereals and of raw materials for the manufacture of margarine and, as far as possible, to fill the gaps in the supply of raw materials for branches of industry working primarily for armaments production under the Four-Year Plan, while it was also possible to ensure the supply of raw materials required for export.

Italian exports were maintained during 1938 at the same level as in the previous year, while imports fell by not less than 20 per cent., the import surplus being reduced from Lit. 5,700 to 2,900 million. This improvement has permitted a reduction of the net deficit on the clearing accounts with other countries from Lit. 330 million at the end of 1937 to Lit. 260 million at the end of 1938; and as is shown on page 87 the deficit on clearing accounts disappeared by the end of March 1939. The smaller import surplus was in part a consequence of exceptionally good harvests in 1937 and 1938 and otherwise mainly due to strict control of imports. The fact that in a year of shrinking world trade Italian exports have been fully maintained reflects the efforts made to improve the quality of goods exported and generally to render the national export organisation more efficient. While the transformation of the country's economic structure aims at a higher national production, it is part of the official policy to promote the development of foreign trade.

The development of the export trade of countries in south-eastern Europe shows a great variety of tendencies. The exports of Roumania fell by about 32 per cent. from 1937 to 1938 and those of Yugoslavia by 19 per cent., while the exports of Greece rose by 6 per cent. and those of Bulgaria by 11 per cent. Polish exports have been maintained practically at the same level as

in 1937, but imports increased by 3.7 per cent. owing mainly to larger purchases of machinery and other industrial implements as well as automobiles. Polish trade with extra-European countries suffered a material reduction for the first time in many years. The exchange of goods with Germany increased, on the other hand; since the inclusion of Austria, Germany has not only held first place in Polish imports but has also taken the greatest share of Polish exports.

Amongst the countries in northern Europe exports from Denmark have fallen less than the exports from Norway, Sweden or Finland. This is remarkable considering that Danish exports consist to the extent of about 70 per cent. of agricultural products, the explanation being that the prices of eggs, butter and meat — the main produce of the Danish farmers — have kept up well in contrast to the price of cereals, which Denmark produces only for domestic consumption. In Finland exports fell more than imports, the result being the first passive trade balance for eight years; but the balance of payments is still active. Sweden had a larger import surplus, but here also the balance of payments was positive. In Norway, on the other hand, the import surplus was reduced but a smaller income was obtained from shipping.

By a strict control of foreign trade Japanese imports were compressed by nearly 30 per cent., while exports fell by only 14.7 per cent. Manchukuo, on the other hand, increased both exports and imports by 43.9 and 14.7 per cent. respectively. The interpretation of Chinese trade figures is somewhat difficult on account of the hostilities and the changes in monetary values, but the well-known resistance of China to calamities of all kinds would seem to have shown itself in the maintenance of a higher actual trade volume than might have been expected, the reported decline in the foreign trade in terms of Chinese dollars being about 9 per cent.

The table on the opposite page shows that the greatest decline in imports of all countries occurred in the United States (36.4 per cent.) and in Japan (29.2 per cent.), the trade of the former country being affected by the internal business depression which began in the latter half of 1937 and the trade of the latter by the restrictions imposed in connection with the hostilities in China. The greatest fall in exports, on the other hand, is found in the Argentine (39.4 per cent.) and in British Malaya (36.5 per cent.), i.e. in two primary producing countries. The conclusion to be drawn from these facts is obvious: the state of activity in the industrial countries acts directly on the fortunes of the primary producers; particular measures taken to stimulate export trade have no doubt a certain justification, but an even flow of goods internationally presupposes an even trend of business in the various countries. The renewed interest in exports which has been so conspicuous a development over the past year should afford an opportunity for examining the general conditions propitious for a healthy balance between the internal and external activities

of the various countries. The pessimistic view that the striving for self-sufficiency would seriously reduce the field for and the importance of foreign trade has proved to be in the main mistaken: world trade has in fact shown a remarkable resilience even at a time of acute political nervousness.

Changes from 1937 to 1938 in the foreign trade of different countries.*

Imports				Exports			
in millions of national currencies							
Country	1937	1938	% changes	Country	1937	1938	% changes
Manchukuo	848	1,220	+ 43.9	Morocco	1,144	1,502	+ 31.3
Syria	5,360	7,081	+ 32.1	Algeria	4,334	5,650	+ 30.4
Turkey	114	150	+ 31.6	France	23,939	30,596	+ 27.8
Indo-China	1,562	1,917	+ 22.7	Tunis	1,141	1,353	+ 18.6
Philippines	216	262	+ 21.3	Manchukuo	532	610	+ 14.7
Morocco	1,766	2,127	+ 20.4	Syria	2,571	2,928	+ 13.9
Iran	1,259	1,509	+ 19.9	Lithuania	208	233	+ 12.0
Tunis	1,324	1,560	+ 17.8	Bulgaria	5,019	5,578 ⁽²⁾	+ 11.1
Chile	429	502	+ 17.0	Indo-China	2,594	2,947	+ 9.8
Algeria	4,083	4,667	+ 14.3	Eire	22	24	+ 7.4
Peru	235	260	+ 10.6	Greece	9,555	10,149	+ 6.2
France	42,391	45,981	+ 8.5	Turkey	138	145	+ 5.1
Australia	126	133	+ 5.6	Switzerland	1,286	1,317	+ 2.4
Lithuania	212	223	+ 5.2	Siam	168	170	+ 1.2
Poland-Danzig	1,254	1,300	+ 3.7	Brazil	5,092	5,099	+ 0.1
U. S. S. R.	1,341	1,387	+ 3.4	Italy	10,434	10,379	- 0.5
Siam	110	113	+ 2.7	Poland-Danzig	1,195	1,185	- 0.9
Germany	5,455	5,443 ⁽¹⁾	- 0.2	Estonia	106	104	- 1.9
Bulgaria	4,986	4,934 ⁽²⁾	- 1.0	Denmark	1,569	1,527	- 2.7
New Zealand	56	55	- 1.5	Norway	811	774	- 4.6
Latvia	231	227	- 1.7	Iran	2,582	2,460	- 4.7
Brazil	5,315	5,177	- 2.6	Portugal	1,202	1,141	- 5.1
Sweden	2,123	2,068	- 2.6	Mexico	892	838	- 6.1
Netherlands Indies	489	486	- 0.6	Uruguay	99	93	- 6.1
Greece	15,204	14,761	- 2.9	Peru	365	341	- 6.6
Portugal	2,353	2,284	- 2.9	U. S. A.	3,349	3,094	- 7.6
Egypt	37	36	- 3.0	Sweden	2,000	1,839	- 8.0
Denmark	1,674	1,624	- 3.0	China	838	763	- 8.9
Ceylon	221	214	- 3.2	Netherlands	1,148	1,039	- 9.5
Estonia	111	107	- 3.6	United Kingdom	521	471	- 9.6
Yugoslavia	5,148	4,949	- 3.9	Australia	148	133	- 10.1
Uruguay	80	76	- 5.0	Finland	9,379	8,431	- 10.1
Eire	43	41	- 5.6	Colombia	184	165	- 10.3
Argentina	1,558	1,461	- 6.2	Germany	5,901	5,249 ⁽¹⁾	- 11.0
China	953	886	- 7.0	Hungary	588	522	- 11.2
Colombia	170	158	- 7.1	Philippines	331	291	- 12.1
Finland	9,151	8,482	- 7.3	New Zealand	67	58	- 12.5
Union of South Africa	101	93	- 7.9	Latvia	261	227	- 13.0
Norway	1,280	1,176	- 8.1	Palestine	6	5	- 13.5
India	1,644	1,501	- 8.7	Czecho-Slovakia	11,954	10,240	- 14.3
Netherlands	1,550	1,415	- 8.7	Japan	3,125	2,667	- 14.7
Roumania	20,285	18,520	- 8.7	Belgium	25,206	21,493	- 14.7
United Kingdom	953	859	- 9.9	Ceylon	310	264	- 14.8
Palestine	15	14	- 10.6	Canada	1,004	846	- 15.7
Switzerland	1,807	1,607	- 11.1	India	1,983	1,623	- 18.2
Hungary	484	418	- 13.6	Yugoslavia	6,272	5,047	- 19.5
Canada	809	677	- 16.3	Union of South Africa	123	98	- 20.3
Belgium	27,487	22,694	- 17.4	Haiti	42	33	- 21.4
Mexico	614	493	- 19.7	U. S. S. R.	1,729	1,329	- 23.1
British Malaya	686	551	- 19.7	Egypt	39	29	- 26.1
Italy	13,942	11,124	- 20.2	Chile	933	674	- 27.8
Haiti	47	36	- 23.4	Netherlands Indies	988	694	- 29.8
Czecho-Slovakia	10,980	8,388	- 23.6	Roumania	31,568	21,529	- 31.8
Japan	3,732	2,641	- 29.2	British Malaya	899	571	- 36.5
U. S. A.	3,084	1,960	- 36.4	Argentina	2,311	1,400	- 39.4

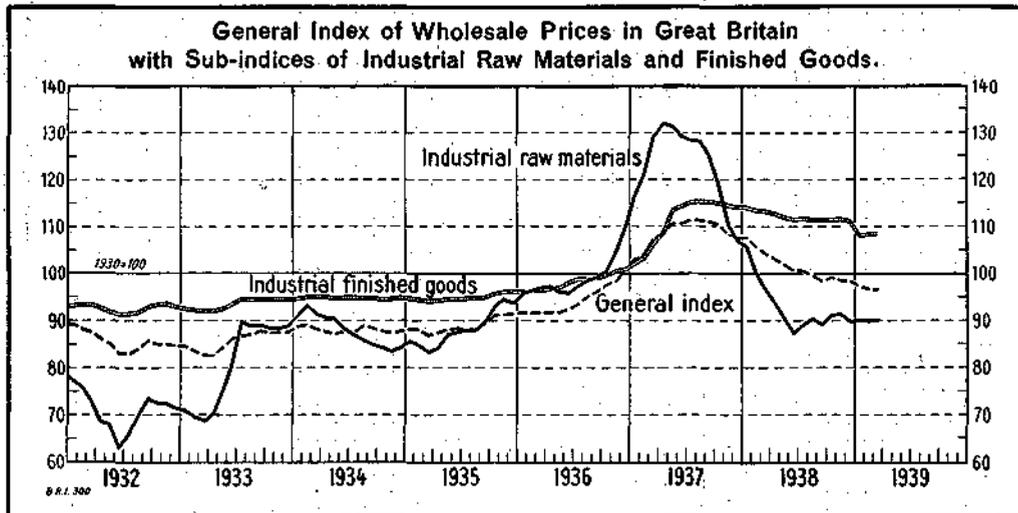
* Partly provisional figures.

⁽¹⁾ Excluding trade between Germany and Austria.

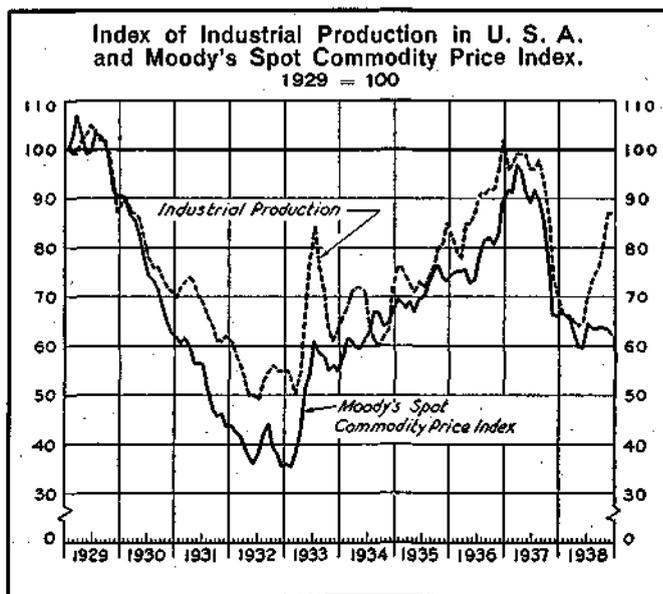
⁽²⁾ Including exchange premiums.

3. PRICE MOVEMENTS.

The main characteristics of the commodity markets last year may be summed up as follows: the rapid fall in prices of industrial raw materials which began in 1937 came to a standstill in the middle of 1938 and a certain recovery set in, though only within narrow limits; prices of cereals, on the other hand, continued to fall as a result of abundant crops. Lower prices for foodstuffs tended to reduce somewhat the cost of living, but prices of finished industrial products, though slightly declining, would seem to have been a little higher in 1938 than the average for the previous year. The average import and export prices of Germany and the United Kingdom show the same tendencies: from 1937 to 1938 average prices of imports (mostly raw materials and foodstuffs for both countries) fell by around 7 per cent., while prices for exports (mostly finished goods) rose by about 2 per cent. Of particular interest are the variations which have occurred over the last two years in the relation between the prices of finished goods and of basic materials, as is apparent from the following graph giving index numbers of wholesale prices in the United Kingdom:



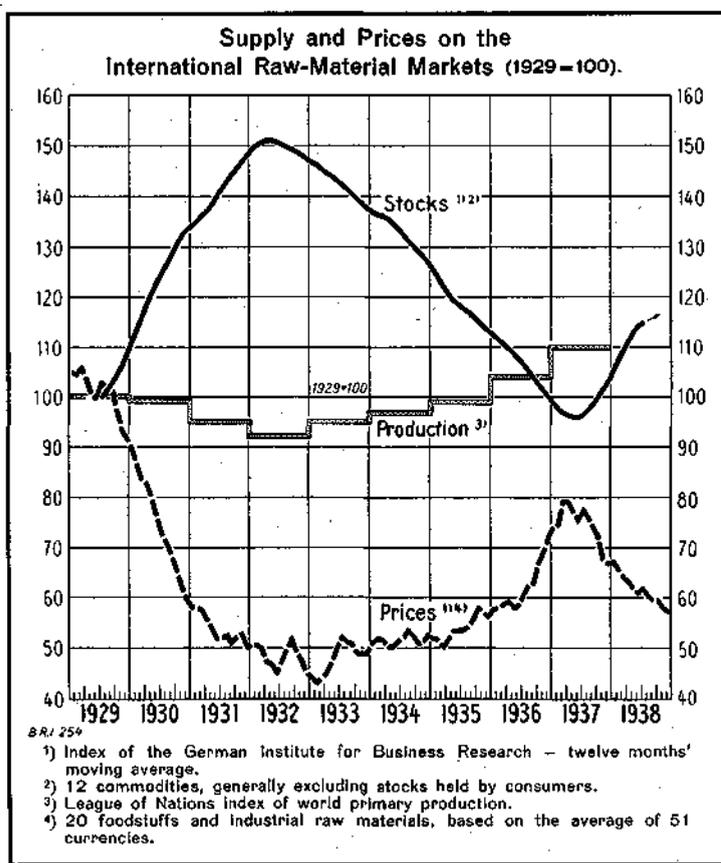
From the middle of 1933 to the autumn of 1936 prices of finished goods and of industrial raw materials showed a high degree of stability and did not diverge from one another by more than 10 per cent. At the end of 1936 and the beginning of 1937, however, prices of raw materials rose altogether too sharply under the influence of an acceleration in the world's industrial recovery coupled with general replenishment of manufacturers' stocks and heavy market speculation, partly associated with exaggerated beliefs as to the requirements for armament production. Not only was the rise disproportionate from the point of view of the supplies which became available on the different markets, but it introduced a serious disequilibrium in the cost and price structure. There was, at the beginning of 1937, also a rise in the price of finished goods but not in the same degree, and the higher prices charged made it difficult to maintain the volume of sales to the ultimate consumers. Stocks accumulated



and when the reaction came it was particularly violent, being affected by the rapid fall in industrial production in the United States and some other countries and by the increase in the supplies of raw materials induced by the earlier rising prices. During the fourteen months from April 1937 to June 1938 the price index of industrial raw materials in Great Britain fell from 132 to 87 and since then has shown little recovery, despite the rapid increase in

industrial activity in the latter half of 1938. In the above graph, reproduced from the Monthly Survey of the U. S. Department of Commerce, a comparison is made for the United States between the volume of industrial production, according to the Federal Reserve index, and Moody's index of prices for 15 staple commodities (including both industrial materials and foodstuffs). The latter index, which is more sensitive than the more comprehensive indices of primary and semi-manufactured products, has usually moved fairly consistently with industrial activity; but this relationship was broken in the latter half of 1938. For though prices of rubber, non-ferrous metals, scrap steel, hides and silk advanced from late June there was no sustained general rise in the prices of staple commodities. The main reasons for this failure of prices to respond to the trend of industrial activity were the large stocks available to meet increased demands, the record crops of cereals and generally the depressing influence of political uncertainty.

The prices of staple commodities are back at the level obtaining in early 1934 and still nearly 40 per cent. below 1929. No real reaction has, in fact, set in against the precipitous decline in the latter half of 1937; for that reason some improvement in prices of staple commodities from the present depressed levels would be generally welcomed. It is, however, important that this improvement should not be too rapid. There can be no doubt that the sharp advance in the prices of raw materials from the middle of 1936 to the early spring of 1937 was one of the causes of the subsequent setback in business. Stocks of raw materials reached their lowest level for many years at the end of 1936 and it was this low level of existing stocks which made possible the sharp price rise. Recent investigations would seem to show that, in general, surplus stocks become exhausted and prices rise quickly just before the upper turning-point of the business cycle, i. e. immediately before the setback. When, on the other hand, raw-material stocks are more plentiful, they act as a brake on an advance in prices and in that way



furnish support to a more lasting recovery. A gradual rise in raw-material prices is certainly compatible with sustained recovery, but the experience of 1936-37 shows that too sudden a rise brings its own retribution. This would seem to indicate that it is not the production of raw materials which dominates the trade cycle, but the consumption of raw materials in industries producing investment and consumption goods. As the production of consumption goods shows a relatively great stability throughout the trade cycle

the main cause of the changes in the absorption of raw materials must lie in fluctuations in the production of investment goods. Changes in cost and price structure by which these fluctuations are largely governed are influenced by the abundance or depletion of raw-material stocks in so far as they lead to a rise or fall in costs; and this influence is apparently predominant and overrules influences from superabundant or depleted stocks as deterrents or stimulants to production. The part played by visible raw-material stocks would seem to be that of a reservoir taking up surplus output and supplementing current needs as the case may be. Organisation of raw-material production by so-called restriction schemes may seek to prevent the continuation of unremunerative production, but they do not contain any element of stimulation. And they must be so administered as not to impair the normal function of visible stocks, which is to serve as a brake on a too rapid increase in the costs of the manufacturing industries when recovery sets in.

When in the autumn of 1938 the demand for raw materials strengthened, there was a certain tendency to increase quotas of production and export of internationally controlled commodities, but a reaction set in in the following winter, the restrictions being again tightened up when prices showed every sign of remaining at their comparatively low levels.

Visible stocks of primary products, as a rule, increased somewhat during 1938 but are in most cases not higher than at the end of 1935 when a

general recovery was well on its way. Government reserves for emergency purposes, though not published, are known to be higher than ever before, but stocks in the hands of manufacturers (as distinct from visible stocks) are probably comparatively low since the general tendency seems to have been to buy mainly for fairly immediate needs.

Visible stocks of commodities

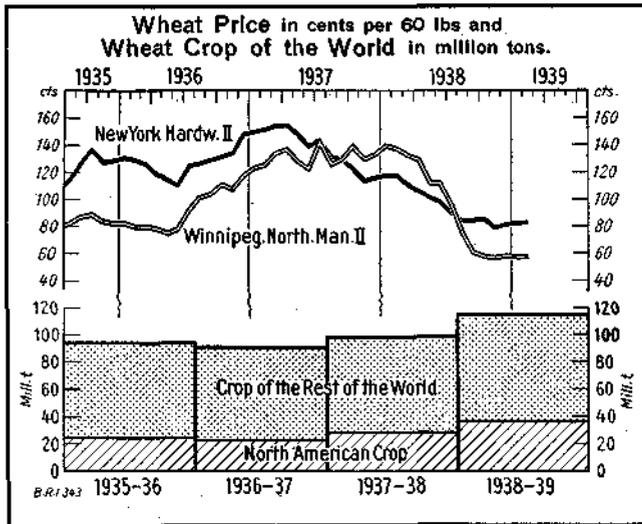
End of year	Wheat	Sugar	Tea	Coffee	Copper	Lead
	million bushels	thousand tons	million lb.	million bags	thousand tons	
1935	484	6,102	265	7.8	294	287
1936	312	5,351	236	7.8	190	227
1937	333	6,097	217	7.0	264	193
1938	484	6,064	243	7.8	288	199

End of year	Spelter	Tin	Cotton	Wool	Petroleum	Rubber
	thousand tons		thousand bales	million lb.	million barrels	thousand tons
1935	83	19.3	7,768	457	460	595
1936	57	29.9	8,002	481	441	434
1937	78	35.8	9,066	567	483	502
1938	138	37.2	9,652	559 *	471	441

* End of November.

Among the agricultural products, stocks of wheat and cotton were higher at the end of 1938 than at the end of the previous year; in 1938 the yield of the world wheat harvest was the highest on record: European production exceeded by 5 per cent. the previous high of 1933 and production in the United States was 11 per cent. higher than the previous maximum harvest in 1928.

The price of Canadian wheat on the free world markets fell by over 50



per cent. during 1938, which was a bad year for cereals generally. The prices of products of animal origin (butter, meat, eggs, etc.) were much better maintained, the average net decline during the year being less than 5 per cent. Wheat-exporting countries have, of course, felt acutely the impact of the fall in price, but, generally, the part of the farmers' income derived from wheat production is not great. The

1938 wheat crop in the United States was approximately 1,000 million bushels, and, if the price on the farm is taken at about 50 cents, the total cash income from the crop will be \$ 500 million, which is not a very large element — in fact, less than 7 per cent. of the total estimated farm cash income of roughly \$ 7,500 million. Wheat is, however, the important cash crop of several large districts both in the United States and elsewhere and its political significance is generally great.

One of the reasons why prices of animal products have kept up better than prices of cereals is the increased consumption of more expensive foods (such as meat and eggs) and the decline in the consumption of bread by populations with a higher standard of living. In the United States the aggregate value of the annual output of the poultry trade (eggs, chickens, etc.) exceeds the value of the annual wheat production. The greater resistance of the prices of animal products is not merely a recent phenomenon — it has been a feature of price movements since the middle of the nineteenth century and was particularly noticeable in the severe agricultural depression in 1896 when the wheat price slumped heavily. Changes in consumers' demands must, of course, lead to changes in production, but the necessary adjustments may be difficult to achieve. Danish farmers have been known to respond with great expedition to changes ruling on the main export markets and have in that way gained an advantage over their competitors. When from 1870 onwards European production of cereals became subject to intense competition from overseas countries, Denmark decided not to grant protection to

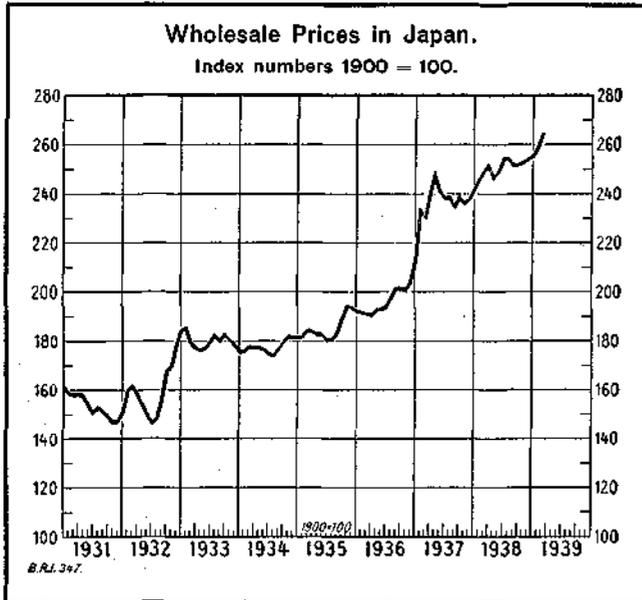
Wholesale Price Indices.

1929 = 100.	1937	1938		1939			Percentage change from Dec. 1937 to Dec. 1938
	Dec.	June	Dec.	Jan.	Feb.	March	
Canada	87	84	77	77	77	.	- 11.3
United Kingdom	94	88	86	85	85	85	- 8.6
Denmark	111	103	102	102	102	101	- 8.3
Belgium	77	74	71	71	71	71	- 7.9
Netherlands	76	72	71	70	70	70	- 6.6
Sweden	97	93	91	91	91	91	- 6.6
Albania	67	62	63	63	62	.	- 6.0
Portugal	103	98	97	.	.	.	- 6.0
U. S. A.	86	82	81	81	81	.	- 5.7
Norway	107	103	101	99	99	99	- 5.6
Poland	60	59	57	57	57	57	- 5.3
Greece	126	123	120	120	120	.	- 4.9
Finland	104	99	100	100	100	.	- 3.9
Switzerland	78	76	75	75	75	75	- 3.2
Yugoslavia	79	79	77	77	76	76	- 3.0
Hungary	88	88	85	85	85	86	- 2.9
Latvia	96	94	93	95	96	.	- 2.6
Danzig	102	98	100	.	.	.	- 2.0
Estonia	86	86	86	87	87	.	- 0.9
Italy	101	101	101	102	102	102	0
Germany	77	77	78	78	78	78	+ 0.8
Roumania	79	80	81	83	.	.	+ 2.3
Bulgaria	65	63	67	67	66	.	+ 3.2
Czecho-Slovakia	80	80	85	86	.	.	+ 5.4
Japan	110	116	116	118	120	121	+ 5.8
France	101	105	109	110	109	109	+ 8.4

its farmers but to adapt its agriculture to meet the growing demand for butter, bacon, eggs, etc.; and this policy has been followed fairly consistently up to the present time.

The various influences to which commodity prices have been subject since the middle of 1938 — the partial recovery of industrial materials and the continued fall in cereals — have led to a remarkable stability of the general level of wholesale prices in most countries.

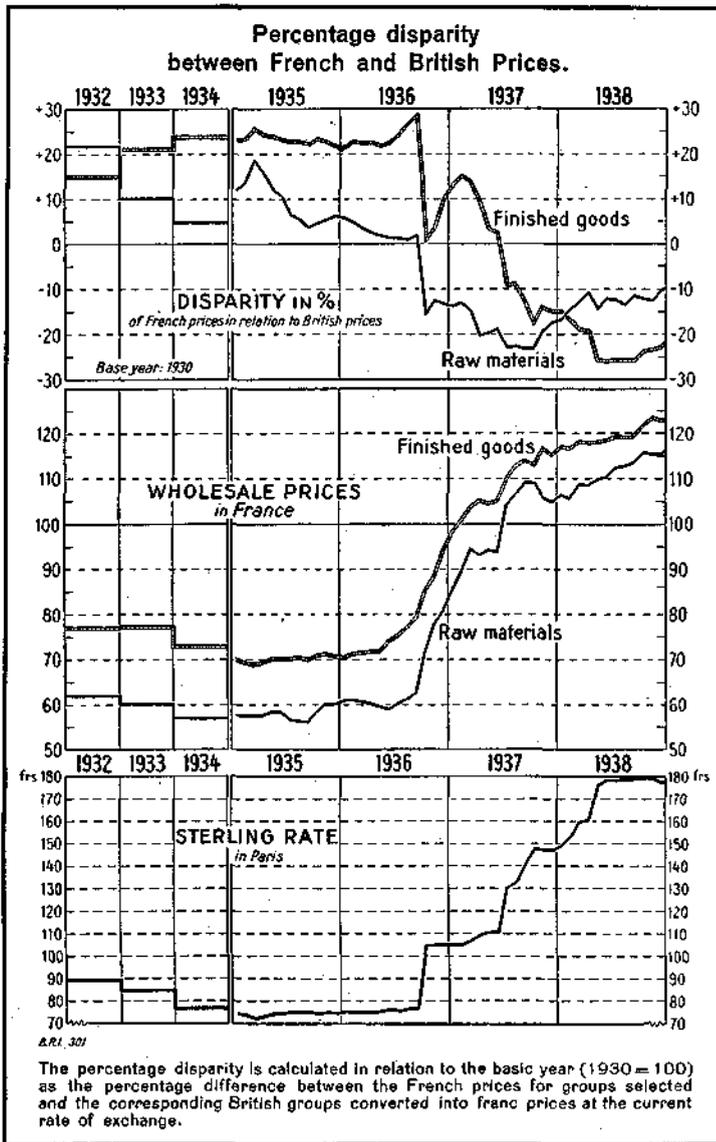
Japanese prices, however, continued to increase in 1938 after a steep rise during the previous year; and the price margin obtained through the depreciation of the yen by nearly 70 per cent. would seem to have been fully wiped out.



In Italy the general level of wholesale prices rose by some 25 per cent. from the time of the devaluation of the lira in the autumn of 1936 to the end of 1937, but they have since then remained stable at about the same level as that reached in 1929. Variations occurred, however, in the price movements of different groups of commodities; while finished products, particularly foodstuffs and textiles showed an increase, semi-finished products remained unchanged and raw materials declined.

Prices in France rose again in 1938 but less sharply than in the previous eighteen months. The movements of French prices during recent years provide an interesting example of the connection between internal and external equilibrium in a country's price structure. Some of the main tendencies may be illustrated by a comparison between the differential price movements of raw materials and finished products in France and the United Kingdom from 1932 to 1938, as shown in the graph on page 53.

In 1935, while the rate of about 75 francs to the pound was still ruling, French prices, despite the fall that had occurred in the previous two years, remained above British prices — for finished products the disparity was as great as 23 per cent. compared with 1930 — a sign of the overvaluation of the French currency at that time. In the following year the disparity was accentuated in the case of finished products since costs of production were increased through the social and other changes introduced in the summer of 1936, and, as the graph indicates, a growing divergence set in at the same time between price movements of finished products and of raw materials. With the devaluation in September 1936, which resulted in a pound rate of about 105 francs, the divergence between French and British prices suddenly contracted, but both the external and the internal disparity reappeared to some extent at the end of the year and widened considerably at the beginning of 1937. It was at the beginning of 1937 that the 40-hour week was introduced and important wage increases were made. During 1937 the franc fell by stages from 105 to 112 and in the summer to 135, being 150 to the pound by the end of the



year. The rise in French prices began, however, to slow down and soon a marked disparity arose in favour of French prices, further enhanced by the fall in the franc below 150 to the pound early in 1938, followed by the de facto stabilisation at a rate of about 178. The disparity became even more pronounced in respect of finished goods than raw materials, the situation existing in the summer of 1936 being thus entirely reversed.

The violent movements of exchange values, prices and costs during the last ten years have shown the importance of studying the disturbances which arise in the internal structure of costs and prices and in the relation of different categories of prices between home

and foreign markets. Thus a much greater insight is gained into the influence which the various factors in operation exert not only upon the external but also upon the internal equilibrium of the different national economic systems and into the importance of this double equilibrium.

In a period of falling prices the wholesale levels in countries with stable exchanges and relative freedom from restrictions must in a measure adapt themselves to the general movements but, as costs are less amenable to adjustment, a lack of balance may appear in internal production. The fall in prices which occurred in the latter half of 1937 and continued in 1938 has caused great difficulties in adjustment for many countries, and experience has shown that prices of finished products have partaken but little in the downward movement. Such prices as are controlled by national arrangements

are usually the last to move. They too are, however, subject to pressure; and in this connection the reduction in British steel prices of from 5 to 8 per cent., which was decided upon in December 1938, may be quoted by way of example.

For consumers and producers the prices quoted in their national currencies are, of course, those of immediate importance; but, in order to show the degree of convergence between the price levels in different countries, a common denominator is required and may suitably be found in gold. A recalculation of the various price indices on a gold basis also serves to indicate to what extent gold prices have been reduced since 1929. The graph on page 52 shows wholesale prices in a number of countries on a gold basis in comparison with pre-war conditions (1913-14 as 100).

With the exception of Germany, where price movements (calculated in gold at the official rate of the mark) have been dissociated from the external trend since 1933, and of France, where, owing to the recent depreciations, prices in terms of gold are still lower than elsewhere, a certain convergence of gold prices is noticeable at between 65 and 75 per cent. of pre-war prices. As can be seen from the graph, the price indices of the various countries tended to converge also in 1929 but then at a level 40 per cent. higher than before the war. In terms of gold the level of world wholesale prices now stands at only one-half of what it was ten years ago and has remained so more or less for five years, despite the great increase in current gold production and in armaments expenditure.

III. PRODUCTION AND MOVEMENTS OF GOLD.

Gold production in 1938 rose both absolutely and relatively more than in 1937. The increase over the previous year was 5.6 per cent., the quantity produced being nearly 37 million ounces, equal to \$1,290 million. The main recipient of gold was again the United States whose reserves increased by \$1,750 million — over 35 per cent. more than the total current gold production. In the autumn of 1938 when most of this gold was shipped to New York it served as a vehicle for violent transfers of banking funds, the spectacular nature of which might easily obscure the more profound effects of changes in currents of trade and investment. As a matter of fact, over one-half of the gold acquisitions of the United States during 1938 may be associated with the country's large export surplus and less than half with a net influx of capital. Capital movements — and notably the transfer of nervous funds — assumed greater importance, however, in the first four months of 1939, being caused increasingly by fear of war, which has brought institutions and individuals alike to increase their liquidity, especially in dollars. Larger holdings of gold abroad by central banks is another manifestation of the same preoccupation, gold earmarked with the Federal Reserve System increasing by \$333 million in 1938.

A net loss of gold was sustained by the British Exchange Equalisation Account, which probably parted with something like £200 million during 1938, mostly for export to the United States, a part, however, returning to France, especially in the closing months of the year. The strain exerted on the London market brought the gold price on 26th November 1938 to the high record of 150 shillings and the turnover for the year at the daily official fixings to £208 million, compared with £123 million in the previous year. Hoarding of gold showed opposite tendencies during different periods of 1938, but the net result would seem to have been an increase of \$100 to 200 million in the aggregate of gold hoarded. In the opening months of 1939, however, substantial amounts moved out of hoards, mainly into dollars.

The writing-up of central bank gold reserves to rates more in conformity with the current price of gold has continued, the revaluation of the Bank of England's holding being particularly notable. By the end of March 1939 about 90 per cent. of the world's monetary gold stock had been thus revalued.

1. THE SUPPLY OF GOLD.

The continued increase in the annual gold production can be seen from the table on the following page.

The 1938 gold production in the U.S.S.R. is estimated at the same figure of 5 million ounces (\$175 million) as in 1937, no further information being available as to the actual amount produced. The known exports of gold from the U.S.S.R. in 1938 amounted to \$115.5 million compared with \$200 million

Year	South Africa	U. S. S. R. (¹)	U. S. A. (²)	Canada	Other producing countries	World Production (³)	million dollars (⁴)
	in thousands of fine ounces						
1930	10,716	1,501	2,286	2,102	4,318	20,923	732
1931	10,878	1,656	2,396	2,694	4,702	22,326	781
1932	11,559	1,938	2,449	3,044	5,264	24,254	849
1933	11,014	2,700	2,537	2,949	6,326	25,526	893
1934	10,480	3,858	2,916	2,972	6,950	27,176	951
1935	10,774	4,500	3,619	3,285	7,376	29,554	1,034
1936	11,336	5,280	4,296	3,748	8,338	32,998	1,155
1937	11,735	5,000	4,753	4,096	9,304	34,888	1,221
1938	12,161	5,000	5,008	4,716	9,969	36,854	1,290

(¹) No official statistics for U. S. S. R. are available, but percentage changes are given irregularly. Present figures are estimates. (²) Including Philippines. (³) Figures partly revised.
 (⁴) Amounts are given in dollars of present day value of \$35 per ounce of fine gold.

in the previous year, the gold being sold through London. A decree of the Soviet Government in the autumn of 1938 laid down that in future no permission would be granted for exports of domestic gold to countries other than France, Great Britain and the United States, all export of gold to countries with controlled exchange markets being specifically prohibited. Modern gold-mining machinery has from time to time been purchased for Soviet account in the United States, which may be taken as a sign of the continued development of the country's gold production.

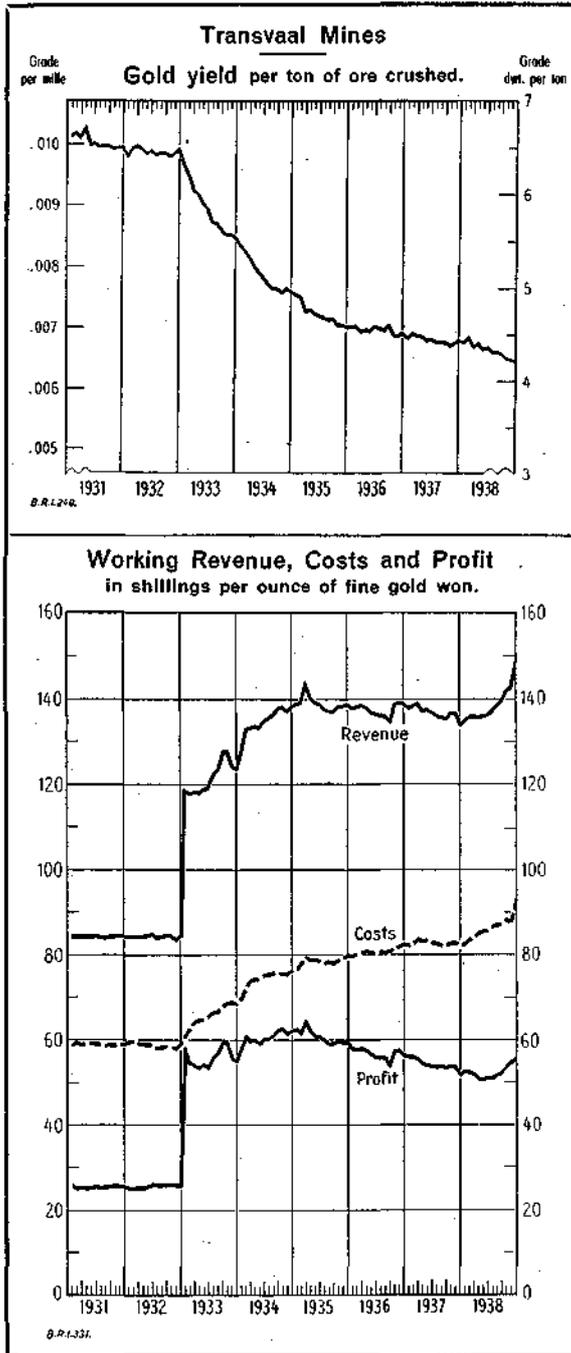
Gold production in South Africa rose by 3.6 per cent. in 1938, i. e. at the same rate as in the previous year, despite the further reduction in the average grade of ore milled. The following table and graph shows some of the main changes for the years 1932 to 1938 in the conditions of South African gold production:

Transvaal Chamber of Mines.
 Comparison of conditions of the large mines in 1932 and 1938.

	1932	1938	Percentage change
Price of gold (annual average)	85 s.	141 s. 9d.	+ 66.8
Grade of ore milled:			
yield in dwt per ton . . .	6.48	4.35	- 32.9
Quantity of ore milled: tons	35,210	54,275	+ 54.1
Gross receipts per ton milled	27 s. 7d.	31 s. 1d.	+ 12.4
Working costs per ton milled	19 s. 2d.	19 s. 3d.	+ 0.4
Working profit per ton milled	8 s. 5d.	11 s. 10d.	+ 40.6
Total working profits	£14.7 million	£31.9 million	+ 117.6
Total gold output:			
in pounds of the day . .	£49.1 million	£83.6 million	+ 70.3
in ounces	11,554	12,157	+ 5.2

The rise in the price of gold, while the cost per ton milled remained steady, made it profitable to work lower-grade ores, so that, even if a greater quantity of ore was milled annually, the lives of the mines were prolonged. The mining companies have aimed less at the greatest possible immediate profits (such as would have been obtained if higher grade ores had continued to be milled) than at the preservation of a comparatively high rate of profits in the future.

The milling of a greater quantity of ore presupposes, however, that a sufficient supply of labour can be obtained (thus the policy adopted has provided increased employment in the Union). As a matter of fact, the necessary supply was forthcoming. The average number of European employees on the Rand rose from 23,051 in 1932 to 39,408 in 1938 and of natives from 214,781 to 309,286 in the same period. More labour has been recruited in recent years from tropical Africa, though the total so far is only about 10,000. It is reported that, thanks to improved medical and other services, more suitable working and living conditions are arranged, as reflected, for instance, by a decline in the sickness and death rate. The supply of workers — European and native — is naturally influenced by alternative openings for employment; in that respect the depression in 1929, reducing the possibilities of employment in other occupations, favoured the mining companies. It is interesting to note that even the short boom in 1936–37, with higher demand for diamonds, farm products and basic materials, somewhat affected the supply of native labour, while the renewed fall in prices in 1937 made it again possible to engage more natives from Union territories. In 1938 the Trade Union of European Employees asked for certain im-



provements in their conditions; as a result of negotiations a savings fund was established to which the industry contributes about £500,000 per annum.

A rough analysis of the distribution of the amounts realised by gold sales can be given for the large companies of the Witwatersrand affiliated to the Transvaal Chamber of Mines (accounting for practically the whole output of gold):

Distribution of amounts realised by gold sales	£ million	Percentage
To the community, working costs	51.7	61.8
To the government, taxation and share of profits	13.4	16.1
To shareholders, dividends.	17.2	20.6
Miscellaneous (including capital expenditure provided out of current revenue)	1.3	1.5
Total . .	83.6	100.0

From 1932 to 1938 the number of employees and workers increased by nearly 50 per cent.; but the output of gold rose by only 5.2 per cent. In 1932 there were 32 producing mines in operation, but in 1937 there were 37 of them (including six brought into operation since 1932) and 22 new mines not yet in the producing stage, of which many show prospects of considerable output in years to come. It is therefore to be expected that South African production will continue to increase at an accelerated rate.

While the South African output rose by only 5.2 per cent. from 1932 to 1938, the output in the rest of the world nearly doubled. The sharp rise in the world's gold supply over recent years has thus been almost entirely

Gold production in the principal countries	1932	1938	Percentage change from	
	In thousands of fine ounces		1932 to 1938	1937 to 1938
South Africa	11,559	12,161	+ 5.2	+ 3.6
Rest of the world: . . .	12,695	24,693	+ 94.5	+ 6.7
U. S. S. R. (1)	1,938	5,000	+ 158.0	—
U. S. A. (2)	2,449	5,008	+ 104.5	+ 5.4
Canada	3,044	4,716	+ 54.9	+ 15.1
Australia	714	1,570	+ 119.9	+ 13.7
Mexico	584	916	+ 56.8	+ 8.3
Rhodesia	581	816	+ 40.4	+ 1.0
Japan (1)	402	755	+ 87.8	+ 4.4
Other countries	2,983	5,912	+ 98.2	+ 6.6
Total Gold Production .	24,254	36,854	+ 52.0	+ 5.6

(1) Estimated figures.

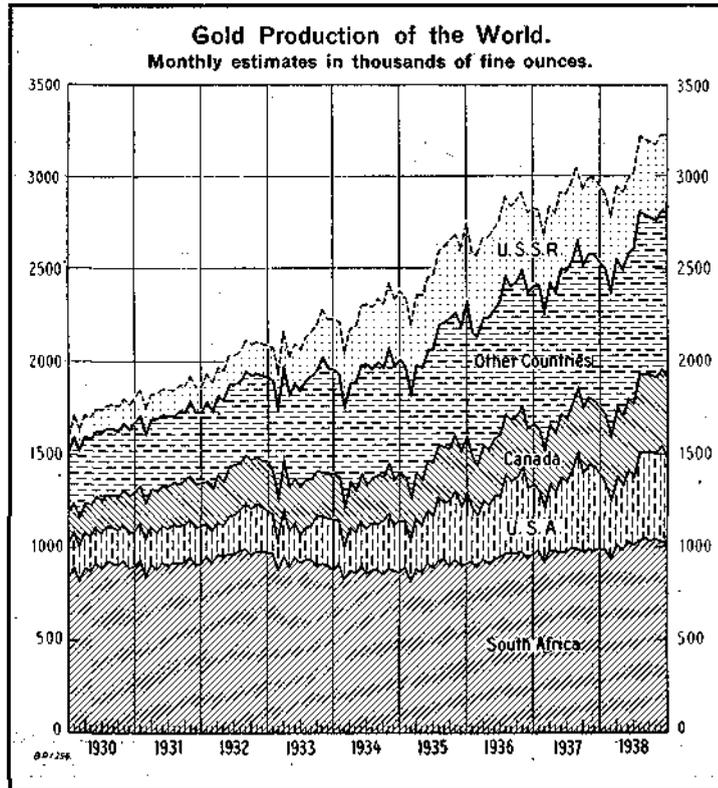
(2) Including the Philippines.

due to expansion outside South Africa; but this development may be reversed in the future, partly as a result of increased output of the South African mines and partly because the more rapid exploitation in other countries may lead to a relatively rapid exhaustion of their gold deposits.

For the moment, however, the tendency is still one of continued expansion in other countries than South Africa. In the United States production increased at the rate of 3 per cent. but rose in the Philippines by 25 per cent. (from 692,000 ounces in 1937 to 862,000 ounces in 1938). Six new mines

were opened in these islands in the first half of the year and the opening of others was in preparation.

In Canada, production also advanced by rapid strides, rising by 15 per cent. from 1937 to 1938. Mines already opened increased their output and new mines began to be worked. Greater activity seems to have been expended on the improvement of established mines than in the search for new ones. But a new railway 100 miles long was opened by the Canadian National Railway Co. for the service of new gold-



mining areas. In general, the aeroplane continues to be a useful means of transport for far-off districts. The importance of the gold-mining industry may be seen from the fact that it accounts for fully 50 per cent. of the total value of the country's primary metal production.

Besides the four major producing centres — South Africa, United States, Russia and Canada — of particular importance is Australia, where gold production rose by 120 per cent. from 1932 to 1938 and in the latter year advanced by nearly 14 per cent. In general, governments have continued to take steps to stimulate gold production: in Japan the price paid to producers was again increased; in Roumania the premiums allowed on domestic gold were established at fixed rates for different categories of producers, total production amounting to 175,000 ounces in 1938; in France, Fr. fcs 100 million were allocated to the Ministry for the Colonies for the development of production in Guiana, Guinea and Madagascar. In Yugoslavia, the state mines produced 17,500 ounces in 1938 out of a total production of about 78,000 ounces. Modern methods of mining and search for gold are being employed everywhere; it remains to be seen to what extent their

application will tend to exhaust the available deposits at a relatively rapid rate, especially as few countries follow the more cautious policy of the South African companies. Even without regard to government aid the attractiveness of gold mining is at present very great. At 148 shillings per fine ounce the price of gold is 74 per cent. above what it was in 1929, while in terms of sterling the price level of other commodities, as measured, for instance, by the wholesale index, is still below the 1929 level; and costs of production have not generally risen more in gold mining than in other lines of production.

The receipts of gold from Eastern countries, which were of great importance for a number of years, reaching a maximum of \$378 million in 1932, fell to \$68 million in 1937 and to \$57 million in 1938.

Gold from the East	India*	China	Hong Kong	Total
	in million dollars (at \$ 35 per fine ounce)			
1931	208	18	20	246
1932	320	39	19	378
1933	202	24	33	259
1934	220	18	22	260
1935	150	14	11	175
1936	109	12	10	131
1937	50	17	1	68
1938	43	0**	14	57
Total	1,302	142	130	1,574

* Private holdings only. ** China showed a net import of \$ 4 million.

It is more difficult than ever to estimate the amounts of gold absorbed by the arts and industry. An increased tendency to acquire gold for ornaments was noticeable in 1937 with the rise in prosperity, but gold continued to return in undiminished quantities — in the form of scrap, coins, etc. — so that net industrial consumption was slight and, for the world as a whole, was probably less than the amount of gold obtained from Eastern hoards.

In these circumstances the amount of gold available for monetary use in 1938 may be estimated at about \$1,300 million, i. e. slightly more than the annual production of \$1,290 million.

2. MOVEMENTS OF GOLD TO AND FROM MONETARY AUTHORITIES AND PRIVATE HOARDS.

It is not difficult to account for the disposal of the \$1,300 million of gold available for monetary use, since the reported gold reserves of banks of issue rose by \$1,750 million during 1938. This figure includes those gold holdings shown as such in the central bank returns and practically all the gold in the U.S. Exchange Stabilisation Fund, but generally excludes gold held under other items and omits the U.S.S.R. and Spain, about which sufficient

information is not available. Unreported reserves are in particular those of the British Exchange Equalisation Account (the gold holdings of which have been published at six-month intervals during 1937 and 1938) and the French, Dutch and Swiss exchange funds, the gold holdings of which have not been published.

The difference of \$450 million between the amount of gold produced and the increase in the reported reserves represents a reduction in the non-reported gold, i.e., in the aggregate of the amounts absorbed by the exchange funds or by private hoards in the western world. Information published regarding the British Exchange Equalisation Account is summarised in the following table.

British Exchange Equalisation Account	In million fine ounces	In millions sterling at 140 shillings per fine ounce
1937, 31st March . . .	26.7	186.7
30th September . . .	39.9	279.0
1938, 31st March . . .	42.5	297.8
30th September . . .	21.7	151.8
Decrease from 31st March 1938 to 30th September 1938 . . .	20.9	146.0

As the price of gold was rising between March and September 1938 the Exchange Account lost just about £150 million during the six months. Further losses were incurred during the last quarter (which led to a transfer of gold to the Account from the Bank of England early in 1939), and private estimates have placed the net reduction of the British gold holdings during 1938 at about £200 million, at the current gold

price, or say \$900 million. Thus the British losses amounted to roughly double the \$450 million which were transferred from unreported to reported holdings; it is therefore necessary to account for the further \$450 million which did not find its way to the reported reserves.

There is reason to believe that the aggregate gold holdings of the French, Dutch and Swiss exchange funds increased on balance during the year. The repatriation of funds to France during the last two months of 1938 increased the gold holdings of the exchange fund to a figure higher than at the end of 1937. The Swiss fund, the nominal amount of which remains unchanged at Sw. fcs 538.6 million, would seem to have held more in gold and less in balances at the end of 1938 than a year earlier. The Dutch fund is reported to have increased its gold holdings at certain periods of the year by means of advances obtained from the Nederlandsche Bank, but resales of gold from the fund took place particularly from the end of February 1939. On the year 1938 alone, however, there can be little doubt that the total gold holding rose on balance. In that way the greater part of the \$450 million may be accounted for as having been absorbed into the unreported holdings of various exchange funds. Even if account be taken of reductions in other unreported gold holdings of monetary authorities, the amount by which private hoards increased during the year could hardly have been higher than one or two hundred million dollars.

What makes it somewhat difficult to estimate the net effect during 1938 of the propensity to hoard is that opposite tendencies were at work during

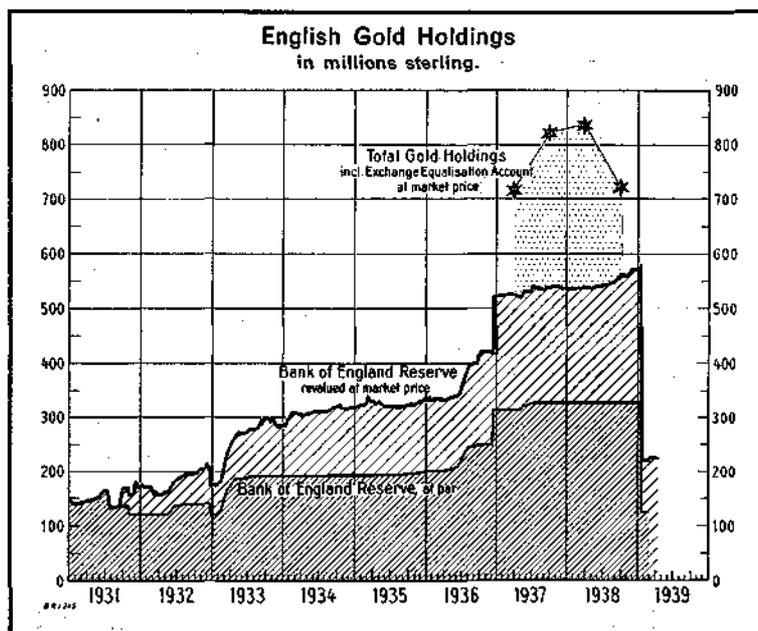
different parts of the year. In the opening months, as the recession in the United States increased in intensity, fears arose as to the maintenance of the gold value of the dollar; on the exchange market substantial withdrawals of funds from New York made themselves felt, and on the London gold market fresh demands for gold set in for hoarding purposes.

At the end of February 1938 President Roosevelt declared that there was no question of a devaluation of the dollar and thus helped to arrest the flight from the American market and also the movement into hoards. Soon after, the political situation in Europe gave rise to anxiety and to a consequent recrudescence of hoarding. In July 1938 the premium on gold coins rose on some days to 9 per cent., a sign of the widespread demand for gold; in fact, the amount hoarded probably reached the maximum for all time in the middle of 1938.

But a change in the trend was imminent. At the beginning of August the view began to gain ground that sterling was overvalued in relation to the dollar; further, the French franc was again under pressure and the exchange fund in Paris was losing substantial amounts of gold. Moreover, the possibility of political complications in Europe loomed larger on the horizon. Continental holders of sterling anxious to obtain a currency less liable to be directly affected by a European conflict, began to move into dollars. Holders of gold also became nervous, fearful that in an emergency their holdings might be blocked by embargos or otherwise; so they too began to dispose of their gold and acquire dollars. The net result was a movement out of gold hoards (and sterling), and this movement would appear to have continued with minor interruptions throughout the autumn and winter, becoming particularly intense in March 1939. Not only dollars were bought but also other currencies, particularly French francs, as funds were re-

patriated to France after the Reynaud reforms in the late autumn.

Some indications of the recent fluctuations in gold hoarding may be gathered from changes in the gold held in the United Kingdom outside the reserves of the Bank of England and the Exchange Equalisation Account. In the following table the figures are

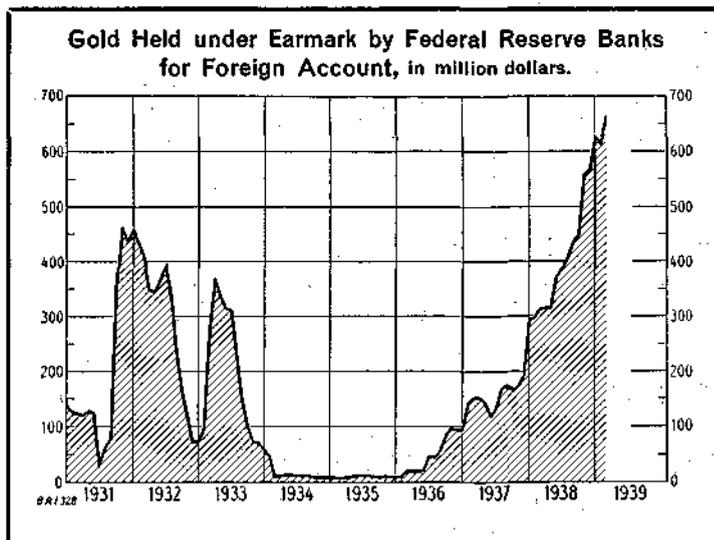


given in pounds at 140s. per fine ounce (to eliminate fluctuations in the gold price):

In millions sterling at 140s. per fine ounce	1937.		1938	
	31st March	30th Sept.	31st March	30th Sept.
Exchange Equalisation Account . .	187	279	298	152
Bank of England	517	538	538	538
Total reserves . . .	704	817	836	690
Less Bank of England's gold reserve at 1st January 1932	200	200	200	200
Increase in reserves from 1st January 1932	504	617	636	490
Net import of gold to U. K. since 1st January 1932	744	786	825	811
Gold held outside the reserves of the Bank and the Account	240	169	189	321

In its comments on the balance of payments for 1938 the Board of Trade Journal says that "the considerable excess of net imports during the past few years, over and above stocks held by the Exchange Equalisation Account and the addition to the holding of the Bank of England, is accounted for by gold transferred to London for safe custody or bought in the London market and held for account of overseas banks and individuals".

A further complication arises from the fact that the British monetary authorities may hold part of their own reserves earmarked with foreign central banks. Even so, the increase from March to September 1938 of over £130 million in the gold held outside the reserves of the Bank and the Account is



of interest, for it may be concluded that during those months, and especially in September, foreign banks and individuals — to a considerable extent, central banks — converted sterling holdings into gold and that gold was also shipped to London for safe custody. The holding of gold by monetary authorities in a foreign centre is largely for convenience

in the settlement of foreign payments; in the event of war, shipments of gold may prove not only risky but extremely difficult to arrange with any promptitude. In this connection it is of interest to note the increased earmarking of gold with the Federal Reserve System, the figures of which are published monthly and shown in the graph on the previous page.

Specific information as to the gold held abroad by individual central banks is available in some cases. Up to the end of November 1938 the Nederlandsche Bank return showed separately the amount of gold held abroad, then about 24 per cent. of its total reserve. Similarly the return of the Swiss National Bank showed that one-third of its gold holding was held abroad in the middle of 1938. At the end of 1938 the Sveriges Riksbank had nearly 30 per cent. of its reserves abroad; and it is also known that a large part of the reserves of the National Bank of Belgium has been shipped to foreign centres. The British monetary authorities may also hold gold abroad, inter alia, in Canada and South Africa. In the autumn of 1938, when the insurance on war risk was high, the Reserve Bank in the latter country adopted the practice of earmarking gold for account of owners abroad, instead of shipping the gold to Europe or elsewhere, the facility in question being extended to private persons by an announcement in November. As a result, gold exports from South Africa almost ceased from September 1938, but they recommenced in the spring of 1939 when the gold thus earmarked had risen to £40 million (at the end of March).

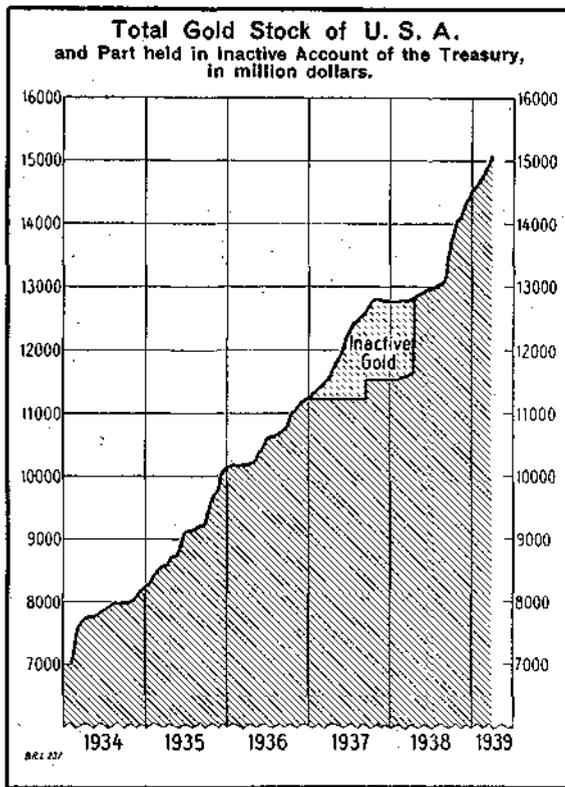
In the United Kingdom the steady accumulation of gold, which had been proceeding since 1932, ceased in the summer of 1938. Net imports of gold, bullion and specie amounted to £85 million in the first seven months of the year, followed by net exports of £147½ million in the remaining five months; for the whole year the net exports were £62½ million. The change in the flow of gold was primarily the result of movements initiated by overseas holders of sterling and gold in London. The deficit on current account of the payments balance, estimated at £55 million for 1938 (or about the same as for the previous year), would not in itself appear to have led to any appreciable export of gold, for it was probably largely covered, as in recent years, by the excess of sinking-fund and maturity payments on overseas loans above new overseas issues, the latter amounting in 1938 to only £28 million. Net exports of gold from the United Kingdom continued in the first three months of 1939, amounting to £95 million, including £56 million in the month of March. There is evidence of increasing sales of hoarded gold on the London market, the proceeds being converted principally into dollars.

Gold movements affecting the United States in the different phases of the year are generally the converse of those to and from the United Kingdom. In the first seven months of 1938 net gold imports were at the rate of only \$44 million a month, while in the remaining five months the average monthly rate rose to \$335 million. Total net imports were \$1,974 million — the highest annual total ever recorded. Together with gold derived from domestic production the net imports affected the gold holdings of the United States in the following way:

U. S. A. Gold Stock and Gold Movements 1938, in million dollars			
Net imports	1,974	Increase in monetary gold stock	1,752
Domestic production	148	Net increase in earmarking for foreign account	333
Total	2,122	Total	2,085

The reasons for the high figure of earmarking have already been noted above. With the addition of \$1,752 million to the American reserves in 1938 and further gold acquisitions in the first four months of 1939, the United States holds over \$15 milliard, about 55 per cent. of the world's monetary gold. The ostensible reason for the record gold imports in 1938, concentrated as they were into a few months, was an inward movement of funds (notably flight of capital from Europe); but other factors, and particularly the large American

export surplus at about \$100 million a month, which emerged in the latter half of 1937 and continued all through 1938, must also be taken into account as an important cause of the year's gold acquisitions. Preliminary estimates of the United States' balance of payments show, in fact, a surplus on current account of \$965 million. Thus substantially more than half of the year's increase in the American gold reserves was in net payments of merchandise exported. The co-ordination in the different periods of the year between gold movements and the settlement of commercial payments was, however, profoundly disturbed in such a way as to give the transfer of volatile funds an apparently greater significance than they actually had: in the first half of the year —



largely under the influence of fear of a devaluation of the dollar — foreign holders of banking funds in New York withdrew about \$400 million and in that way made dollar exchange available, which served to offset the demands of traders having to make payments in the United States. In the latter half of the year, on the other hand, gold to the extent of \$1,730 million was shipped to the United States to provide not only for the movement of funds but also for current commercial payments (indeed, for more than the net trade balance, since American commercial

credits were curtailed). There was an increase of \$240 million in the gold earmarked for central banks and of \$665 million in foreign banking funds; the amount held as banking funds may be associated with "hot money", and it is of interest to note that more than half of the increase in these funds during the latter half of the year simply made good withdrawals during the first half, and that for the year as a whole the net increase of American banks' liabilities to foreigners was only about \$265 million. It is the volatile nature of "hot money" more than its absolute magnitude which makes it so conspicuous a factor in the exchange markets and gives rise to exaggerated ideas of its importance in comparison with the more fundamental tendencies of trade balances and commercial credit operations.

But the part played by of capital movements increased early in 1939. From 1st January to 18th April 1939 gold imports into the United States exceeded \$1,000 million, of which perhaps one quarter may have been needed for purchases of goods, the remainder representing chiefly a continued transfer of private short-term balances to the New York market. The gold shipments were largely attributable to operations of monetary authorities who shipped gold in order to be able to meet demands for dollars in the exchange markets. It would seem as if gold continued to be dehoarded in London at a somewhat accelerated rate, but the decline in gold hoards in the United Kingdom would appear to be limited by the fact that gold cannot be held in the United States for account of private individuals or firms.

The total increase in the gold reserves of the United States during 1938 — \$1,750 million — happens to be the same figure as the world increase in the reported reserves of banks of issue and governments. The table on the following page sets out for each country separately the published reserves at the end of 1936, 1937 and 1938, the countries being divided into three groups: countries in which the published reserves increased in 1938 (Group 1); those where there was practically no change in the size of the reserves (Group 2); and those in which a decline occurred (Group 3).

The United States apart, Sweden, the Netherlands, Switzerland and South Africa are the countries whose gold reserves increased the most in 1938, but the combined increase of these four countries was under 13 per cent. of the increase in the reserves of the United States. The gold holdings of the Sveriges Riksbank rose by \$77 million or S. Kr. 317 million (at the price of gold at the end of the year). At the same time the net foreign exchange holdings of the Riksbank were reduced by S. Kr. 226 million (at the current rate of exchange) so that by far the greater part of the gold acquisitions was the result of a conversion of foreign exchange into gold. In 1938 the current account of the Swedish balance of payments showed a surplus of about S. Kr. 40 million compared with S. Kr. 180 million in the previous year. It is difficult to estimate the capital movements accurately since considerable transactions — partly not recorded in the available statistics — are known to have taken place for the purpose of securing the value of commercial claims between Sweden and foreign countries, a variety of transactions being employed for this purpose.

Reported gold reserves of banks of issue and governments	End of 1936	End of 1937	Loss (-) or gain (+) during 1937	End of 1938 ⁽¹⁾	Loss (-) or gain (+) during 1938
	in million dollars (at \$ 35 per fine ounce)				
Group 1:					
U.S. A.	11,268	12,760	+ 1,502	14,512	+ 1,752
Sweden	240	244	+ 4	321	+ 77
Netherlands	490	930	+ 440	995	+ 65
Switzerland	655	649	- 7	699	+ 51
South Africa	203	189	- 14	220	+ 31
Roumania	114	120	+ 6	133	+ 13
Hungary	25	25	0	37	+ 12
Norway	98	82	- 16	94	+ 12
Canada	188	184	- 4	192	+ 8
Colombia	19	16	- 3	24	+ 8
Yugoslavia	48	51	+ 3	57	+ 6
Mexico	46	24	- 22	29	+ 5
Greece	26	24	- 2	27	+ 3
China	8	16	+ 8	18	+ 2
Latvia	15	15	0	17	+ 2
Poland	75	83	+ 8	85	+ 2
Java	60	79	+ 19	80	+ 1
Morocco	8	5	- 3	6	+ 1
United Kingdom	2,584	2,689 ⁽²⁾	+ 105	2,690 ⁽²⁾	+ 1
Total	16,160	18,184	+ 2,024	20,236	+ 2,052
Group 2:					
Algeria	14	14	0	14	0
British India	275	274	- 1	274	0
Brazil	25	32	+ 7	32	0
Bulgaria	20	24	+ 4	24	0
Chile	29	30	+ 1	30	0
Danzig	6	5	- 1	5	0
Denmark	54	53	- 1	53	0
Egypt	55	55	0	55	0
Estonia	15	15	0	15	0
New Zealand	23	23	0	23	0
Portugal	68	69	+ 1	69	0
Turkey	26	29	+ 3	29	0
Total	610	623	+ 13	623	0
Group 3:					
Peru	20	20	0	19	- 1
Lithuania	12	13	+ 1	11	- 2
Finland	35	27	- 8	25	- 2
Germany	46	48	+ 2	45	- 3
Uruguay	77	74	- 3	69	- 5
Czecho-Slovakia	91	92	+ 1	83	- 8
Belgium	632	597	- 35	581	- 16
Italy	208	210	+ 2	193	- 17
Argentina	501	469	- 32	431	- 38
Japan	463	261	- 202	164	- 97
France	2,995	2,564	- 431	2,435	- 129
Total	5,080	4,375	- 705	4,056	- 319
Grand total ⁽⁴⁾	21,900	23,250	+ 1,350	25,000	+ 1,750

⁽¹⁾ Partly estimated.

⁽²⁾ Partly estimated and including also other countries (but not the U. S. S. R. and Spain).

⁽³⁾ Not including Exchange Equalisation Account: 30th September 1937, \$ 1,395 million and 30th September 1938, \$ 759 million.

The increase in the gold reserves of the Nederlandsche Bank amounting to Fl. 115 million occurred in the first quarter of 1938, while from April to November the reserves remained unchanged, to fall by Fl. 20 million in December — the first decrease since the autumn of 1936. In addition, the exchange fund would seem to have acquired gold up to the middle of April 1938 and to have lost some gold in the last months of the year. The increase of Sw. fcs 210 million in the gold reserves of the Swiss National Bank was practically all offset by a corresponding reduction in the foreign exchange holdings of the Bank. There have been different periods of inflow and outflow of funds on the Swiss market during the year, but the movements have been within fairly narrow limits; besides, the current account of the Swiss

balance of payments would seem to have been in equilibrium. The increase of £6 million in the gold holdings of the Reserve Bank of South Africa reflects the continued prosperity of the country, profiting from the higher price at which its gold production was sold.

The additions to the gold reserves of other countries have in some cases resulted from purchases of internally produced gold, as, in Roumania; in others they more clearly reflected a surplus in the balance of payments, as in Norway, while in the case of Hungary the increase largely represents a transfer of gold from miscellaneous assets to the reported gold reserves.

Among the countries which lost gold on balance during 1938 the net decline of B. fcs 646 million in the reserves of the National Bank of Belgium should be seen in connection with a net gold transfer of B. fcs 2,480 million from the holdings of the Belgian Ministry of Finance to the National Bank. Moreover, the foreign exchange holdings of the National Bank were reduced by B. fcs 176 million. As the current balance of payments would seem to have been in equilibrium, the reductions in the gold and foreign exchange holdings are the result of a variety of capital movements — withdrawals of funds held by foreigners, some efflux of Belgian francs, repayments of external loans, credit operations by Belgian companies on foreign markets, etc. A loss of gold and foreign exchange by the Argentine reflects the heavy import surplus, the actual loss being even higher than the amounts shown in the returns of the Banco Central (126 million Argentine pesos, since the exchange fund parted with gold in the course of the year. The gold reserves of the Bank of Japan, which stood at Yen 807 million at the beginning of 1938, were reduced by Yen 300 million in July, when a revolving fund was formed to facilitate the import of raw materials required for the maintenance of exports. Japanese gold exports to the United States, amounting to \$169 million in 1938, include newly-produced gold, the annual output in Japan and Korea being estimated at about \$50 million, and also gold collected from the Japanese public.

The reduction in the gold reserves of the Bank of France was a result of a transfer on 3rd February 1938 of about Fr. fcs 4 milliard (at the price then current on the market) from the Bank to replenish the resources of the Stabilisation Fund. When, later on in November, the gold holdings of the Bank of France were revalued, no similar transfer was made but the revaluation profits were employed towards reducing the debt of the State to the Bank. If a comparison is made of the combined gold holdings of the Bank and the Stabilisation Fund at the beginning and at the end of the year, there would seem to have been a net gain of gold. In fact, both the current and the capital account of the French balance of payments appear to have been substantially in equilibrium during 1938.

3. REVALUATION OF GOLD RESERVES AND CHANGES IN NOTE CIRCULATION.

The first question which arises with regard to a proposed revaluation of a country's gold reserves is, of course, whether a revaluation should be made at all; if this question is answered in the affirmative it must be decided at what rate the revaluation should be carried through and to what purposes the so-called "revaluation profits" should be allocated.

When the United States wrote up its monetary gold stock in January 1934 to the new rate of \$35 per fine ounce, it departed from an established practice. Earlier revaluations had been made only when the domestic gold price had been definitely fixed with a legal stabilisation of the currency, while the American Gold Reserve Act provided for alterations in the gold value of the dollar within certain limits. The revaluation profits amounted to \$2,812 million, of which \$2,000 million were allocated to an exchange stabilisation fund; the remaining \$812 million were kept as a separate item in the Treasury statement, \$642 million being used in later years to retire bonds carrying the national bank note circulation privilege; of the remainder \$142 million is still shown in the General Fund of the Treasury. The revaluation by Belgium in 1935-36 was made, on the other hand, in connection with the restoration of the gold standard at a fixed rate for the belga. The American precedent has, however, been followed by an increasing number of countries.

In the autumn of 1936, when the gold bloc ceased to exist, Italy, which fixed the value of its currency in relation to the U. S. dollar, as well as France and Switzerland, which kept open the possibility of changing, within certain limits, the value of their currencies in terms of gold, proceeded to revalue their gold reserves. The book profits resulting from the revaluation of the Banca d'Italia's gold holdings, amounting to about Lit. 1,380 million, were credited to the account of the Ministry of Finance. In Switzerland the revaluation book profits of Sw. fcs 538.6 million were allocated to an exchange stabilisation fund, the resources of which have been kept in gold, foreign exchange or balances in Swiss francs. From time to time proposals have been put forward for the "utilisation" of the revaluation profits in the exchange fund; the Swiss National Bank has emphasised that the spending of these profits by central or local authorities would have undesirable monetary effects; the Bank declared, however, in 1938 that it would be ready to grant the Federation and the Cantons certain discounting facilities on favourable conditions. The deliberations which followed envisage the granting by the Bank of two credits of Sw. fcs 75 million each, one to the Federation and one to the Cantons, at a rate below the official discount rate, the credits to be offset later against amounts accruing to the Federation and the Cantons from the revaluation profits.

In France the Monetary Law of 1st October 1936 provided for the revaluation of the gold reserves of the Bank of France at a price corresponding to the higher of the two limits then fixed for the value of the franc. Of the book profits Fr. fcs 10 milliard were allocated in gold to an exchange

stabilisation fund and about Fr. fcs 7 milliard were utilised to increase the margin of the Bank's advances to the State. Further, it was decreed that, when the exchange fund should be liquidated, all profits then resulting from a stabilisation of the franc should be devoted to amortisation of the public debt (not necessarily of the advances granted by the Bank of France). A second revaluation was made in 1937; the book profits amounting to nearly Fr. fcs 7 milliard were allocated to a fund for support of government rentes. The Bank of France at the same time received the assurance that a sum of the same magnitude, "with priority rights for the Bank", would be earmarked for the repayment of the Bank's advances to the State out of amounts available from the exchange and the rentes funds. This guarantee was supplemented by a law in April 1938, which provided that the total of the resources of the exchange and the rentes funds should "by priority" be devoted to repayment of the Bank's advances.

In connection with the Reynaud reform plan a third revaluation was made in November 1938, the book profits amounting to about Fr. fcs 31½ milliard. By that time the "provisional" advances of the Bank of France to the State had reached about Fr. fcs 52 milliard; their liquidation was fully provided for, partly by the immediate cancellation of about Fr. fcs 31½ milliard from the revaluation profits and partly by a guarantee that, when the exchange and the rentes funds were liquidated, their resources should be definitely allocated for the repayment of the remainder, the amounts involved being about Fr. fcs 21 milliard. At the same time the "permanent" advances granted by the Bank to the State were increased from Fr. fcs 3.2 milliard (the amount fixed in 1928) to Fr. fcs 10 milliard, to be more in conformity with the new value of the franc and the increase in the budget total.

The gold price of 27.5 milligrammes nine-tenths fine, upon which the third revaluation was based, corresponds to the rate for the U. S. dollar of Fr. fcs 35.8; with a cross rate between the dollar and the pound of \$4.68 the sterling rate of the franc would be Fr. fcs 167.5. This rate may in a sense be regarded as the higher limit of the value of the franc, the lower limit being 179 to the pound, announced by the government in May 1938.

The original amount allocated to the French exchange fund in October 1936 was Fr. fcs 10 milliard in gold at the rate of revaluation then adopted. Through changes in the value of the franc the resources of the fund have risen to about 14 milliard current francs. When the gold acquisitions of the fund had almost exhausted its available franc resources in May 1938, it was announced that from time to time advances could be made to the fund by the Ministry of Finance and the rentes fund. Such advances have been made first in May 1938 and later from November 1938. Further, in April 1939 the Minister of Finance transferred Fr. fcs 5000 million gold from the fund to the Bank of France, the counterpart of this gold increasing the fund's franc resources available for further gold acquisitions.

By an amendment to the statutes of the National Bank of Hungary, adopted in the summer of 1938, the gold and foreign exchange holdings of the Bank were to be valued each quarter at the average rates ruling on the Budapest exchange market during the last fortnight of the previous quarter.

This is the first example of the principle of a variable rate being applied to the valuation of gold reserves on the basis of quotations on the domestic market. (Canada in 1934 provided for valuation at the current price of gold on the New York market, i.e., on a foreign market.) The first return drawn up under the new rules was published for 15th January 1939, the gold being brought into account at Pengö 5,700 per kilo fine, compared with the previous price of Pengö 3,800 (less Pengö 6 for minting charge). The addition to the book value of the assets resulting from the revaluation did not affect the amount shown as "metallic reserve" but was applied to increase the holdings of gold and foreign exchange included in "other assets", which rose by Pengö 69 million. No revaluation profits were shown in the balance sheet of the Bank since the higher book value of the gold and the foreign exchange was offset by a revaluation of certain foreign liabilities in gold.

A revaluation in Finland in December 1938 followed the usual principle of applying a fixed rate. The Bank of Finland's gold holdings were, according to a change in the statutes, to be revalued at a maximum price of FM 50,000 per kilo fine gold, i.e., at a maximum rate about 8 per cent. below the current market price. In the revised balance sheet of the Bank the gold reserve increased by FM 508 million, while the foreign exchange holding (also written up) rose by about FM 180 million. But these increases were partly offset by a reduction of about FM 250 million in the "sundry assets" item, under which amounts due to the difference between the actual and the legal purchase price of gold and foreign exchange acquired after the depreciation in 1931 had been entered. The actual book profits realised were used to raise the capital of the Bank from FM 1,000 to 1,250 million, the remainder being transferred to a "valuation adjustment account" included in "sundry accounts" on the liabilities side of the Bank's balance sheet. The main purpose of the revaluation adopted in Finland was to increase the Bank's note-issuing powers. In recent years the "note reserve" of the Bank of Finland — representing unused power to issue notes — had fallen to less than FM 500 million. Through the revaluation of the gold holding and as a result of an increase of the fiduciary issue from FM 1,200 to 1,800 million (by an amendment of the statutes), the "note reserve" was raised to more than FM 1,500 million.

A revaluation of the gold reserve of the Eesti Pank was made in March 1939 on the basis of the London gold price on 28th June 1933 — the day of devaluation of the Estonian crown. The difference between the gold price at that date (122s. 4d. per fine ounce) and the current market price would create a reserve available in the event of a future stabilisation. The book profit from the revaluation amounted to E. Kr. 6.6 million, of which E. Kr. 2.5 million were transferred to the Ministry of Finance and the remaining E. Kr. 4.1 million to a special reserve fund established for the purpose of strengthening the general position of the Eesti Pank.

The decision taken early in 1939 to revalue the gold in the Issue Department of the Bank of England must be seen in connection with the transfer of £350 million in gold (at the current price of about 148½ shillings per fine ounce) from the Bank to the Exchange Equalisation Account. From 1932 to

1938 some £200 million gold, at the old price of 85 shillings per fine ounce (equal to about £350 million at the current price), had been acquired by the Bank from the holdings of the Account. When, by the end of 1938, the gold holdings of the Account had been considerably reduced, the "new gold" which the Bank had acquired was retransferred to the Account to be available for its primary use of supporting the sterling exchange. As the gold in the Issue Department of the Bank continued to be valued at 85 shillings per ounce the gold reserve of the Bank was reduced by about £200 million and this sum was replaced in the Issue Department by an approximately equal amount of securities obtained from the Account. This necessarily affected the fiduciary issue, i. e., that part of the note issue of the Issue Department not covered by gold.

Under the Currency and Bank Notes Act of 1934 the normal amount of the fiduciary issue was to be £260 million, but it had subsequently been reduced by Treasury minute to £200 million. It was also by Treasury minute that the fiduciary issue was enlarged to £400 million early in 1939 as a consequence of the gold transfer. It was thought, however, that so important a change should be submitted to Parliament. In the bill passed provision was made for a revaluation of the assets in the Issue Department of the Bank. The gold remaining in the Issue Department was thus written up from £126 million (at the old price) to £221 million (at 148s. 5d.) and £5 million bought back from the Account to raise the total to £226 million. With this increase of £100 million it was possible to limit the amount of the fiduciary issue to £300 million, the Treasury's power to authorise temporary changes being retained. Under the new rule the gold and other assets in the Issue Department are to be revalued weekly at the current price as certified by the Bank of England. The following table illustrates the changes which have been made:

Bank of England — Issue Department.

In millions sterling	Gold in Issue Department 1	Fiduciary Issue 2	Notes issued by Issue Department 3 (1 + 2)	Notes held in Banking Department 4	Actual Note Circulation 5 (3—4)
1939, 4th January . . .	326	230*	556	68	488
11th " . . .	126	400	526	51	475
1st March	226	300	526	48	478

* The fiduciary issue was temporarily raised from £ 200 to £ 230 million over the Christmas period; it would have stood at £ 200 million on 11th January 1939 if the transfer of gold and the increase of the fiduciary issue to £ 400 million had not been made.

With each weekly revaluation at current prices of gold and other assets in the Issue Department an adjustment may be made between the Department and the Account to compensate for any variation affecting the amount of the note issue. The Chancellor of the Exchequer in the House of Commons emphasised that the weekly revaluation constituted a change in machinery and had no bearing whatever on the ultimate stabilisation of gold or on any other matter of high policy.

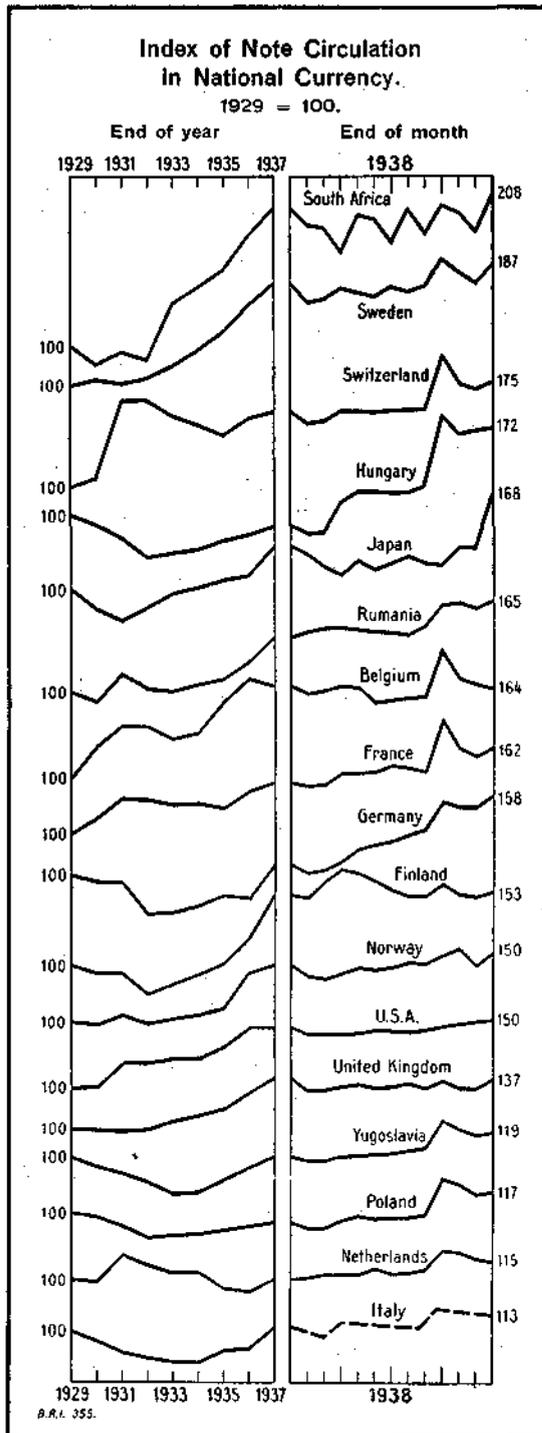
By the revaluation £95 million of securities were released from the Issue Department of the Bank of England and passed (with some minor adjustments) to the Exchange Equalisation Account to constitute a capital reserve. By the transfer of gold in January 1939 and this further transfer of securities the Account has increased its holdings both of gold and sterling assets, and its power of neutralising an inflow as well as an outflow of funds has thus been enhanced. No question of principle as to a division of profits arose in connection with the revaluation of the gold, for the Treasury already receives — under the Currency and Bank Notes Act of 1928 — any profits gained by the Issue Department of the Bank of England and is, of course, the owner of the assets in the Exchange Equalisation Account. The Chancellor of the Exchequer could not regard the £95 million obtained from the revaluation as profits in the ordinary sense. It was, he said, rather in the nature of an unrealised capital appreciation which could not appropriately be used as if it were revenue.

In addition to the countries mentioned above (United States, Belgium, Italy, Switzerland, France, Finland, Estonia, Hungary and the United Kingdom) a great number of others (e.g., Canada, the Argentine, Roumania, Japan and Latvia) revalued their gold holdings in recent years. In March 1939 about 90 per cent. of the world's monetary stock of gold had thus been revalued (excluding the reserves of the U.S.S.R., for which no recent information as to quantity or method of valuation is available). Among the countries which have not revalued, the largest gold holdings are those of the Netherlands; the three Scandinavian countries — Denmark, Norway and Sweden — and several countries in the British Empire — South Africa and India etc. — are also in this group. Most of these countries have ample monetary reserves even at the old gold price and have, therefore, no immediate reason to revalue. An interesting development in recent months has been the action of the Finnish and British authorities in revaluing their gold holdings for the purpose of providing an increased backing at current values for the domestic note circulation.

The graph on the next page shows for a number of countries the yearly changes in note circulation from 1929 to 1937 and monthly changes during 1938, calculated as an index with 1929 as the base.

There was a temporary expansion in the note issue of most countries in the autumn of 1938 when the increase in the amount of notes outstanding, which normally occurs at the close of the third quarter, was intensified by higher cash requirements of public departments and a widespread demand for notes from institutions and individuals anxious to increase their cash in hand in view of possible moratoria or other obstacles to ordinary methods of payment. In the following months a return of the amount of notes issued in September took place in most countries, but the increase was generally not completely reabsorbed.

The long-term growth in note circulation in recent years is in some cases clearly connected with a rise in the national income, though the fact that commodity prices have generally remained at a lower level than in 1929 makes the increase in circulation appear surprisingly high in some



cases. Investigations have been made by many central banks into questions connected with the volume of note issues; as a rule it has been found anything but easy to indicate the reasons for the changes in the volume outstanding or to account for the distribution of the notes among different categories of holders.

For the United States a study in the Federal Reserve Bulletin of December 1938 attributed the long-term growth in circulation principally to increased holdings of individual savings in the form of currency and to a shift from bank deposits to currency as a means of day-to-day payments. The former tendency is reflected in an increase in large notes (\$50 and over) and can be explained, to a great extent, as an after-effect of the banking difficulties in the early 'thirties and as a natural reaction to the reduction in interest rates paid on savings and other time deposits. The greater use of cash for day-to-day payments was at first also due to banking difficulties and particularly to the absence of banking facilities in some communities; it has been furthered by the extension of service charges on cheque accounts. Relief payments to a large number of people without banking accounts may also have increased the demand for notes. Finally, it should be mentioned that the commercial banks have increased their cash holdings by about \$300 million since 1933; when the banks possess large excess reserves they are no

longer under the same pressure to return redundant currency.

Many of the factors responsible for the growth in the circulation in the United States have no doubt operated elsewhere, but a number of particular factors are also found in different countries.

The increase in the German note circulation amounted in 1938 to RM 2,700 million, of which RM 1,125 million were in respect of the incorporation of Austria and the Sudeten districts. For Switzerland and some other countries account has to be taken of the volume of notes — difficult to estimate — in the hands of foreign holders. For Roumania the increase in 1938 was closely connected with an extension of industrial and other advances by the National Bank, and for Japan the repercussions of the continued hostilities in China were reflected in increased cash requirements by the State and by the public in view of rising commodity prices. In Italy, on the other hand, the amount of notes issued has been severely kept down.

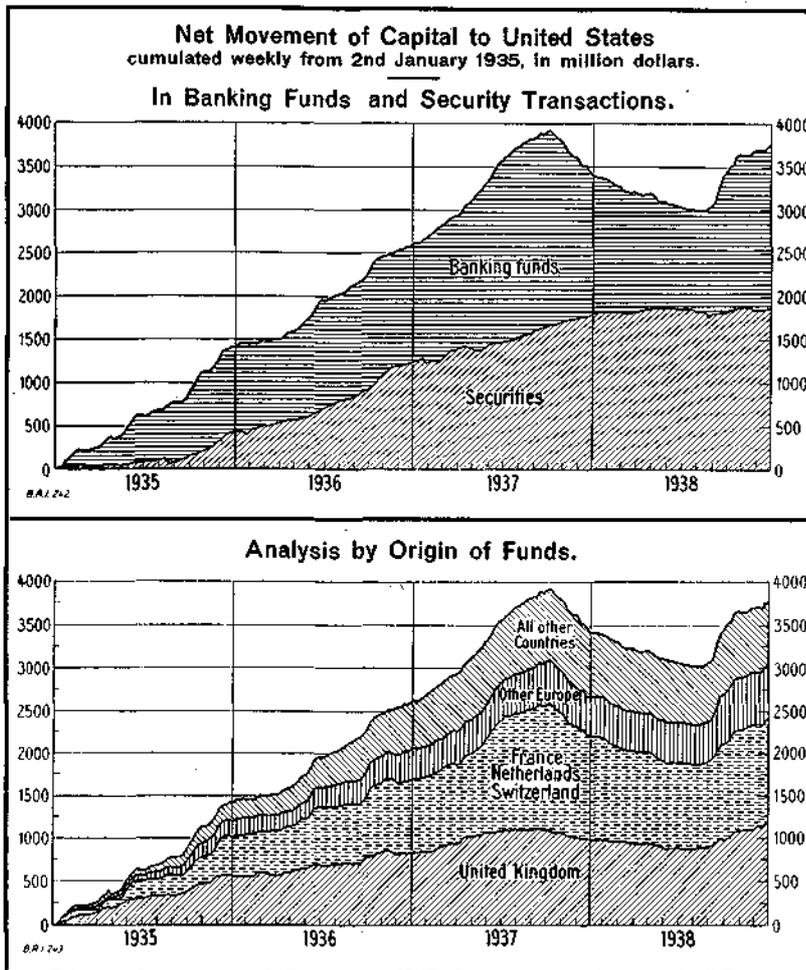
Abandonment of the gold standard has not meant the abandonment of gold either as a means of settling balances between different countries or as the usual backing for the domestic circulation according to the cover regulations of central banks. More attention is no doubt paid to the Resolution of the London Conference of 1933 "that under modern conditions monetary gold is required not for internal circulation but as a reserve against central bank liabilities and primarily to meet extraordinary demands for payments caused by some disequilibrium on the foreign account". While the record volume of international gold movements shows the extent to which gold is being used for international settlements, recent enactments provide interesting examples of the connection still maintained between the gold reserve and the volume of notes in circulation.

IV. CAPITAL MOVEMENTS AND INTERNATIONAL INDEBTEDNESS.

The year 1938 was one of abrupt changes in capital movements between the main creditor countries. The outflow of funds from the United States, which began in the autumn of 1937, continued in the first half of 1938, and in the ten months up to July amounted to nearly \$1,000 million. This movement, essentially of "hot money", was mainly caused by fears of currency complications in the United States in view of the severity of the business recession. Then, in the summer of 1938, came the improvement on the New York Stock Exchange, a growing apprehension with regard to the exchange value of sterling and, a little later, the increase of political tension in Europe. With the acute phase of the crisis in September there set in a violent movement of capital from Europe which in two months brought \$600 million to the United States. At no other time has such an abrupt reversal occurred. The flow continued at a slackened rate in November and December, to regain intensity in the early part of 1939. The spectre of war, besides provoking these massive movements of funds between nations, has even led to a certain

flight of capital internally in some countries, investment declining in those frontier and other districts which it is feared may be the site of future battlefields.

But spectacular transfers of nervous money from one market to another must not be allowed to obscure the continuous working of economic forces beneath the surface. Changes in currents of trade, in relative prices, in foreign investments and in the distribution



Net Capital Movement to U.S.A.

In million dollars	Grand total	Banking funds			Brokers' balances	Securities		
		Total	Foreign	U. S.		Total	U. S.	Foreign
1935, Jan.-March	259	212	(1) 58	(2) 154	21	26	- 6	32
April-June	357	314	156	158	9	34	22	12
July-Sept.	283	212	137	76	0	71	75	- 4
Oct.-Dec.	514	226	253	- 26	- 24	311	226	85
1936, Jan.-March	98	3	- 25	28	- 6	100	111	- 11
April-June	438	259	201	59	16	163	97	66
July-Sept.	334	126	120	7	7	201	109	92
Oct.-Dec.	327	9	32	- 23	- 10	328	284	44
1937, Jan.-March	323	171	191	- 21	- 9	161	158	3
April-June	631	546	491	55	14	70	- 6	76
July-Sept.	350	183	131	52	14	154	56	98
Oct.-Dec.	-502	-644	-575	- 69	16	127	37	90
1938, Jan.-March	-203	-234	-219	- 15	7	24	- 12	35
April-June	-161	-195	-164	- 31	4	30	5	25
July-Sept.	407	449	375	74	6	- 48	- 30	- 18
Oct.-Dec.	326	272	272	1	- 17	71	86	- 15
1935, Jan.-Dec.	1,412	965	603	361	6	442	317	125
1936, Jan.-Dec.	1,196	397	327	70	7	792	601	191
1937, Jan.-Dec.	802	256	238	18	35	512	245	267
1938, Jan.-Dec.	369	293	264	- 29	0	76	49	27
Totals 1935 to 1938	3,779	1,911	1,433	478	48	1,821	1,211	610

In million dollars	Countries of origin							
	U. K.	France	Holland	Switzerland	Other Europe	Canada	Latin America	Far East
1935, Jan.-March	141	25	9	8	37	- 10	27	19
April-June	167	89	39	20	30	- 10	11	11
July-Sept.	72	- 14	34	42	58	- 2	27	61
Oct.-Dec.	175	110	32	61	66	22	7	38
1936, Jan.-March	6	12	10	43	6	- 2	32	- 2
April-June	122	18	73	75	33	28	40	43
July-Sept.	98	- 38	3	50	71	113	17	27
Oct.-Dec.	49	98	35	38	57	12	42	- 11
1937, Jan.-March	98	9	37	28	41	- 9	135	- 14
April-June	152	35	90	256	34	- 11	45	24
July-Sept.	27	- 5	34	118	78	45	26	27
Oct.-Dec.	-112	- 56	- 79	-130	- 52	- 70	3	3
1938, Jan.-March	- 56	- 15	- 52	- 63	- 1	28	- 10	- 37
April-June	- 49	- 29	6	60	16	- 11	12	- 47
July-Sept.	94	71	32	20	112	1	31	27
Oct.-Dec.	203	31	26	50	53	32	- 53	- 10
1935, Jan.-Dec.	555	210	115	130	191	0	71	128
1936, Jan.-Dec.	274	89	115	205	167	150	130	56
1937, Jan.-Dec.	164	- 18	82	272	101	- 44	209	41
1938, Jan.-Dec.	192	58	13	- 54	179	51	- 21	- 68
Totals 1935 to 1938	1,186	340	325	554	638	157	390	157

(1) Increase of U. S. banks' liabilities to foreigners.

(2) Decrease of U. S. banks' assets abroad.

of newly-mined gold have their effect on the transfer of funds and bring into the picture important factors resulting from changing monetary and economic conditions in the countries of the world.

To obtain a balanced idea of the true character of the capital movement towards the United States it is necessary to take a broad view over the past few years. Throughout 1935 and 1936 the net movement of recorded capital towards the United States continued fairly evenly, with some accentuation at times, at a rate of slightly over \$100 million a month; the influx was accelerated in the first nine months of 1937, the monthly average rising to nearly \$150 million. The one-way flow then received its first real check for over three years and was reversed by the repatriations in the ten months to July 1938, the efflux declining, however, from \$170 million a month in the last quarter of 1937 to \$60 million a month in the first seven months of 1938.

Then came an abrupt reversal of the trend: the flow back to the United States from \$70 million in August 1938 rose sharply to \$390 million in September, thence declining slowly to \$220 million in October and rapidly to \$110 million in November and December together. The movements in September and October 1938 were predominantly of banking funds and had an obvious connection with political conditions in Europe. In these two months gold movements towards the United States were at the unprecedented rate of over \$500 million a month — twice as high as at the most acute phase of the gold "scare" in the spring of 1937. The essential elements of the detailed statistics on capital movements compiled from the beginning of 1935 and published by the U. S. Treasury are contained in the table and illustrated by the preceding graphs.

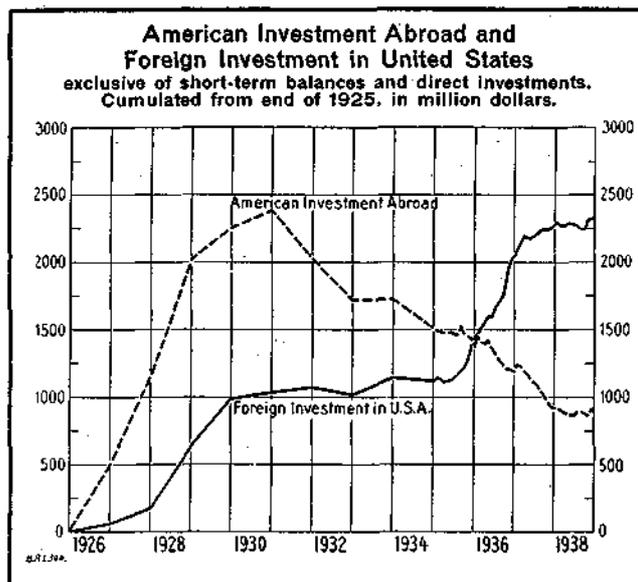
From the beginning of 1934, when the new value of the dollar was fixed, to the end of 1938 the capital flow to the United States amounted in all to \$4,200 million and comprised three main classes of funds:

(i) More than one-third, i.e. some \$1,500 million, represents American funds repatriated from abroad; of these funds nearly \$900 million were long-term and accounted for by sinking-fund operations, redemptions and repurchases by foreigners, and over \$600 million were short-term, inter alia balances accumulated in England in 1933 when the dollar was depreciating and amounts derived from the liquidation of accounts in Germany.

(ii) Rather less than one-third, nearly \$1,200 million, is due to foreign buying of American securities. Foreign acquisitions of American securities during the past ten years were made in two great waves, nearly \$1,000 million in the two years 1928-29 and over \$1,000 million from the middle of 1935 to early 1937. Experience after the stock market declines of September 1929 and March 1937 indicates that while foreigners con-

sidered as a whole bought American securities during the bull markets they did not sell on balance during the subsequent declines in prices. On the other hand, American investment abroad reached its highest point in 1930 and has since continuously declined.

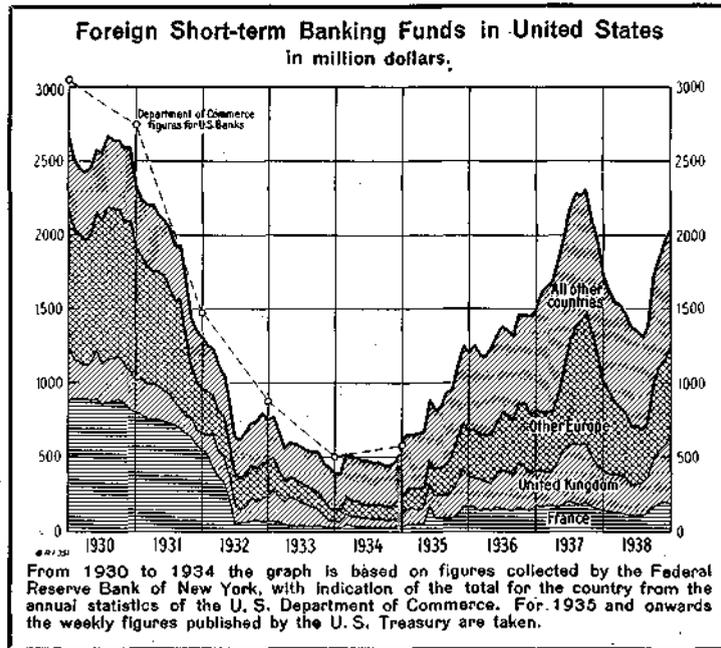
Foreign investment in American securities and the liquidation of American investments abroad are thus two



comparatively stable elements — together they account for \$2,700 million, nearly two-thirds, of the total influx of capital to the United States since 1934.

(iii) The final factor in the capital movement since 1934 has been the building-up of balances by foreigners in the United States, which accounted for \$1,500 million, a little more than one-third. Most of these

balances are on demand deposit with American banks, which at the end of 1938 had foreign deposits amounting to \$ 2,000 million. Total foreign deposits, as high as \$ 3,000 million at the end of 1929, fell rapidly during the following years (their decline representing in a large degree the liquidation of the gold exchange standard) to the



very low figure of \$500 million in 1933-34. As the dollar depreciated foreign balances were drawn down to the absolute minimum compatible with current business requirements at the bottom of the depression.

How much of the \$1,500 million of foreign balances accumulated from January 1934 to the end of 1938 should be considered as "floating" money cannot be determined with precision. Some accumulation was certainly necessary for ordinary business requirements, particularly after the de facto stabilisation of the dollar. These business balances cannot be reduced beyond a certain minimum, but there can be little doubt that the bulk of the foreign short-term funds which arrived at particular periods of acute tension, as, for example, in September and October 1938, was not needed for business purposes and constitutes an unstable element in the foreign exchange market.

The Federal Reserve Bulletin for February 1939, from which the essential elements of these paragraphs have been taken, indicates that "an analysis of the capital movement itself suggests that while this movement has been caused to an important degree by disturbed conditions abroad only a limited amount now represents nervous foreign money ready to leave this country as soon as conditions abroad become more stable." Though this conclusion must be somewhat modified by the heavy inflow in the first four months of

1939, it serves as a reminder against an exaggeration of the quantitative importance of "hot money" compared with the movement of other funds.

A form of capital flight which has increased in volume is the purchase of American bank notes in Europe. The significance of this movement may be seen from the following table:

Shipments of U. S. currency to and from Europe	Net shipments to Europe	Net receipts from Europe
	In million dollars	
1935	—	9.3
1936	8.6	—
1937	—	26.1
1938 January–August	—	26.0
1938 September–December	24.7	—
1939 January–March	30.8	—

Imports of U. S. currency into Europe practically ceased with the devaluation of the gold bloc and in 1937 and the first eight months of 1938 over \$50 million were dehoarded in Europe and shipped back to the United States. But in September and October 1938 the European demand for dollar notes reached unusually high proportions and large imports from the United States were necessary. This movement continued in the early months of 1939 when it was estimated that a total of around \$500 million in dollar notes were held abroad.

The export of capital to the United States owing to monetary uncertainties in European countries was a factor of particular importance early in 1935 before the devaluation of the Belgian franc and, later, up to the devaluation of the gold-bloc currencies in September 1936. From this date capital has returned more or less continuously to Switzerland and Holland. The particularly strong current in 1937 dwindled, however, in the first half of 1938 and dried up in the last half of the year. The cessation of a net influx to these two countries from the middle of 1938 is partly due to a counter-current of foreign-security purchases, made more attractive by the great number of introductions to the stock exchanges of Amsterdam and Zurich. Early in 1939 an outward flow of capital occurred, closely connected with international political developments. Neither Holland nor Switzerland was greatly affected by the repatriation of French capital during the year, which for Belgium in May 1938 was a factor of great importance.

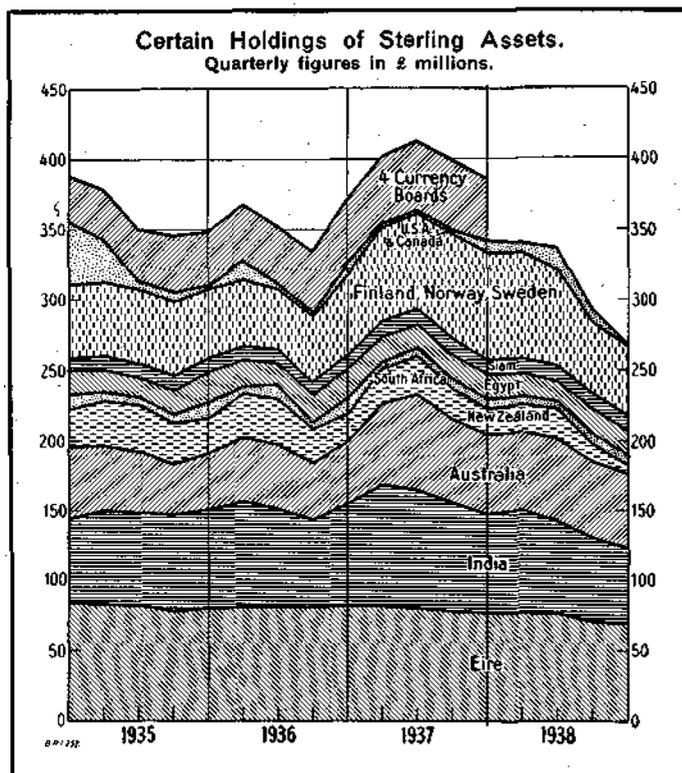
Indeed, France experienced in the winter of 1938–39, for the first time in several years, a sustained home-coming of national funds previously exported. Recoveries after September 1936 and in October 1937 were short-lived and eventually reversed. From early May 1938, however, when the franc was lowered to just within 179 to the pound, confidence in the stability of the exchange returned and an influx of capital generally estimated at some Fr. fcs 16 to 18 milliard occurred. The greater part of this capital was lost again in the summer months, but in September, during the height of the international crisis, French

funds were not exported, and from October onwards, particularly after the inauguration of the financial and other reforms early in November, there has been a further tide of French capital towards France estimated at Fr. fcs 16 to 20 milliard during the winter 1938-39.

The bulk of French repatriations of capital in May and since the autumn of 1938 came from England and included gold and notes hoarded as well as balances with British banks and sterling securities. London, in fact, has been subject to three distinct outflows of funds in addition to the usual and not inconsiderable commercial credit adjustments which are made when a currency declines for a prolonged period. Firstly, there was the outflow to France, which has just been mentioned. Secondly, London was the most important source of funds exported to the United States (nearly \$200 million in September and October 1938 alone), although in this connection the function of London as a conduit pipe for foreign funds is always a factor to be remembered. The third outflow — more important than is usually realised — was due to the employment by sterling-area countries of part of the funds they had previously accumulated in London to meet current deficits in their balances of payments. In the period up to the middle of 1937 sterling received support from the active balances of payments of sterling-area countries which built up reserves largely in the form of balances and other short-term assets in London. But, as the reserve centre of this area largely producing primary commodities, London must be prepared to see the sterling reserves constituted in the good years utilised at times when the prices of primary commodities fall and the balances of payments of the producing countries become passive.

The sterling area is not, of course, a new phenomenon as a trading area, although during the gold-standard period its existence as a currency area was obscured by universal stability on gold. But a strain on sterling, similar to the present one and rarely appreciated in its full significance, occurred from the outbreak of the agricultural crisis in 1928 onwards. It is generally known that before the fall of sterling in 1931 the currencies of the agricultural countries were already affected and that the Australian and New Zealand pounds, for example, depreciated before the end of 1929. But it is seldom realised that these countries and others defended their currencies largely by selling sterling. In the last nine months of 1929 Australian London funds were drawn down by over £30 million; Indian official sterling reserves fell by £40 million from the end of 1929 to 1931; New Zealand's sterling funds, previously perhaps £10 million or more, were practically exhausted; the National Bank of Egypt's sterling holding was reduced from £30 million early in 1929 to £15 million in 1931. Moreover, considerable fresh sterling resources were being supplied to these countries through new loans on the London money and capital markets and, though in part these loans were offset by amounts obtained from regular sinking-fund and other repayments of overseas issues, there was a substantial addition to the visible reduction in sterling balances, increasing the strain imposed on the sterling exchange. So long as the United States was lending freely abroad, the effects of this drain were to some extent covered up — but American foreign loans stopped dead in 1931.

The re-establishment of sterling-area balances started in the autumn of 1931, and by the spring of 1934 these sterling reserves had increased by over £200 million — some £50 million each for Australia and India, £20 million each for New Zealand and South Africa, and so on. The United States is now liquidating its foreign investments. And some sterling-area countries which in the earlier period had gold reserves to fall back upon, such as Australia and New Zealand, have practically disposed of them and now rely entirely on their sterling balances as international reserves. From the middle of 1937 to



the end of 1938 the net sterling funds of the sterling-area countries shown in the graph fell by some £100 million — India lost over £30 million, New Zealand £20 million, and Irish banks £10 million; Australian London funds probably fell £15 million, while the banking funds of the Scandinavian countries were drawn down by an amount which may be estimated at £20–25 million. If other sterling-area countries not included in the graph be added, such as Portugal, the Argentine, Japan, etc., it is certain that the drain on this account was fully £120 million over the eighteen months. In

contrast to the period 1928–29 new loans to sterling-area countries have played but a minor part, such loans as have been given being generally offset by regular sinking-fund and other repayments.

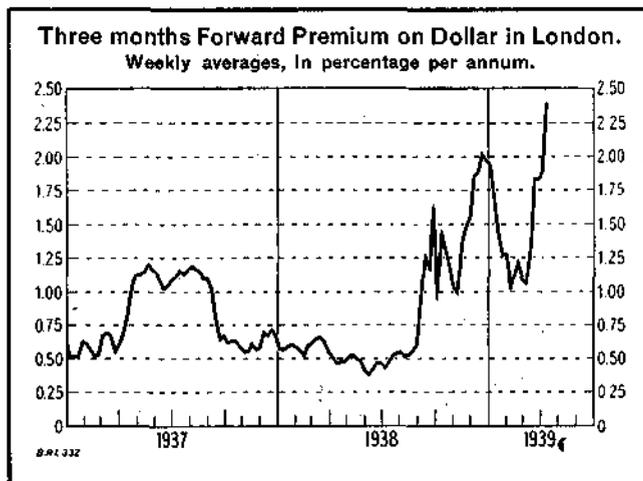
The primary cause of the decline in these sterling reserves was the worsening of the balances of payments of sterling-area countries with other countries than the United Kingdom. It should, however, be remembered that for the British market there was some compensatory gain arising from the fact that the fall in commodity prices, which caused the difficulties of the primary producing countries, allowed British imports of foodstuffs and raw materials to be obtained more cheaply — according to the Board of Trade the average value of British imports was 6 per cent. less in 1938 than in 1937.

To some extent the reduction of sterling assets was also due to the conversion of reserves into dollars and gold, e. g., the gold holding of the

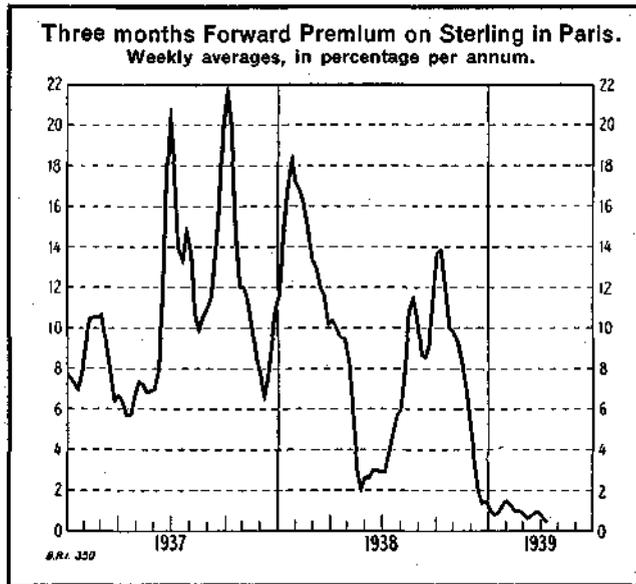
Sveriges Riksbank increased by about £15 million in 1938, £2 million were bought by the Irish Currency Commission and £3 million by the Norges Bank. In so far as these countries have a surplus in their balance of payments it is natural that they should acquire part of the current gold production, but the concentration of the purchases at periods of strain on the gold market, when the price of gold was exceptionally high, may be taken as striking evidence of the preference for gold at times of acute unrest.

The actual incidence of capital movements on the exchange markets may be modified by swap transactions, the relative importance of which is often difficult to assess. The previous graph shows the excess of sterling assets over sterling liabilities of Canadian and United States banks. For the Canadian banks this is a fairly small and comparatively stable item which arises from the fact that Canadian banks have branches in countries linked to sterling whose excess of deposits is employed in London. The excess of United States banks' sterling assets over liabilities, or vice versa, arises, however, essentially from swap operations. In the absence of any material change in market rates in London and New York, these balances tend to move with changes in the forward dollar-sterling rate. When there was a discount on the forward dollar at the end of 1934 the amount of American swap money in London was very large. The excess of American banks' sterling assets over sterling liabilities (covered forward) was about £40 million. Early in 1935 this swap money disappeared from London and, indeed, in the middle of 1937 American banks had excess sterling liabilities of about £10 million. The decline of the premium on the forward dollar in London to below $\frac{1}{2}$ per cent. in the middle of 1938 caused a fairly considerable movement of American swap money to London. In June, July and August 1938 the sterling assets of American banks in excess of their sterling liabilities was around £10 million, while their net contracts for forward sales of sterling rose above £15 million. With some English banks offering 1 or $1\frac{1}{4}$ per cent. on certain amounts of foreign deposits the net yield, taking into account the loss on the forward rate equivalent to $\frac{3}{8}$ or $\frac{1}{2}$ per cent., was about $\frac{3}{4}$ per cent., i.e.,

far higher than could be obtained on three-months' investments in New York. With the abrupt rise of the premium on the forward dollar in September 1938 such transactions became unprofitable and swap money was withdrawn as the contracts became due; by the end of the year American banks had excess sterling liabilities of £8 million.



Other swap money in London was at times of



greater importance than American. The premium on sterling in Paris has moved sharply in recent years, reflecting changing views as to the future of the French franc rather than differential interest levels. In May 1938, after the spot rate of the franc had been allowed to fall to 179, the contraction of the forward premium on sterling in Paris was accompanied by a reduction of French swap money in London. In July and August, however, the for-

ward franc weakened and French swap money returned to London; but in the middle of August these transactions were officially discouraged and, in the absence of a demand for forward francs by French banks, the discount widened sufficiently to be attractive to large firms with liquid resources. At certain times of the year French swap money in London amounted to £30 million or more. Belgian swap money in London has also been important at times and changes in market rates in Brussels, particularly the call-money rate, are strongly influenced by the discount on forward belgas and the amount which can be earned in London on banking funds.

Swap transactions undertaken in response to the development of differential interest rates may be generally considered a stabilising factor in the exchange markets, but in 1938 the effect of the movements of foreign swap money in London was largely to postpone pressure on sterling from the summer to the autumn, that is, to the time when the strain for other reasons was at its greatest. From September to the end of the year the three-months' forward discount on sterling vis-à-vis the dollar fluctuated between one and two per cent. per annum, i. e., sufficient to be attractive to English banking funds, even with market rates in New York down to zero.

It has already been remarked how business balances in New York were reduced during 1933 when the dollar was depreciating — and have since been reconstituted. A transfer from London of trade balances of a somewhat similar nature occurred in 1938. To some extent this type of transfer takes place through commercial channels, i. e., the proceeds of British exports in foreign currencies are left abroad while imports are increased and paid cash or in advance. In other countries, where it has been possible to make estimates, it has been found that this commercial factor is of greater importance than is usually imagined, amounting roughly to the equivalent of a half of one month's turnover of foreign trade. This relationship would give an amount of, say,

£50 million for England. This figure may appear on the high side but account must be taken of the growing importance of international corporations with large liquid resources which may be shifted from market to market.

Moreover, a large part of the world's trade, in addition to that in which England is involved as a partner, is conducted in sterling. When sterling declines for a prolonged period exporters from foreign countries are naturally disinclined to make invoices in sterling, and there is evidence that in these countries, and even in countries of the sterling area itself, foreign trade contracts have been expressed less often than usual in sterling but rather in the home currency of the exporter. This fact has greater significance than at first appears for, immediately the change in invoicing is made, sterling balances accumulated in readiness to meet maturing trade contracts are released and may be exported — or when utilised are not reconstituted as they otherwise would be. Foreign exporters have sometimes used another technique, giving, as usual, credit in sterling, but obtaining immediate banking advances in sterling, the proceeds of which were converted into dollars or gold, the advance being later redeemed from the importer's payment.

All in all, if the period from the middle of 1937 to the end of 1938 be taken, the decline of sterling-area reserves and of business balances in London must have caused a profound strain on sterling, although transfers of funds from and to New York and Paris at times dominated the exchange markets.

A year ago it was possible to say that trade financing in the sterling and dollar areas was back to normal proportions and conditions. The setback in the value of world trade naturally brought with it a decline in the amount of necessary finance. In addition, terms of credit have tended to be shorter, so that the total volume of trade financing outstanding has fallen more sharply than trade itself. American exporters to Europe have considerably shortened the usual terms of credit, insisting in many cases on cash payments — a factor which has enhanced the effect of the export surplus of the United States.

This contraction of the terms of credit given in international trade has been further accentuated by the disturbances brought about by the prolonged decline of sterling exchange, some effects of which have been mentioned in preceding paragraphs. In these conditions the function of gold as a hedge against exchange losses has become of greater importance, purchases of gold being considered as a sort of "insurance" against the decline of the currency in which contracts are expressed. In this connection it is interesting to observe that German exporting and importing firms, which had already been authorised to have exchange balances in their own names, were also permitted to buy and hold gold, the movements of which have at times been reflected in German customs statistics. In addition, the conditions on which the Reichsbank purchases export bills in foreign currencies (and thus itself assumes the currency risk) were made more attractive to exporters when in March 1939 it was decided, with regard to bills drawn on a foreign country in the currency of another foreign country, to apply rates corresponding to those obtaining in the country in whose currency the bill was drawn.

Export operations normally entail a greater degree of risk than domestic business. In recent years the usual credit risks have been greatly augmented by risks of currency instability and the danger of having the proceeds of exports tied up for indefinite periods by the application of clearings or of exchange restrictions in the importing country.

Owing to the reluctance of exporters to grant credits in certain directions and currencies, credit insurance by private companies, which is an old-established business, has been supplemented by more active government assistance in the form of insurance against credit and currency risks or of direct granting of credits by some official body. Some credits are thus granted not to the foreign importer direct but to the government of the importing country. In most cases the necessity for this government intervention was found in the early post-war years in developing trade with Russia — but in recent times, particularly since 1931, the field for government guarantees has greatly extended with the deterioration of monetary conditions throughout the world.

In England the Export Credits Guarantee Department of the Board of Trade has, from small beginnings, grown into an important part of the mechanism of financing British exports. The maximum of the liabilities which the Department may assume at any particular time was raised from £25 million to £50 million in 1937 and again to £75 million in 1938. The essential business of the Department is the guarantee of receipts from exports against losses from credit, currency and other risks — it does not usually provide funds to finance such transactions. Nevertheless, the Department has been instrumental in placing on the market Russian notes for £10 million carrying the Department's guarantee in 1936, and in 1938 guarantees of Turkish bills, also for £10 million, were given.

An interesting example of the changing methods of international trade financing is given by the agreement with Turkey. This agreement provided for the issue of 5½ per cent. Turkish bills on the market up to £10 million guaranteed by the Department and covering British exports of machinery and other manufactured goods to Turkey. Linked to this was a scheme for the export of Turkish natural resources on the world market, the proceeds of which would be used to meet the service of the credits. In addition, a British government guarantee for a £6 million loan was given to provide for Turkish purchases of armaments materials in the United Kingdom. The clearing agreement, already in existence, was also modified to limit future accumulations of arrears.

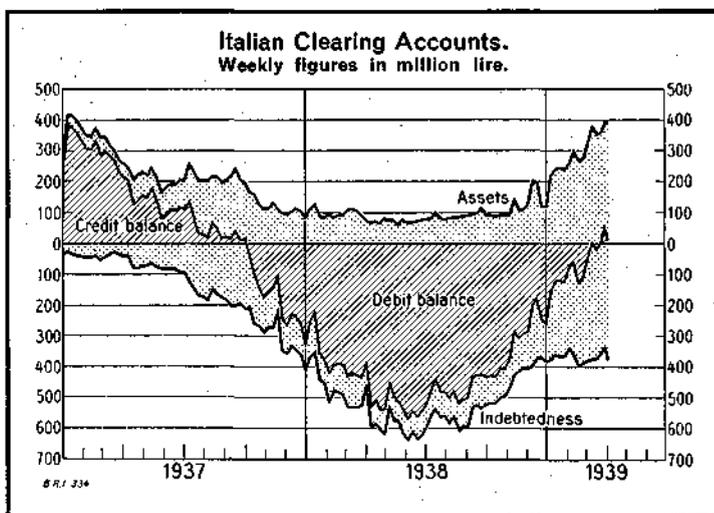
In Germany also the system of insurance of export credits has been considerably extended in recent years, generally, however, by private companies which may reinsure with the government, although direct Reich guarantees have, for example, been given in the past to cover the whole of the business done by German exporters with Russia, and, early in 1939, a Reich trade credit of RM 150 million was granted to cover Turkish imports from Germany. The German export-guarantee system is part of the general scheme of export assistance, which provides advice to exporters regarding the formulation of

contracts, foreign exchange restrictions, the laws in the foreign country concerned, etc.

In September 1938 a scheme for export-credit insurance was announced from Washington, providing for cover up to 80 per cent. of the risk. The U. S. Export-Import Bank has for some years specialised in the direct financing of export transactions where facilities from private sources could not easily be obtained, particularly for deliveries of American railroad equipment and heavy machinery to South American countries. In recent months this bank has arranged credits amounting to \$25 million for financing American exports to China and \$6 million for financing the export of cotton to Poland. In the latter case the transaction was due to the necessity of granting credits longer than three months, for which private facilities could not be found.

Schemes for official insurance or reinsurance of the risks involved in export credits now exist, in various stages of development, in a large number of countries. The increased amounts which it becomes necessary to insure reflect the difficulty, even impossibility, of assessing the political and other risks on anything like an actuarial basis.

It is extremely difficult to have precise information regarding the development of the various clearing accounts during the year. In many countries these accounts are not published or, where they are published, the denomination of the accounts in a number of currencies to which different exchange rates are applicable makes investigation difficult and conclusions uncertain. In Italy, clearing accounts are, however, all published in lire, and it is possible to obtain a good picture of general developments.



The movement of Italian foreign trade, which, in the last months of 1938, was balanced by the reduction of imports, is reflected in the clearing accounts, there being a rapid decline of the gross indebtedness in the last half of 1938 followed early in 1939 by an increase of clearing assets, so that by March 1939

the debit balance, which had been considerable in the middle of 1938, disappeared.

The field of new short-term credits, other than those directly connected with foreign trade, has remained restricted. In April 1938 the Argentine Government contracted two-year credits at 3½ per cent. in Holland

and Switzerland of Fl. 12½ million and Sw. fcs 40 million respectively. In June the Belgian Government also raised short-term credits in Holland and Switzerland for Fl. 35 million and Sw. fcs 25 million. In July the French Government raised a fifteen-month credit of Fl. 75 million in Amsterdam. At the end of November 1938 Fl. 150 million French railway bills fell due and were repaid in gold, but the French Government simultaneously raised a further Fl. 100 million on fifteen-month 2¾ per cent. Treasury bills.

Old, pre-1931, short-term foreign credits continue in general to be slowly withdrawn, and 1938 marked the winding-up of the company formed to administer and liquidate the bulk of the foreign assets of the Austrian Credit-Anstalt. Cash payments on capital account, amounting in all to 76 per cent. of the company's bonds, have been made, while some remaining slow assets have been passed over to a Swiss company for eventual realisation.

As in recent years, new money for long-term foreign issues was almost negligible in amount in 1938 and for the principal creditor markets was exceeded by repayments and repatriations of old loans by the debtors.

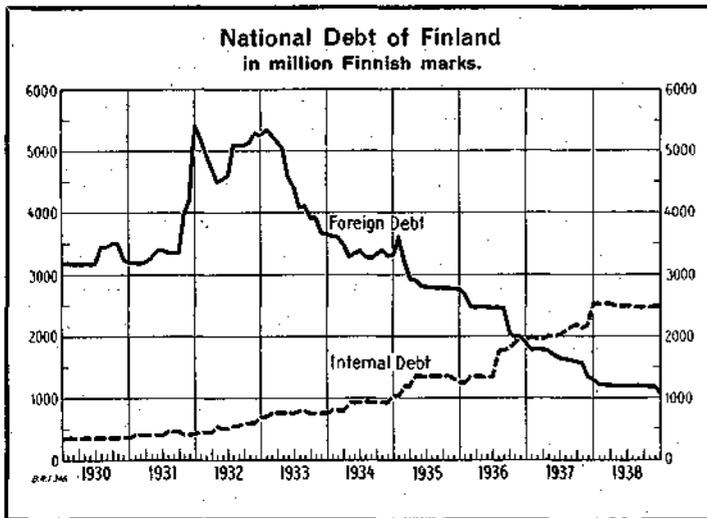
On the London market Empire issues at £24 million, a figure not very different from that of recent years, greatly exceeded issues for foreign countries, which were only £4½ million. The relaxation of the embargo on foreign issues, which was conceded in February 1938 was reimposed in December. Of industrial issues for the Empire the most important appear to have been, as in previous years, issues and introductions to the market of the securities of the South African gold mines. Amongst the government issues that of £7 million floated by the Australian Commonwealth Government in May, repayable in fourteen to eighteen years and bearing interest at 3¾ per cent., was one of the most important. An Australian conversion issue of £2½ million in December 1938 was notable in that for the first time the rate of interest, at 4 per cent., was higher than that of the maturing loan, which bore interest at 3½ per cent. This is the first Australian sterling issue on a 4 per cent. basis since July 1933 and reflects the general rise of long-term interest rates on the London market.

Foreign long-term issues for new money in the United States, at \$36 million, were at about the same level as the average for the last five years. The most interesting issue was the 4½ per cent. ten-year loan of \$25 million at 95½ for the Argentine Government in November 1938, which, although technically for new money (and thus the first new issue for any foreign government except Canada since 1930), is to be regarded rather as a continuation of the conversion programme of recent years, under which \$115 million dollar bonds have been retired in addition to amortisation payments of \$35 million. Also in November, the Canadian Government made a \$40 million refunding issue of 3 per cent. 30-year bonds at 97¼.

A French government loan for Fl. 175 million was issued in December 1938 through a group of Dutch and Swiss banks at 4 per cent. redeemable in thirty years, and the proceeds were used for the conversion or repayment of practically the whole of the external debt of the railways, including loans in dollars, florins and Swiss francs.

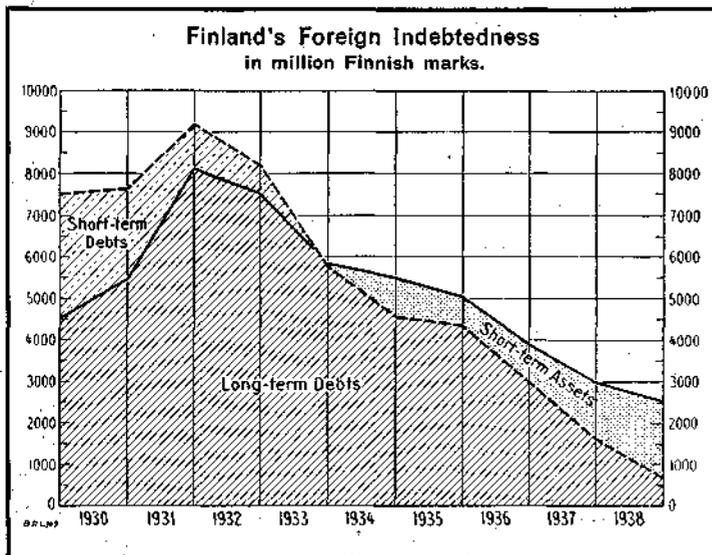
While new long-term issues on foreign account remain on the same low plane as in recent years, repatriations and redemptions by the debtor countries have continued. During the past five years some \$800 million has been utilised for the purchase of foreign securities in the United States for repatriation or redemption, largely by such countries as the Argentine, Belgium and Finland, which borrowed heavily at high rates of interest in the 'twenties.

The development as regards Finland is of particular interest. Surpluses of about FM 1,000 million per annum on the current account of the balance of payments for the last eight or nine years have been utilised chiefly to repay



foreign indebtedness; replaced to some extent by internal loans. This development is illustrated in the accompanying graphs, the first of which shows the debt of the government, both internal and foreign. The foreign debt was increased by depreciation of the Finnish mark in 1931 and 1932, but from 1933 onwards steadily reduced by the depreciation of

the dollar in the first place and also by the issue of internal loans for the redemption of foreign, particularly dollar, bonds. From 1929 to 1938 total government indebtedness, both internal and foreign, remained unchanged, on balance, at FM 3,500 million but the foreign indebtedness has been reduced



from 90 per cent. of the total in 1929 to 30 per cent. at the present time.

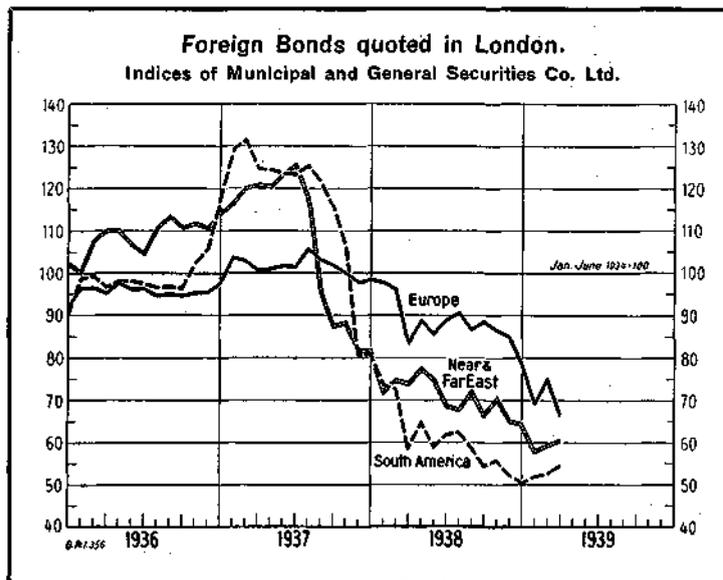
The second graph shows the total long and short-term foreign debt of Finland, both official and private, excluding, however, the dollar foodstuffs loan of 1923 (the so-called war debt), the equivalent of FM 400 million.

The total debt, which stood at FM 7,500 million in 1929, rose above FM 9,000 million with the depreciation of the currency at the end of 1931. From 1933 the surplus of assets on short-term account has been deducted from the outstanding long-term debt to give the net foreign debt which, reduced to under FM 700 million at the end of 1938, was less than one-tenth of the total ten years earlier, and, indeed, was more than covered by the gold reserve of the Bank of Finland, amounting to FM 1,100 million. As a consequence net interest payable to foreign countries, originally by far the most important debt item of the balance of payments, has been reduced since 1932 by two-thirds, from FM 583 to 195 million per annum, to take second place after tourists' expenditure abroad.

The rapid repayment of Finnish foreign indebtedness is the more remarkable as the structure of Finnish foreign trade has changed with the greater industrialisation of the country — the import of production goods, only 15 per cent. of total imports before the war, rose to 24 per cent. in the 'twenties and 30 per cent. at the present time. The favourable prices obtained for pulp, paper and timber for a number of years help to explain Finland's active balances on foreign account. The decline in these prices since 1937 has somewhat altered the situation; in April 1939 the Finnish Government issued a three-year 2½ per cent. loan for armament purposes, of which S. Kr. 20 million was placed on the Swedish market.

While Finnish bonds have been a profitable investment for the foreign bondholder, this has been by no means true with regard to many other outstanding foreign loans during the past two years. The graph shows the three most important components of the index calculated by the Municipal and General Securities Company, based on average quotations of over one hundred foreign bonds in the first half of 1934. These bonds have a nominal value of £600 million, one-fifth of the sterling value of all foreign bonds quoted

on the London Stock Exchange. The complete index (not shown in the graph) fell by 50 per cent. from the spring of 1937 to the early months of 1939. All groups took part in the decline, European bonds falling from over 100 to under 70, those of the Near and Far East from 120 to 60 and South (and Central) American bonds from 130 to little over 50 — the fear of war in Europe, actual war in



the Far East and the collapse of primary commodity prices were the principal influences during the past two years.

In March 1938 Austrian bonds became subject to the transfer moratorium in force in Germany, but the severe all-round decline in foreign-bond quotations during the year appears to have occurred more from fears of the future than from an actual aggravation of the defaults or new infringements of service conditions. For example, while South (and Central) American issues continued to fall during 1938, the few actual changes, such as the improvement in Chilean and Peruvian loan services, have been rather in favour of the bondholder.

In Europe, the Bulgarian Government offered an increase in the amount paid on current coupons, while the Hungarian Government early in 1939 supplemented the foreign-bond settlement of 1937 with permission for one-third of dividends due to foreigners to be transferred. The service of Yugoslavian foreign bonds was also improved and further progress was made for the service of Polish bonds to be paid at a reduced rate of interest, in general, a reduction from 7 to 4½ per cent. being made. As regards Greece, however, although the foreign-debt service is made on a reduced scale, no offer satisfactory to the bondholders has been made.

In the Near East, further transfer facilities were accorded for certain Turkish foreign loans, but, as regards the Far East, Japanese foreign bonds continued to decline, although no default has occurred, and Chinese bonds have been affected on account of the difficulties experienced by the Chinese Government in collecting revenues in the occupied parts of the country.

During a year when the foreign-bond market has been subject to exceptional shocks, the endeavours of several debtor countries to make such improvements in the service of defaulted bonds as were in their power should not pass unnoticed. Conditions of political unrest and the consequent low prices of foreign securities even where full service is maintained are, however, inimical to a revival of foreign-security issues on the creditor markets except in certain areas, as for instance issues in the United Kingdom for the British Empire. Apart from this, what new foreign-investment activity remains is, for the most part, that undertaken by large international enterprises by way of direct, or "entrepreneur", investments. And even these activities are often hampered by difficulties in transferring profits, unless the investment itself, as, for example, in the case of the development of oil resources, provides the material for transfer.

V. THE TREND OF INTEREST RATES.

Exceptional liquidity, both institutional and of private individuals, is the order of the day, and short-term interest rates generally remain at extraordinarily low levels or are still declining. In the United States a negative rate of interest has made its appearance. The increases of rates in Belgium in the spring of 1938 and in New Zealand late in the year are attributable to circumstances peculiar to the countries concerned. While long-term rates continued to decline in the United States and some other countries, the French market in particular showing a notable downward adjustment, long-term rates in England have risen steadily for four years from about $2\frac{3}{4}$ per cent. in 1935 to just above $3\frac{1}{2}$ per cent. at the present time, and the spread between short and long-term rates has grown wider. With one or two exceptions, international movements of funds have had little influence on interest rates. The business recession and political disturbances arresting the flow of private capital into new enterprise tended further to depress rates to low levels. Capital markets are dominated more and more by government borrowing for armament purposes.

Though actual movements of rates have been slight during the year, many highly interesting developments have occurred, bringing to light tendencies of profound significance for the credit structure of the various countries.

(1) CENTRAL BANK CREDIT AND SHORT-TERM INTEREST RATES.

As in 1937 when the cumulation of business activity to boom conditions was not reflected in changes of bank rate, so in 1938 international political crises left rates still at very low levels. The table on the following page shows the official discount rates of European central banks in force at the end of 1938 and of March 1939 compared with earlier years.

Nineteen of the twenty-five central banks had discount rates unchanged during the year, while five banks decreased their rates and there was only one increase on balance. In each case the rate taken is believed to be that most representative for the central bank concerned. Some banks, as, for example, the Bank of England, only announce one rate, while most others publish more than one — as many as nine in Latvia, there being separate rates for credit granted to banks in towns and in the country, for private persons, for firms, and against export bills, etc.

Of the five countries whose discount rates were reduced on the year, that of the Bank of France is of particular interest as reflecting the improved external position of the country, especially since November last. In September 1938, when rediscounting at the Bank increased sharply, the official discount rate was raised from $2\frac{1}{2}$ to 3 per cent., to be reduced in November to $2\frac{1}{2}$ per cent. and in January 1939 by a further $\frac{1}{2}$ per cent. to 2, equal to the lowest rate ever quoted by the Bank of France in the past. The supple

Discount rates of European central banks	Lowest 1925-1929	End 1936	End 1937	End 1938	Change in 1938	End March 1939 (d)
1. Rates decreased in 1938						
France	3½	2	3	2½	—½	2
Norway	4½	4	4	3½ (a)	—½	—
Roumania	6	4½	4½	3½	—1	—
Spain	5	5	5	4	—1	—
Lithuania	7	5½	5½	5	—½	—
2. Rates unchanged in 1938						
Switzerland	3½	1½	1½	1½	—	—
England	4	2	2	2	—	—
Netherlands	3½	2	2	2	—	—
Sweden	3½	2½ (a)	2½ (a)	2½ (a)	—	—
Czecho-Slovakia	5	3	3 (a)	3 (a)	—	—
Danzig	5½	5	4 (a)	4 (a)	—	—
Denmark	5	4	4	4 (a)	—	3½ (a)
Finland	6	4	4	4	—	—
Germany	5	4	4	4	—	—
Hungary	6	4	4	4	—	—
Portugal	8	4½	4 (a)	4 (a)	—	—
Estonia	7½	4½ (b)	4½ (b)	4½ (b)	—	—
Italy	5½	4½	4½	4½	—	—
Poland	8	5	4½	4½	—	—
Latvia	6	5 (c)	5 (c)	5 (c)	—	—
Yugoslavia	5½	5	5	5	—	—
Albania	9	7	6	6	—	—
Bulgaria	9	6	6	6	—	—
Greece	7½	7	6	6	—	—
3. Rates increased in 1938						
Belgium	4	2	2	2½	+½	—

(a) ½ per cent. lower for rediscounts of banks.
 (b) ½ per cent. lower for bankers' acceptances.

(c) ½ per cent. higher for private firms.
 (d) Where changed since the end of 1938.

use of bank rate in France in recent times contrasts in an interesting way with the more rigid policy of earlier years and also with present conditions in certain other countries. The improvement in credit conditions in France since November last is also illustrated by the growth of deposits with the credit banks and the easing of market rates, the rate of discount for ordinary Treasury bills of 75 to 105 days being 1½ per cent. from 12th December 1938 against 3 per cent. in September. On 24th April 1939 this rate was raised to 1¾ per cent.

The reduction of bank rate in Roumania from 4½ to 3½ per cent. early in May 1938 was part of a plan aiming at lower interest rates throughout the country and is to be seen in the light of the new regulation of banking business and the decree of 4th May 1938 reducing the maximum legal rate of interest from 5 to 4 per cent. above bank rate, i. e. from 9½ to 7½ per cent.

The figure given in the table for the Bank of Spain at the end of 1938 was that quoted at Burgos, where the rate was reduced to 4 per cent. in November 1938, the lowest ever quoted by the Bank.

The decrease from 4 to 3½ per cent. in Norway was made already in January 1938, and rather over a year later (February 1939) a similar reduction was made in Denmark. Both decreases reflect the activity of the current account of the balance of payments and the generally favourable flow of capital. Norwegian banks continued to gain in liquidity: one of the two private banks which had to be supported by the Norges Bank in 1932 was able to dispense with any further assistance and it is expected that this example will soon be followed by the other bank. In Denmark, easier monetary conditions

were foreshadowed as early as the autumn of 1937 when the Nationalbank relaxed its bond-selling policy, which had been a feature of the years 1935-36. In 1938 the Nationalbank further increased its bond holding and on 1st November reduced from $\frac{1}{2}$ to $\frac{1}{4}$ per cent. the interest it pays on sight deposits.

The one European official discount rate which was higher on balance was that of the National Bank of Belgium, which in May 1938 made an energetic defence of its currency against the violent outflow of funds from the country after the abrupt depreciation of the French franc to 179 to the pound. The various measures taken included the doubling of bank rate from 2 to 4 per cent. and the application of a programme, in co-operation with the important credit banks of the country, designed to prevent any extension of credit not justified by commercial needs, as business activity was declining and prices falling. These measures may be summarised as follows:

(a) The banks to refrain from granting any new credit not justified by perfectly normal industrial or commercial transactions. Credits requested by persons not engaged in business to be refused, save in exceptional cases.

(b) The banks to permit the utilisation of acceptance credits, working credits and discount credits already granted to their customers
— only within the limits of average utilisation of such credits during the preceding year (to end April 1938), and
— only upon proof of the commercial nature of the credit requirements.

Paper not corresponding to these conditions would not be eligible for rediscount at the National Bank.

(c) The banks to refrain from substituting themselves one for the other in the granting of credit.

(d) Regarding paper drawn by foreign customers on Belgian concerns, or passed by foreign banks to Belgian banks, the banks to receive such paper for discount only subject to the agreement of the National Bank to rediscount it.

(e) The banks to refrain from the repayment of deposits and other creditor accounts of their customers before the time fixed.

The defence thus adopted resolves itself into the observance of two fundamental principles:

(i) to give out gold against cash (currency) without restriction, but

(ii) to make cash scarce, i. e. make it difficult and expensive for anyone who does not hold cash to obtain it. This involves an increase of bank rate and a restrictive credit policy — or at least strong resistance to an expansion of credit dictated by speculative motives.

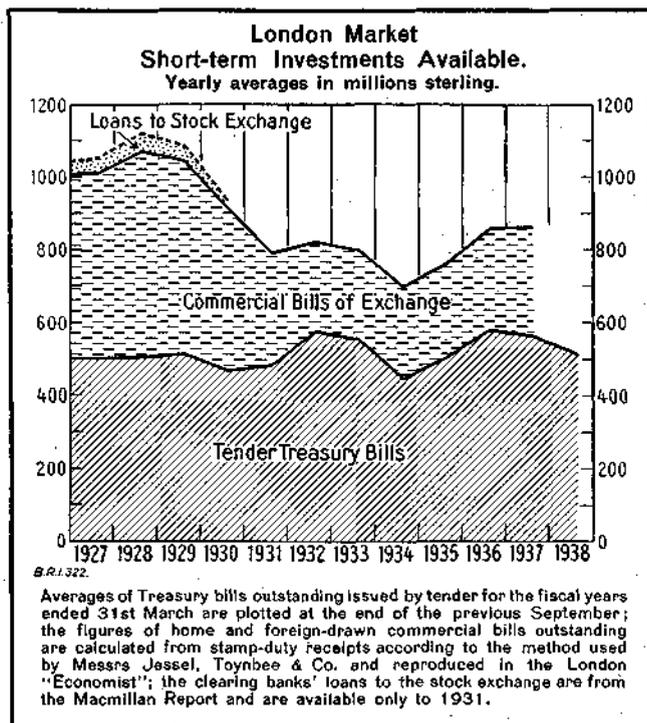
Within a few days after the adoption of these measures the attack on the currency faded away, in ten days the credit measures were relaxed and twenty days after the original increase bank rate was reduced from 4 to 3 per cent., so that any slight inconvenience which might have been caused

to ordinary business could have been only of a temporary character. Further decrease of bank rate was postponed by the repercussions of the international political events of the summer and autumn, but a reduction to 2½ per cent. was made in October 1938. On 17th April 1939, however, bank rate was again increased to 4 per cent.

Conditions on the London money market were practically unaffected by the large outflow of funds and the business depression. These factors, indeed, offset each other somewhat as falling prices and the liquidation of stocks released funds for other employment, while the exodus of capital withdrew money largely employed at short term. An important factor in preventing disturbances on the money market was, of course, the well-known mechanism of the Exchange Equalisation Account which, with a minimum of friction, restored the amount of cash required by the banks. The offsetting operations of the Account help to explain why there was comparatively little change in short-term money rates, but the reason why they remained so persistently low in London (as in some other centres) is to be found in the abundance of liquid funds at a time of little demand for accommodation from business generally. Bank rate has stood at 2 per cent. for nearly seven years, while the discount on Treasury bills has varied from ½ per cent. only for short periods — and a level as "high" as this has been maintained only by co-operation in the market.

In the London money market the available material for short-term investment has declined considerably during the past ten years. Banking funds may be utilised for financing gold movements and in swaps, but the essential

material for short-term investment consists of bills — bills of exchange financing home and foreign trade and bills financing the Treasury's requirements. The decline in the volume of this material is illustrated in the graph.



The volume of "tender" Treasury bills, which gives a rough idea of the bills available for non-official investors, has fluctuated around £ 500 million during the ten years in spite of the issue of bills to the market to finance the holding of gold by the Exchange Equalisation Account. There has thus been a reduction in the

amount of bills outstanding for the needs of the Treasury, a reduction due to deliberate policy aiming at keeping the floating debt within certain limits. Consolidation loans have been issued from time to time and the proceeds from long-term government issues for other purposes have been applied in the first instance to reduction of the floating debt (expanded again later as the money was utilised). The usual expansion of tender bills over the autumn and winter (due to the seasonal movement of the budget deficit) did not take place for 1938-39, but there was a steep decline from £585 million in June 1938 to £350 million in March 1939 — the lowest point since the war. This contraction was due in the first place to the issue of a government long-term loan for £80 million in June 1938 and later to the great efflux of gold, the holding of which had previously been financed with Treasury bills.

The decline in commercial bills outstanding is primarily associated with a long-term change in methods of financing, direct credits having largely taken the place of bills while commercial and industrial firms finance themselves from their own resources in a much larger degree than formerly. Before 1914 the volume of commercial bills outstanding was roughly double the present figure, which includes, incidentally, some £40 million bills frozen under standstill agreements. Loans to the stock exchange formed only a very small proportion of the assets of the clearing banks in the 'twenties, and the total outstanding is doubtless much less at the present time than it was ten years ago. Total credit facilities granted to the stock exchange and directly by the banks to private persons for the purpose of holding securities are not known and must, of course, be much greater than the loans from the clearing banks to brokers and dealers.

The shrinkage of available material for short-term investment coincides with a growth in demand. The total deposits of the original ten clearing banks, which in addition to the 10 per cent. cash maintain generally some 20 per cent. of short-term assets, have grown from £1,843 million in December 1928 to £2,172 million in December 1938. If the theoretical 20 per cent. were rigidly applied, these deposits would now need a backing of some £430 million bills held directly or indirectly (through loans to the discount market). The suggestion has been made that in order to facilitate the mechanics of the banking system and the money market the Treasury-bill issue should be increased. But the danger of a large government floating debt especially at times of political tension is so great that the wisdom of making such an increase, unnecessary as regards Treasury financing, is to be doubted. It has already been necessary to restrict the circulation of municipal bills, which tended to grow beyond what was desirable. At a time when it has been found necessary to modify many of the traditional customs of the central bank itself in order to keep abreast of realities, it is natural that the clearing banks should have applied the ratios to which they are accustomed to work with that degree of adaptability and elasticity necessary to ensure the smooth working of the banking system in modern conditions.

In the discount market itself the supply of bills has been supplemented by the holding of "shorts", i. e., bonds maturing within a few years. This is

not a new practice and was current even before 1914, but it has been greatly extended in recent years. That this involves certain dangers was exemplified in September 1938 when "outside" money was scarce and the bonds themselves fell sharply on the stock exchange. In present circumstances the disappearance of smaller firms from the market has been an unavoidable process. That the larger companies have been able to maintain a satisfactory earning power even in the adverse conditions of recent years is disclosed by their published accounts.

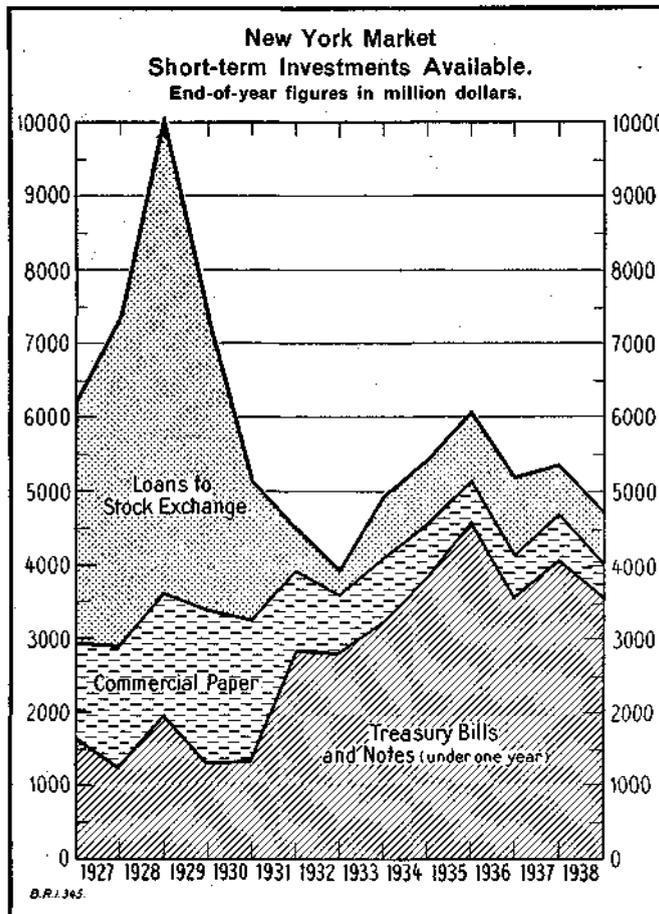
As in 1937 the market passed the end of June 1938 without the need of borrowing from the Bank of England, but at the end of December, largely owing to technical conditions (the last day of the year falling on a Saturday) there was considerable recourse to the Bank. Such borrowing at the Bank of England, always something of a "penalty" in normal times when the margin between market rate and bank rate was, say, $\frac{1}{2}$ per cent., is particularly onerous when the margin amounts to as much as $1\frac{1}{2}$ per cent. In this connection it is interesting to note the utilisation during the past year of a new technique of open-market operations somewhat similar to that employed in New York, where a rate is quoted by the Federal Reserve Bank for the purchase of bankers' acceptances at a level below the rediscount rate and approximating to the market level. In England such a rate was not publicly quoted but was applied at certain times (particularly in May 1938) by the Bank of England's dealer, who let it be known that he would purchase bills at a level near the market rate. The chief difference between this method of supplying money to the market and the usual official buying of bills lies in the passing of the initiative for individual deals from the central bank to the market house requiring funds.

The New York money market in 1938 presents a picture of unprecedented monetary ease due to the combination of a rapid accumulation of funds and a reduction of normal outlets. The excess reserves of all member banks were increased by \$760 million through the cut in reserve requirements made in April 1938. Secondly, the continued recession of business activity in the first half of the year, falling prices and the liquidation of inventories were accompanied by a reduction in the banks' commercial loans which continued until August. The influence of the vigorous upturn of business activity in the second half and of seasonal crop-financing movements was almost wholly offset by the continued repayment of old loans, confirming experience of the past that business concerns themselves, after a recession, are usually in possession of sufficient funds to finance the first stages of expansion. Thirdly, imports of nearly \$2,000 million gold increased both deposits and reserves of member banks, except for \$500 million added to the unused "free" gold of the Treasury.

Concurrent with this great increase in the supply of funds there was an appreciable decrease in the paper available for short-term investment. As in any money market material for such investment is confined to three main classes: short-term paper issued by the government or other public bodies, bills for the financing of domestic and foreign trade, and short-term loans to the stock exchange. In the late 'twenties loans to the stock exchange comprised

the greater part of the New York money market, but these loans have fallen to roughly one-tenth of the former volume, which was then, indeed, far greater than was desirable. Bankers' acceptances and other commercial paper (shown together as "commercial paper" in the next graph), although they expanded slightly in the boom of 1937, have at present roughly one-quarter the volume of ten years ago. And, as in other centres, changes in methods of financing trade, particularly the replacement of bills by direct credits, seem to reveal a long-term trend unfavourable to this type of paper.

Thus the money market of New York, as indeed money markets all over the world, has come to rely more and more on the short (and medium) term issues of the government.

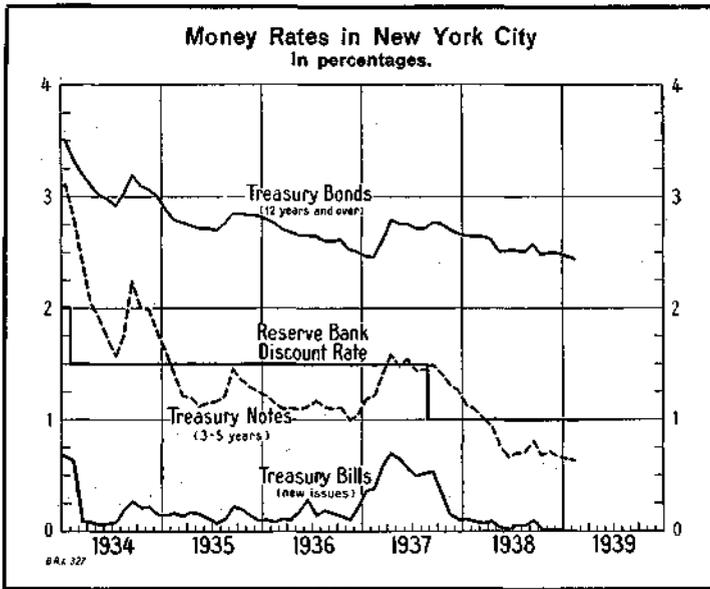


Although this graph has been drawn up on similar lines to that given for London, some warning against too close a comparison is necessary. The figures for loans to the stock exchange are comprehensive for New York but not for London, while the inclusion of U.S. Treasury notes with one year or less to run (in addition to three-months' Treasury bills) has no counterpart in the English graph. As the London market has held "shorts", so Treasury notes with longer than one year to run have been held in New York. (Total notes outstanding amounted to \$8,500 million at the end of 1938, including those with one year or less to run.)

The reduction in the volume of Treasury notes and bills in 1938 was

due partly to continued conversion to longer-dated maturities and partly to repayments from desterilised gold, the latter operation having the double effect of increasing the member banks' cash and reducing the outlet. The result of these influences was a further sharp reduction of interest rates, already abnormally low, and a further piling-up of idle balances.

The reduction of interest rates, particularly those at very short term, continued until, near the end of December, the yield on Treasury bills dis-

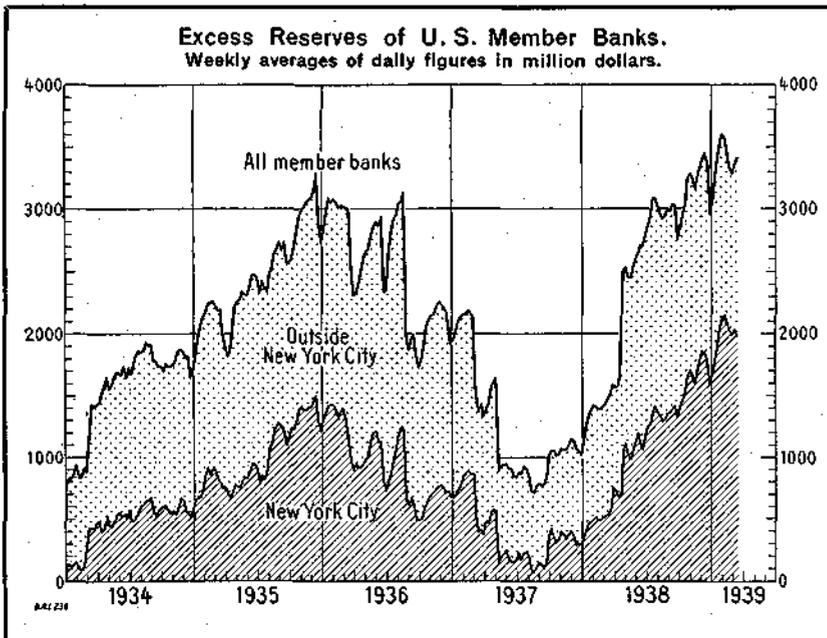


appeared completely and the extraordinary phenomenon of a negative rate of interest made its appearance, not only for bills already on the market but even for new issues; in other words, the Treasury had no interest to pay on its borrowing but received a premium on the issue. The chief reason for this, other than "window-dressing" by the banks, was the demand for short-term

tax-exempt securities to reduce tax liabilities on State tax dates. Further, market quotations of Treasury notes were distorted by the value of prospective "rights" given by maturing notes in connection with subscriptions to new issues of government securities. Thus certain notes rose to one or two per cent. above the price which would have been equivalent to a no-yield basis. This one or two per cent. premium was considered the value of the "rights" to obtain a hundred per cent. allotment of the bonds or notes offered in exchange at maturity.

The idle cash of the member banks, represented by their excess reserves, rose to the record level of over \$4,000 million in April 1939, certain New

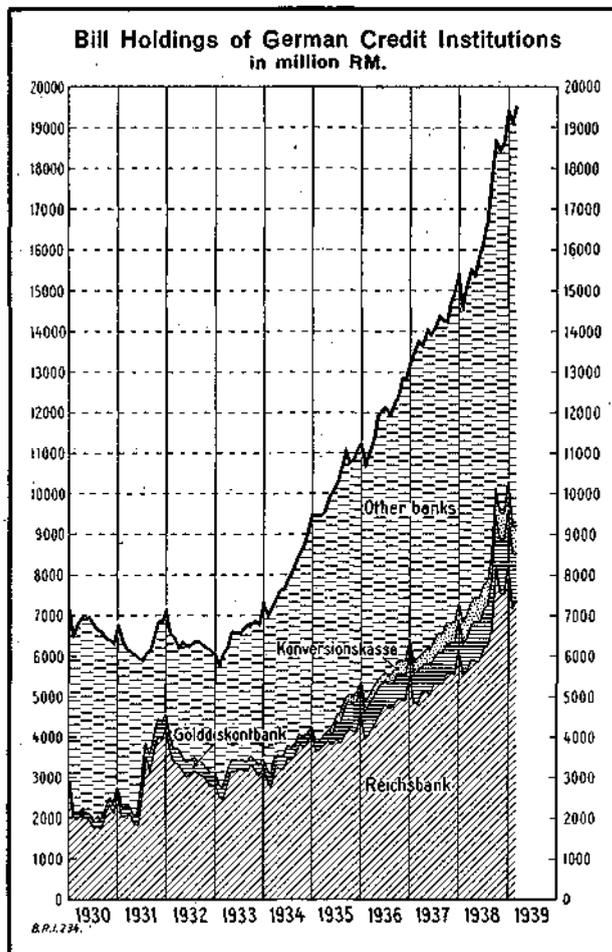
York banks at times showing cash reserves at 50 per cent., and more, of deposits. With a shrinking demand for business accommodation and a reduction in the volume of short-term government paper, money was unusable and had largely to remain unemployed. Even the Federal



Reserve System found difficulty in December 1938 in replacing maturing Treasury bills. In 1938, with industrial production at three-quarters and wholesale prices at four-fifths of 1929 levels, total member bank deposits are slightly, and currency in circulation greatly, in excess of the figures ten years earlier, thus indicating a considerable reduction in velocity of both these means of circulation, as well as a shift in their relative importance as actual means of payment.

In Italy, total credits granted by ordinary banks collecting short-term savings rose from Lit. 29,800 million in June 1937 to Lit. 32,300 million on 30th June 1938, an increase of 8½ per cent. But if the credit facilities granted by certain specialised bodies such as the mortgage and agricultural banks are added to this sum, the grand total in June 1938 amounted to nearly Lit. 43,000 million. Examination of the extension of credit in recent years shows that in the main it was utilised in view of the development of the self-sufficiency programme and for the seasonal financing of the wheat crop; of the total Lit. 43,000 million outstanding in June 1938, the land reclamation scheme, the building industry and public works had absorbed about

Lit. 8,700 million, while Lit. 6,500 million had gone to agriculture, and so on. Between August 1936 and June 1938 the expansion of credit by banks collecting short-term savings rose by Lit. 5,200 million, that is nearly 20 per cent.



The new plan of financing government expenditure in Germany announced by the President of the Reichsbank in March 1938 aimed at curtailing the expansion of central-bank credit and at the covering of government needs from current revenues and savings received through the issue of government loans. Some elasticity was given to this system through the possibility of part payment on contracts by a limited issue of delivery bills of six months' maturity, not, however, rediscountable as were the old "special" bills, the issue of which ceased after March 1938. As the special bills, of six-

months' maturity, fell due for payment (by the latest in September 1938) they came back through the banking system to the Reichsbank, which took over the responsibility of administering such bills as had not been liquidated and of gradually funding them during the next few years in the form of long-term loans. Some of the special bills were replaced by "block bills", a form of consolidation, but the volume treated in this way has not been published. In the meantime the new delivery bills were issued from April 1938 onwards at the rate of about RM 500 million a month, so that at the end of the six months to October RM 3,000 million were outstanding, of which RM 2,000 million had been taken up by the monthly-reporting banks as shown by their returns.

The withdrawal of rediscountable special bills and their replacement by non-rediscountable delivery bills naturally raised problems of liquidity for the banking system.

Large Berlin banks — some items from the returns.

In RM millions at end of:	Assets				Liabilities
	Bills and cheques	Treasury bills	Securities	Advances	Deposits etc.
1935	1,589	613	881	3,438	6,159
1936	2,069	442	996	3,132	6,342
1937	2,620	407	998	3,012	6,781
1938	2,243	1,229	1,151	3,223	7,627

The table shows, as well as the rise in securities, an increase in Treasury bills greater than the decrease in other "bills and cheques". This latter item includes the holdings of rediscountable "Solawechsel" issued by the Golddiskontbank (i.e. one-name three-months' promissory notes issued to mop up liquid market resources wherewith to take over part of the Reichsbank's bill portfolio). The volume of Solawechsel outstanding was previously a good indication of the relative ease of the money market, but in the last half of 1938 Solawechsel were in demand as a readily mobilisable banking asset and an increase in the issue ran parallel with a decrease in banking liquidity in other respects. For the first time for some years there was an expansion in the commercial advances of the banks which, although comparatively small, was significant as an indication of change of direction. Although firms working on public contracts have adequate liquid funds, other firms have recently shown some reduction in liquidity and they turn to the banks for working capital. Other reasons for the demand for advances are to be found in the changes in the ownership of private enterprises due to the aryanisation of Jewish firms.

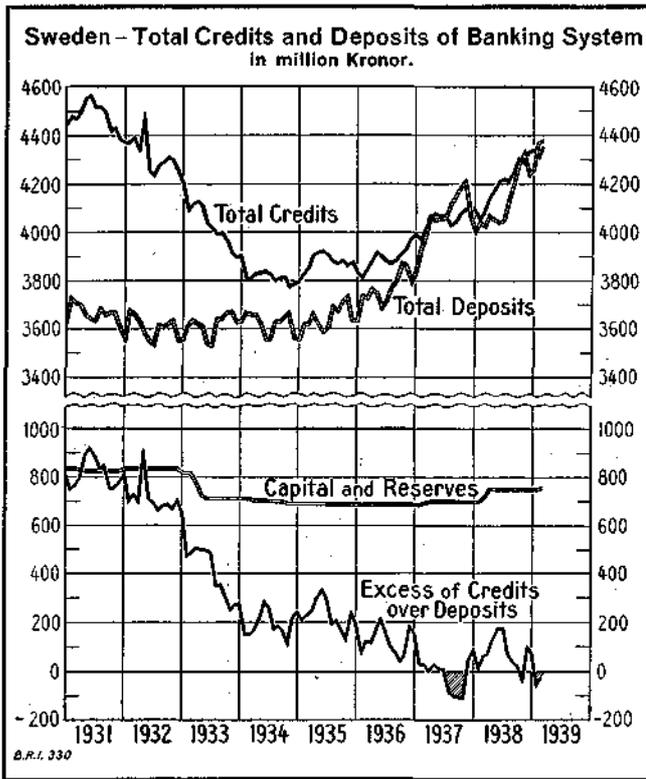
Under a new finance plan announced in March 1939 no more delivery bills are to be issued after April 1939, but from 2nd May 1939 onwards payments will be made partly in cash and partly in tax certificates. This applies in the first place to contractors working for the government, the States, municipalities and associations of municipalities, the government railways and roadways and the postal administration; additions to this list may be made by the Finance Minister.

Sixty per cent. is to be paid in cash and forty per cent. equally in two types of tax certificates. These certificates enjoy a limited legal tender in that they may be given by the recipients in payment up to 40 per cent. to sub-contractors or suppliers working directly or indirectly on government contracts. The first class of certificates may be used at their nominal value for payment of taxes after six months but may, alternatively, be held as an investment for longer than their six-months' term, in which case they carry certain privileges regarding future taxation payments. The second class of certificates may be presented in payment of taxes only after three years at 112 per cent. but may, in the meantime, be utilised as collateral for bank (including Reichsbank) loans. As the financing possibilities offered by the tax certificates are to be made available to the Reich alone, the States, municipalities and public bodies mentioned above must purchase from the Reich with cash the tax certificates they issue. At the same time it was announced that, in order to leave the resources of the capital market available for increased private financing, long-term Reich loans would in future be issued only exceptionally.

The money markets of Switzerland, Holland and Sweden continued to be abnormally liquid, temporary outward movements being practically without effect on money rates owing to the exceptionally high cash holdings of the banking system. Bank rate in Switzerland, unchanged since November 1936 at $1\frac{1}{2}$ per cent., remains the lowest in Europe. The market rate of discount is unvaried at one per cent. and call money in Zurich, which was one per cent. in 1937 and 1938, fell to $\frac{1}{2}$ per cent. in January 1939. Sight accounts at the National Bank, which reflect money-market conditions, rose to over Sw. fcs 2,000 million early in 1938 — twenty times as high as the average level in the more normal years before 1930. Similarly in Holland, with bank rate unchanged at 2 per cent. since December 1936, the market rate of discount has remained at $\frac{1}{8}$ per cent., throughout the year 1938, with only a flicker in September. One-month loans to the stock exchange against securities at $\frac{1}{2}$ per cent. compare with an average of $\frac{3}{4}$ per cent. in 1937 and nearly 2 per cent. in 1936. Cash balances at the Nederlandsche Bank remain very high, and there were few who had recourse to discounting even during September 1938. In March and April 1939 there was some hardening of rates under the influence of the international political situation.

In Sweden, where there is practically no money market outside the banks, the position is best illustrated from the figures of the banks themselves. Before 1932 the total credits granted by the commercial banks exceeded deposits by an amount roughly equal to their capital and reserves, as is shown in the graph on the next page. The excess of credits rapidly declined in the following years and in 1937, for the first time in Swedish banking history, a surplus of deposits appeared. The counterpart of these high deposits was the ample cash balances of the banks at the Riksbank. Conditions were not greatly changed in 1938 although the banks continued to find some outlet for advances, particularly against mortgages.

Elsewhere in Europe there is generally little change from earlier years — if anything, a tendency to still greater monetary ease, conditions affecting



those countries whose market is protected from outside influences by exchange restrictions as well as those retaining free currencies.

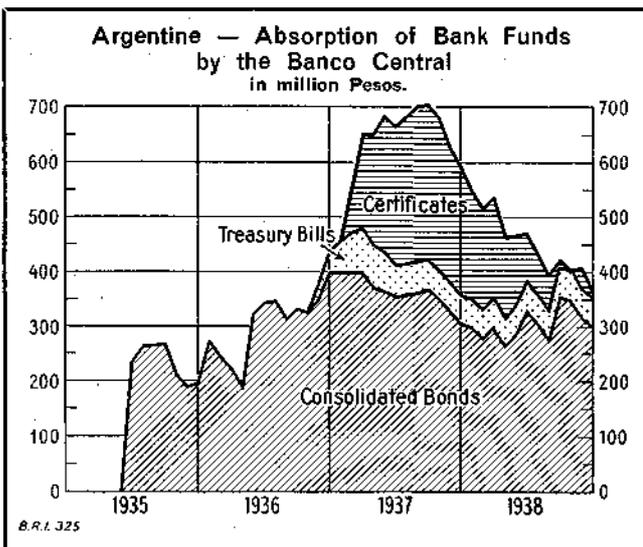
The Central Bank of Turkey reduced its bank rate to 4 per cent. on 1st July 1938 from 5½ per cent. at which it had been maintained since March 1933.

Although the official discount rate remained unchanged, the Bank of Japan introduced a procedure of granting eligibility for rediscount to specified bills before negotiation against the security of corporation debentures, lowered some of the rates of interest on loans with

certain corporation debentures as collateral, and took other measures to facilitate the expansion of the capital market.

In the predominantly agricultural countries overseas, such as Australia, New Zealand, the Argentine and India, the fall in export prices and the consequent passive balance of current international payments has naturally led to some relative tightening of money conditions.

The liquidity of the market in the Argentine, reinforced by the strongly active balance of payments for 1936—37, was kept in hand by the Banco Central's policy of absorbing the surplus banking funds. In 1938 the reverse movement led to a decline in the securities placed on the market, as shown in the accompanying graph. In Australia and India the change of conditions was translated into some pressure on the commercial banks' cash holdings



and a tendency for the internal credit items of the central bank to rise — without the necessity, however, for an increase of bank rate.

The reversal of conditions in New Zealand assumed a more severe character. For some years the government pursued an expansionist policy, the ultimate consequences of which were obscured by the favourable conditions temporarily obtaining. Export prices increased steadily from 1934 to the end of 1937, in all by some 50 per cent., while a very large reserve of sterling assets had been built up in 1933. The extent of the expansion may be gauged from the amount of the Reserve Bank's advances to the government (partly in connection with marketing schemes) which from nil at the end of 1935 and £N.Z. 7 million in 1936 and 1937 rose to £N.Z. 16 million at the end of 1938 (and £N.Z. 20 million in March 1939). Concurrently the ratio of the trading banks' advances to deposits rose from the usual 70 per cent. to 82½ per cent. in December 1937 and 92½ per cent. in December 1938. Exports fell with falling prices from the end of 1937, but imports remained practically unchanged, the export surplus of merchandise dwindling to proportions insufficient to offset the invisible items, and, together with some export of capital, reducing the sterling holdings of the Reserve Bank from over £N.Z. 18 million in June to £N.Z. 4½ million in December 1938. In these conditions drastic action was necessary if the exchange rate was to be maintained and further inflation avoided. In addition to the imposition of exchange restrictions the Reserve Bank raised its discount rate from 2 to 4 per cent. in November. The trading banks have not, however, borrowed from the central bank and, in fact, have held sufficient sterling to obtain whatever home currency they needed from time to time. They have to maintain minimum cash balances of 7 per cent. at the Reserve Bank, which has the right to demand an increase in the percentage. But the problem is not to restrict private or bank borrowing from the Reserve Bank but to induce a contraction of the direct borrowing by the government.

The increases made during recent years in official discount rates are exceptional and cheap money remains the general rule on the various markets. With certain exceptions the same tendency is found in long-term interest rates, despite the growing demand by governments to finance increased armaments and other exceptional expenditure. By the fact that commercial banks in a number of countries hold large amounts of government bonds and also tend to increase their advances against mortgages, a closer link is being established between the money and capital markets.

2. CAPITAL MARKETS AND LONG-TERM INTEREST RATES.

Nowhere have government borrowing and spending assumed greater proportions than in the United States where a considerable budget deficit has been running since 1930. Intensification of the spending programme in 1938, after some slackening in 1936-37, is illustrated by the evolution of the budget accounts and the Treasury's cash position.

U. S. Federal Budget Accounts and Treasury Position 1936-1939.

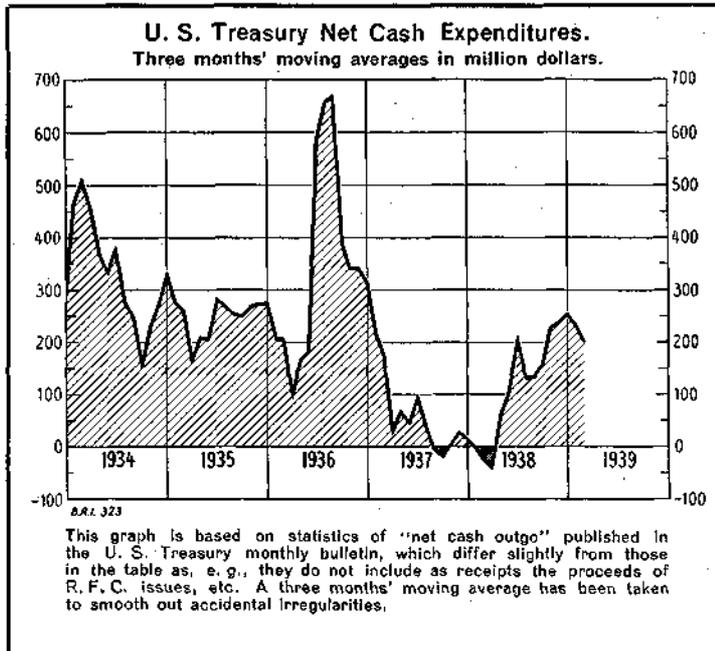
Quarterly figures in \$ millions	Budget accounts			Other accounts (net)	Treasury total cash requirements (-)	Method of financing	
	Re- ceipts	Ex- pendi- ture	Deficit			Change in publicly- offered direct debt, increase (+)	Change in General Fund balance; increase (-)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1936 Third quarter	1,136	1,907	- 771	- 256	-1,027	+ 533	+ 494
Fourth "	1,022	1,956	- 934	- 15	- 949	+ 667	+ 282
1937 First quarter	1,570	1,987	- 417	+ 112	- 305	+ 225	+ 80
Second "	1,565	2,592	-1,027	+ 742	- 285	+ 1,013	- 728
Third "	1,651	1,912	- 261	+ 424	(+ 163)*	+ 143	- 306
Fourth "	1,526	1,778	- 252	+ 225	- 27	+ 140	- 113
1938 First quarter	1,643	1,796	- 153	+ 307	(+ 154)*	+ 14	- 168
Second "	1,422	2,140	- 718	+ 363	- 355	- 569	+ 924
Third "	1,509	2,196	- 687	+ 420	- 267	+ 1,030	- 763
Fourth "	1,418	2,308	- 890	+ 161	- 729	+ 834	- 105
1939 First quarter	1,463	2,225	- 762	+ 816	(+ 54)*	+ 252	- 306

* Surplus of cash receipts.

Columns 1 to 3 show the budget accounts as published, the third column being the accounting deficit. Column 4 shows the net movements of various accounts outside the budget affecting the cash position of the Treasury. This column reflects in particular the encashment of veterans' bonus bonds in 1936; from 1937 onwards the operations of the Treasury Trust Accounts were an important factor, chiefly due to the working of the Social Security programme; the revolving funds of certain government agencies are also included and have become of increased significance from 1938, e. g., in the third quarter \$200 million was received on account of the Reconstruction Finance Corporation, being the proceeds of new issues on the market. In the first quarter of 1939 \$480 million was paid into the Treasury's cash account from issues for the R. F. C., the U. S. Housing Authority and the Federal National Mortgage Association. By the end of February 1939 the Treasury had working balances of \$2,700 million against \$1,200 million a year earlier.

The resultant of the budget deficit and the movements of extra-budgetary funds is the cash deficit (or surplus) of the Treasury to be covered by securities issued to the market or by fluctuations in the General Fund. The gold-sterilisation policy in 1937 is reflected in the table by an increase in the securities publicly offered greater than was necessary to cover cash requirements, with a corresponding increase of gold in the General Fund: the desterilisation programme produced the opposite movement, particularly important in the second quarter of 1938.

The cash deficit practically disappeared from the third quarter of 1937 to the first quarter of 1938, in fact, in the twelve months to March 1938 the Treasury's cash needs were wholly covered by cash income. From the second quarter of 1938 budget expenditure increased while receipts fell off, leading to an expansion of the cash deficit. The Treasury's cash requirements rose from



\$150 million in the last nine months of 1937 to \$1,350 million in the same period of 1938. In the first quarter of 1939, however, a cash surplus again appeared owing to the large receipts from loans raised on the market for account of government agencies, mentioned above. The phases of the spending policy are clearly illustrated by the graph, which gives moving average figures of the cash deficit, and shows how this

deficit was reduced from early 1934 to the spring of 1938 (with a break in 1936 reflecting payment of 'the veterans' bonus), to be increased again in 1938-39.

The continuation of the deficit depends essentially on the "recovery and relief" expenditure, of which the greatest component is the Works Progress Association (W.P.A.), as shown in the table.

Quarterly in \$ millions	Recovery and relief expenditure		
	W. P. A.	other	total
1936			
Third quarter	479	356	835
Fourth "	541	322	863
1937			
First quarter	448	248	696
Second "	428	258	686
Third "	334	198	532
Fourth "	316	184	500
1938			
First quarter	353	143	496
Second "	471	251	722
Third "	559	136	695
Fourth "	621	197	818
1939			
First quarter	546	266	812

The expansionist programme of 1938 included the authorisation of \$1,500 million new loans by the R.F.C. Although some \$520 million have now been raised by the issue of government-guaranteed bonds, an increase of R. F. C. loans has not taken place. On 1st April 1939 the R. F. C. rate for loans to business was reduced from 5 to 4 per cent.

The Treasury's policy of placing the debt upon a long-term basis was continued in 1938:

U. S. Government Interest-bearing Debt (direct).

End of year - in million dollars	1936	1937	1938	Change 1937-38
Publicly-offered:				
Bonds	20,006	21,519	25,525	+ 4,006
Notes and bills	12,492	12,499	9,802	- 2,697
Total	32,498	34,018	35,327	+ 1,309
Government agencies' and trust funds' securities etc.	1,203	2,691	3,572	+ 881
Total	33,701	36,709	38,899	+ 2,190

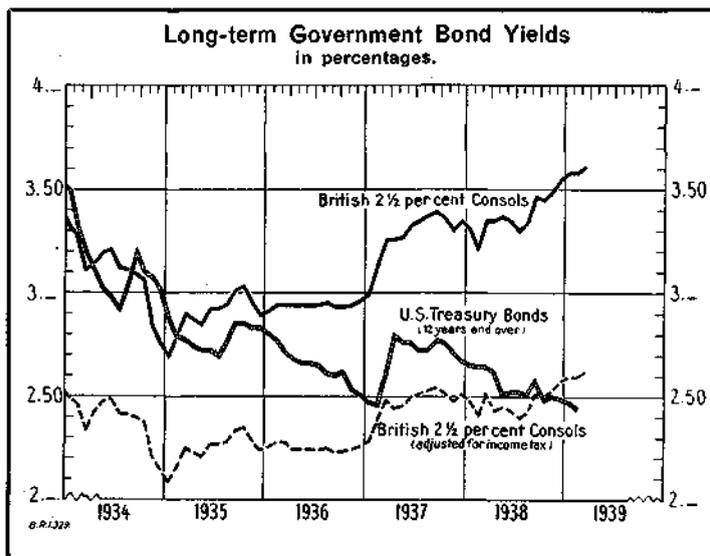
In spite of the increase of the total, under 40 per cent. of the publicly-offered debt now matures in less than five years (against 60 per cent. and over, a year or two ago), while 15 per cent. matures after fifteen years. Also there is no large amount of issues maturing or callable in any single year as was previously the case. This improvement in distribution has been accompanied by a reduction in the average interest on the debt from about 3¾ per cent. in 1930 to 3 per cent. in 1934 and 2½ per cent. at the present time, reflecting the substantial decline in the general level of interest rates during this period.

The decline in long-term interest rates has not, however, had the stimulating effect on private capital issues that might perhaps have been hoped for and expected. Total issues of new capital for American corporations, some \$5,000 million per annum in the late 'twenties, fell below \$200 million in 1933-34 and, after rising to \$1,200 million in each of the years 1936 and 1937, declined again to \$850 million in 1938. The apparent suspension of the flow of new capital into private enterprise is one of the most striking phenomena of the past few years. It is true that borrowers often attempt to make issues directly by private treaty, circumventing the regular issue market and thus avoiding the expenses of public issue and the control of the Securities and Exchange Commission. Moreover, the commercial banks are empowered to make time loans of from five to ten years.

But even taking into account the increasing importance of these factors in recent years, there can be little doubt that the productive utilisation of new capital by private enterprise is only a fraction of what it was a decade ago, the decline being doubtless connected with the failure of American production to recover even to the 1929 level. Other factors would, however, seem to have contributed. Savings from larger incomes, which moreover have fallen sharply compared with ten years ago, tend to be invested in tax-exempt securities for taxation reasons, while a large and increasing proportion of the smaller savings, coming, for example, through the postal savings system and the social security funds, is canalised directly into government securities. Estimates made by the Federal Reserve Bank of New York in its last Annual Report show that altogether investments through these channels in U. S. government direct and fully-guaranteed securities were about \$17,000 million in the last five years (including such investments by commercial banks). During the same period the net increase in investments in business securities from

all these sources (including the banks) was about \$1,100 million. A considerably larger increase in holdings of business securities by life assurance companies was partly offset by the reductions of other institutions. And, in so far as corporation securities are held at all, these holdings are confined to high-grade bonds. None of the institutions invest any appreciable amount in lower-grade bonds or stocks and, in fact, most of them are prohibited by law from doing so.

In the United Kingdom a reduction in direct market issues is also found, though much less pronounced than in the United States. Such issues were £52 million in 1938 compared with an average of £85 million in 1935-37 and £165 million — an exceptionally high figure — in 1928. Capital has, however, been raised more and more in recent years by other than direct market issues; the statistics of the London "Economist" of capital issues for domestic business, including introductions on the stock exchange, etc., gave £110 million in 1938 against an average of £230 million in 1935-37 (1928 not available). The reduced level of private issues in London can hardly be imputed to the monopolisation of the market by the government. The internal government debt was reduced from £6,600 million in 1920 to £6,340 million in 1932 and was only £6,560 million in March 1939 (excluding £575 million issued to the Exchange Equalisation Account against which corresponding assets are held). Government issues for new money are, however, likely to increase considerably in the near future with the progress of the armament programme. The great reduction in government interest payments, which fell from £307 million in 1929-30 to £211 million in 1936-37, was largely due to the conversion of 5 per cent. War Loan in 1932, when at the same time some £2,000 million debt was "funded", i. e. placed on a basis involving no option of repayment by the holder but only by the Treasury. Incidentally, over half of the net internal debt is funded in this way. The interest and management charge of the national debt rose to £217 million in the year 1938-39.



The accompanying graph shows the increase in the yield of Consols during the last four years, the flat yield and a yield calculated to allow for deduction of income tax at the standard rate.

For comparison with the trend of American rates, the average yield of all U. S. Treasury bonds with more than twelve years to run is also given (these

bonds having important tax-exemption rights). Comparison of the actual yields is difficult and apt to be misleading, but the trends are easily seen. Although parallel movements are shown in the autumn of 1935 and early in 1937, these were short lived. For four years the longer trends have been in opposite directions. The extent to which the London clearing banks have bought and sold securities during the last eight years is given in the table, their intervention doubtless consisting in hastening the effects of the natural movements.

Ten London Clearing Banks' Investments — in £ millions.

End of year	Investments	Change on year
1931	297	+ 12
1932	472	+ 175
1933	565	+ 93
1934	594	+ 29
1935	605	+ 11
1936	630	+ 25
1937	605	- 25
1938	606	+ 1

An interesting sidelight on the differences of speed with which changes of interest rates penetrate the various parts of the economic system is given by two significant changes of rates, in opposite directions, during the year under review. While the fall of the yield on government securities from 5 per cent. in 1931 to 2¼ per cent. in January 1935 was taking place, life assurance companies generally maintained their premiums unchanged for new business,

being aided to some extent by favourable mortality experience. But the lower interest earned on insurance funds is naturally exerting its influence and from January 1939 (four years after the decline in interest rates had ceased and was reversed) a group of leading life assurance offices announced increased premiums for new non-profit business, the increase amounting in general to rather less than 5 per cent. on the old rates. While insurance companies find it necessary to take account of relatively lower interest rates, building societies are already affected by the rise which has recently taken place, and a number of important companies have increased the interest paid on tax-free deposits or "shares" from 3 to 3½ per cent., while in some cases the limits on individual holdings have been raised. The building societies are, however, gradually reaching a point where they will need no new money, as the increased volume of repayments of old loans approaches the volume of new loans made. This question raises the problem of an outlet for the savings previously absorbed by the expansion of the building industry. Increased government loans may, of course, in present abnormal circumstances be a most important factor. But it is not inappropriate to mention here the rôle of investment trusts, especially of "unit trusts", which have grown in importance in recent years. From the beginning of the movement some eight years ago the sale of "units" in seventy odd trusts exceeds £80 million. These trusts, which provide for comparatively small holdings the possibilities of "risk-spreading" previously only available to the large investor, are notable particularly as a method of canalising small savings into equities. The idea, originally American, might, if developed in the United States, provide a means of deflecting part of the flow of small savings in that country which at present goes automatically into government bonds.

In recent years the German capital market has been reserved almost

exclusively for issues of long-term government debt. The movement of the debt, as published, is shown in the table.

German internal (post-1924) public debt.

End of year - RM millions	Long and middle term	Short-term	Total
1932	2,666	1,391	4,057
1933	3,555	1,750	5,305
1934	3,684	2,273	5,957
1935	5,773	2,856	8,629
1936	7,717	2,441	10,157
1937	10,344	2,388	12,732
1938	17,588	5,013	22,601

Of the increase in the total debt in 1938 by nearly RM 10 milliard, over one-quarter is due to the expansion of the short-term debt. This reflects the issue from April 1938 of "delivery bills" under the plan announced by the President of the Reichsbank in March 1938.

The rediscountable special bills issued up to March 1938 are not included in the statements of the public debt and thus are not given in the above table. The acceleration of the rate of increase of the debt in 1938 is therefore not so great compared with previous years as appears from the published figures. In 1938 the issues of long-term Reich loans reached record proportions: three issues of 4½ per cent. Reich Treasury bonds (redeemable in eighteen or twenty years) totalling RM 5,200 million were made, to which should be added the fourth issue of RM 1,500 million open for subscription at the end of November 1938 (and from which RM 1,170 million had been received by the end of December). In addition, a twenty-seven-year Reich loan of RM 1,580 million was placed privately with insurance companies and other institutions during the year. Altogether the long-term government issues amounted to nearly RM 8,000 million in 1938, over half of the aggregate of RM 15,500 million issued in the four years beginning 1935.

In these circumstances the long-term rate of interest was determined by the 4½ per cent. government bonds at slightly under par. Weakening of prices on the stock exchange during the year, however, had the effect of increasing the yield on industrial bonds and shares to around 5 per cent. The banks have naturally been active in placing the large issues of government loans, and in recent years their own security holdings have appreciably increased.

Security holdings of German banks.

End of year - RM millions	1935	1936	1937	1938
Reichsbank	664	524	392	854
Golddiskontbank	302	266	288	203 *
Big Berlin banks	881	996	998	1,151
Other reporting banks	1,054	1,195	1,414	1,641 *
Girozentralen	970	942	1,031	1,375 *
Savings banks	3,649	4,326	5,231	6,860
Total	7,520	8,249	9,354	12,084

* End November.

Some RM 400 million odd of the increase in the holding of the Reichsbank in 1938 is due to an arrangement made at the time of the taking-over of the Austrian National Bank.

In addition to the banks, the various insurance companies and other similar institutions have taken up large blocks of government securities. Further, the indebtedness of the States and local authorities has steadily fallen since 1933. They are instructed not only to exercise the utmost economy but also to build up reserves invested in Reich issues — as a beginning they took over directly several hundred million Reichsmarks of the loan of October 1938. It should be noted in this connection that the revenue of the Reich from taxation has grown considerably in recent years and is estimated at RM 17 milliard for the financial year 1938-39, compared with RM 14 milliard in 1937-38 and under RM 7 milliard in each of the years 1932-33 and 1933-34.

The paramount needs of the Reich have forced the requirements of private industry into the background. Such issues as have been authorised were exclusively connected with the financing of construction work under the Four-Year Plan. New issues of industrial bonds in 1938 amounted to only RM 160 million against RM 260 million in 1937 — negligible amounts compared with those taken by the government. It is recognised, however, that a considerable unsatisfied demand exists for private construction and other fields of private investment grow in urgency and extent so long as the embargo on private issues remains. Such new lending as has been possible by the mortgage banks, for example, has for the most part become available as the result of amortisation and redemption of previously existing mortgages. An essential part of the new financial plan of March 1939 is the cessation of the forcing of government long-term issues — such issues in future are to be the exception and dependent on the condition of the capital market. The market will be opened to private borrowing by industrial companies and mortgage banks, etc. In this connection it is interesting to note that the Loan Stock Law, in force since 1935, is to be allowed to lapse, so that the restriction generally limiting dividends of companies to 6 per cent. will no longer apply.

The quotations of Italian government bonds remained stable throughout the year so that the average yield on the 5 per cent. rendita (1935), for example, was 5.41 per cent. in 1938 against 5.46 per cent. in 1937. In Italy, as in other countries, a large part of savings-bank deposits are canalised towards the government. Deposits in the savings banks and with credit institutions have developed as follows:

Italian Savings Deposits.

End of year - in million lire	Credit institutions	Postal savings banks	Ordinary savings banks	Total
1936	34,251	22,309	19,302	75,862
1937	35,445	25,523	19,687	80,655
1938	39,169	28,022	19,006	86,197

It will be seen that the increase of savings deposits in 1938 was higher than in the previous year. The year 1938 was, in fact, particularly notable for the increases in the capital of Italian joint stock companies as shown in the next table, whereas the amount of fixed-interest-bearing securities issued by public institutions and industrial concerns was relatively modest.

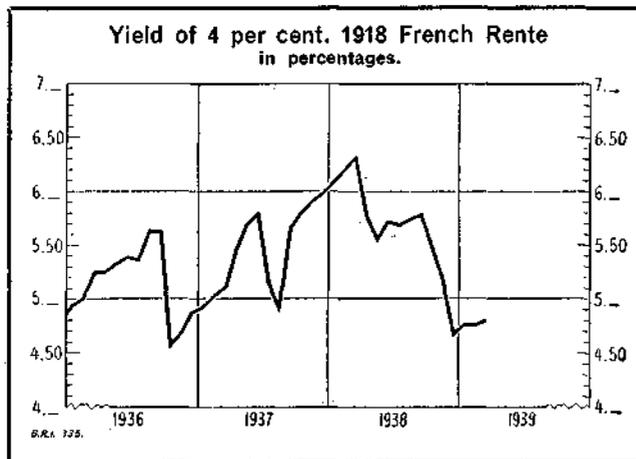
Italian Joint Stock Companies' Capital.

In million lire	New companies formed	Increases of capital	Capital reductions	Liquidations of companies	Net capital increase (+) or reduction (-)	Total capital outstanding at end of year
1934	414	3,134	3,664	3,347	- 3,463	44,320
1935	311	2,787	1,811	1,512	- 225	44,095
1936	354	3,608	1,327	925	+ 710	44,805
1937	2,283	3,282	621	2,054	+ 2,890	47,695
1938	341	6,568	545	929	+ 5,434	53,129

The increases of capital in 1938 (by more than 10 per cent. on the average of the total capital outstanding) are largely to be associated with the tax of 10 per cent. levied on the capital of joint stock companies. The decree authorised the companies to issue new shares to the amount required to pay the tax and permitted the allocation, at the same time, of two bonus shares for each new share paid up in cash. This writing-up of old capital is justified by the fact that companies' assets were deemed to be undervalued since the devaluation of the lira in 1936. By thus increasing their capital, companies will be able to distribute higher dividends without increasing the percentage rate and so without incurring the progressive taxation on dividends over 6 per cent. Further, writing up assets automatically increases the amortisation charges which may be deducted from gross income under the income-tax regulations.

The yield on French government bonds has reflected the monetary and other uncertainties of recent years. There was, however, a marked improvement in 1938, particularly in the latter part of the year, the yield of the

4 per cent. 1918 rente, for example, falling from 6¼ per cent. in March 1938 to under 4¾ per cent. in December.



The fall of the rate of interest at the end of 1938 was a reflection of capital repatriations inspired by confidence in the new financial plan of the government. It was stated that the government would give the capital market

some relief from new issues. There were, in fact, no long-term government issues at all in 1938.

Net Borrowing of French Treasury.

In Fr. fcs millions	1936	1937	1938
Direct borrowing			
Bank of France	+ 19,448	+ 12,471	- 4,490
Caisse des dépôts et consignations	+ 802	+ 667	+ 1,361
Total	+ 20,250	+ 13,138	- 3,129
Market borrowing			
Short-term: Ordinary Treasury bills (up to one year)	- 9,537	+ 530	+ 10,995
Special Treasury bills (up to one year)	+ 4,455	- 1,890	- 2,376
Caisse de pensions de guerre (one-year bills)	-	+ 2,648	- 1,919
Caisse autonome de défense nationale (18 months' bills)	-	-	+ 4,029
Total	- 5,082	+ 1,288	+ 10,729
Middle-term: Special Treasury bills (2 to 10 years)	+ 2,000	+ 570	- 898
National defence bonds (3 to 9 years)	-	+ 5,360	-
Caisse autonome de défense nationale (3 to 30 years)	-	-	+ 5,047
Total	+ 2,000	+ 5,930	+ 4,149
Long-term: 5 per cent. 30-year bonds	+ 800	-	-
4½ per cent. 60-year rentes	-	+ 8,000	-
Total	+ 800	+ 8,000	-
Miscellaneous (including foreign issues)	- 1,369	+ 800	+ 3,670
Grand Total	+ 16,599	+ 29,156	+ 15,419

As the above table gives only the net results of the borrowings and repayments made by the Treasury, it should be observed that the diminution of Fr. fcs 4,490 million, which appears under the "direct borrowing" from the Bank of France for the past year, is due to the fact that the profit on revaluation in 1938 (i. e. Fr. fcs 31,456 million) has been affected to the repayment by the Treasury of part of the advances from the Bank. In the same fashion the net results for 1936 and 1937 take account of sundry repayments made by the Treasury to the Bank out of the profits of the revaluation made in October 1936. The issue by the Caisse autonome de défense nationale of Fr. fcs 5 milliard 5 per cent. thirty-year bonds in May 1938 is included as medium-term in the table since holders may opt for repayment at par after three years and at intervals of three years thereafter until 1968. The item "miscellaneous" in 1938 includes two issues in Dutch florins producing Fr. fcs 3 milliard in all.

In spite of the improvement in the capital market shown by declining yields, there was no revival of private issues.

French Private Capital Issues.

In Fr. fcs millions	Existing companies			New companies	Grand total
	bonds	shares	total	shares	
1935	1,856	777	2,633	130	2,763
1936	596	517	1,113	48	1,161
1937	2,310	1,202	3,512	43	3,555
1938	1,804	1,008	2,812	40	2,852

Private bond issues fell from Fr. fcs 6.4 milliard in 1928 to 1.8 milliard in 1938, while share issues fell from Fr. fcs 8.3 to 1.0 milliard. This decline is even more remarkable when account is taken of the reduction by 50 per cent. in the gold value of the franc.

The graph showing the yield of government rentes, in fact, gives little indication of the cost of private borrowing. The Minister of Commerce, in October 1938, said that it was not rare for first-class industrial bonds to yield 7 or 8 per cent. "If in addition", he said, "account be taken of the charges, principally fiscal, which weigh on the borrower, one finds that when a loan yields 7 or 8 per cent. to the lender it costs 10 or 11 per cent. to the borrower. As a result only those enterprises are disposed to borrow for which new investment would yield more than 11 per cent...."

Even first-class local authorities had to borrow on very severe terms; for example, a bond issue of the City of Paris bearing interest at 6 per cent. was issued at 90. Some improvement in conditions for private borrowing were, however, noticeable towards the end of 1938 and early in 1939, so that twenty-year debentures of the 5½ per cent. type were issued at 90½, whereas a few months earlier 6 per cent. bonds were issued at 84.

In Switzerland, Holland and Sweden long-term rates continued to decline during the year while private capital issues for new money fell off in a greater or less degree. In each case the yields of government securities are down to around 3 to 3½ per cent. In all three countries the decline in interest rates in recent years has raised problems for insurance companies, and Swedish life assurance companies recently made a further 10 per cent. increase in premiums for new business. Before 1935 premiums were based on the assumption of a 4 per cent. average yield on investments; in 1935 the actuarial base was lowered to 3½ per cent., in 1937 to 3 per cent., while under present market conditions a 2¾ per cent. yield is the maximum obtainable on life assurance companies' investments. In Holland one of the large life assurance companies took over a mortgage bank in 1938 and will thus be enabled to invest its funds directly at a time when remunerative investments are difficult to find.

Elsewhere in Europe, comprehensive armament and investment programmes to be financed wholly or partly by government loans have been drawn up in Yugoslavia and Hungary. In Yugoslavia the Finance Minister was authorised to issue an internal loan of 4 milliard dinars at 6 per cent. over the next 6 years. The proceeds of this loan, the first government internal issue to be placed on the market since 1923, are to be utilised for armaments and public works (particularly the construction of new railways). The Hungarian plan is for a total expenditure of 1,000 million pengö on armaments, communications and agricultural improvements over a period of five to ten years. Pengö 600 million are to be raised by a capital levy spread over the period while 400 million are to be raised by loan. The first tranche of this loan, 125 million pengö 5 per cent. thirty-year bonds, was successfully issued at 96 in July 1938.

The "investment programme" of the Polish government, announced in 1936 and directed principally towards acceleration of the industrialisation of the country, was completed in the year 1938-39 with a total expenditure of 2½ milliard zloty. A new long-term investment plan, formulated in 1938, envisages government expenditure over a period of fifteen years. During the first three years 2 milliard zloty, raised chiefly on the internal market, are to be spent, 60 per cent. on armaments.

Of extra-European countries the United States has already been mentioned. Elsewhere, the most interesting capital-market developments appear to be in Japan and Australia.

In Japan the cost of the hostilities in China continues to dominate the bond market. The demand by the government compared with other issues is shown by the following table:

Japanese Internal Bonds

In million Yen	Government	Local governments	Bank	Corporation	Total
1) amounts outstanding at end of year					
1935	8,208	2,097	1,914	3,026	15,666
1936	9,072	2,262	1,838	3,158	16,746
1937	10,585	2,334	2,283	3,157	18,782
1938	14,935	2,373	2,569	3,624	23,923
2) increase on year					
1936	+ 864	+ 165	- 76	+ 132	+ 1,080
1937	+ 1,513	+ 72	+ 445	- 1	+ 2,036
1938	+ 4,350	+ 39	+ 286	+ 467	+ 5,141

The government bond issues follow a rising course from an average of 125 million yen a month in 1937 to 310 million in the first half and 420 million in the second half of 1938. Two-thirds of the government issues in 1938 were taken by the banks, whose holdings have doubled since 1934. The yield on government bonds further declined on the year, being 3.83 in December 1938 against 3.94 in December 1937.

A very large internal loan, £A 72 million, was floated in Australia in November 1938, £A 68 million for conversion and £A 4 million new money for armament purposes. The issue was made at par for a term of sixteen to eighteen years and bore interest at 3⁷/₈ per cent.; subscriptions totalled £A 62.7 million (including £A 52.3 million for conversion), to which was added £A 3 million from the sinking fund. The £A 6 million remaining was taken up for cash by the Commonwealth Bank. With reference to this subscription the Directors' Report for December 1938 states:

While activity (in Australia) was well sustained there was a danger that declining export income might adversely affect internal conditions. The Board consequently directed the policy of the Bank towards aiding governments in their defence and works programmes, keeping the trading banks' liquidity at a level which would permit them to satisfy the legitimate requirements of credit-worthy customers and preventing any undue rise in interest rates.

The Commonwealth Bank's subscription to the loan is thus to be regarded partly as an "open-market operation" aimed at mitigating the stringency on the money and capital markets, which otherwise would follow from declining exports and falling London funds. The fall of these funds in 1938 would have been more severe but for receipt of £5 million from a loan in London.

The capital markets of the world, almost without exception, are dominated by government borrowing for armaments and other economically unproductive purposes. Comparison with the period of high business activity ten years ago gives a striking contrast. At that time the internal debts of governments were falling and the markets active with the flow of capital into private enterprise. Now the governments of the world are spending over \$1,000 million a month more than their revenue from taxation, while private issues for productive investment have fallen to a fraction of what they were in the progressive years 1926-29.

VI. DEVELOPMENTS IN CENTRAL AND COMMERCIAL BANKING.

Territorial changes in Europe in 1938 left their impress on the banking and credit structure of the countries concerned. The absorption of Austria into the German Reich presented comparatively few difficulties for the German banking system as Austria had itself a unified banking structure; the chief problem was one of co-ordination and the strengthening of the weaker Austrian banks. Much more intricate questions were involved in the taking-over of the Sudetenland. The six big Prague banks and others had 143 branches in the Sudeten territory and it was necessary for these banking offices (as well as for savings banks and similar organisations) not only to change the currency of their accounts from crowns to Reichsmarks but also to be severed from their old head offices and adapted to the German system. This was done, according to a plan prepared by the Banking Commissioner of the Reich, principally through the withdrawal of the Prague banks and the extension of the big Berlin banks, particularly the Dresdner and the Deutsche Banks and the Allgemeine Deutsche Credit-Anstalt, which opened new branches in the Sudetenland. Viennese banks, such as the Credit-Anstalt and the Länderbank, took part in the reorganisation, a reminder that before the war the Sudeten district depended for its banking system on Vienna. Altogether it was possible to replace the 143 Czecho-Slovak branches with 73 German banking offices. Questions regarding the currency, the valuation of assets and liabilities, staff, etc., involved complicated technical problems. The continuity of credit arrangements was assisted by the granting of a Reich guarantee for RM 150 million covering the transition period.

The liquidation of the Austrian National Bank and the taking-over of the branches of the National Bank of Czecho-Slovakia in the Sudeten regions were reflected in the returns of the Reichsbank. In March 1938 a branch of the Reichsbank was opened in Vienna, and the Austrian National Bank entered into liquidation. Its principal assets passed to the Reichsbank and were reckoned under the item "sundry assets", which rose by RM 660 million during the months March and April 1938. Included in these assets were the gold and foreign exchange reserves of the former Austrian National Bank amounting, according to the latest return, to Sch. 420 million (say \$80 million), and Sch. 612 million direct debt of the Austrian Government. This debt, converted at the conventional rate (Sch. 3 for RM 2), was replaced by Reich debt of RM 400 million odd and subsequently transferred from the "sundry assets" of the Reichsbank to the "securities" item. The capital of the Austrian National Bank was repaid to the shareholders in the form of 4½ per cent. twenty-year Reich Treasury bonds amounting to RM 37½ million. The discount portfolio of the Austrian National Bank was incorporated in the Reichsbank portfolio, while Austrian bank notes were withdrawn and replaced by Reichsmark notes. Somewhat similar operations were necessary upon the absorption of the Sudetenland, when a proportion of the assets and liabilities of the National Bank of Czecho-Slovakia was taken over by the Reichsbank. The

increase in the note issue of the Reichsbank, due to the enlargement of territory, amounted to RM 775 million for Austria and RM 350 million for the Sudetenland by the end of the year 1938.

Other territorial changes in 1938, the cession of part of the old Czecho-Slovak territory to Poland and Hungary, also involved problems the principles of which did not differ greatly from those treated in the preceding paragraphs. In 1939 the activity of the National Bank of Czecho-Slovakia was further affected, its name being changed to the Bank for Bohemia and Moravia in Prague, while a new central bank was formed for the Slovak territory.

All European central banks felt the effects of the international political crisis of September 1938. September brings the conclusion of the harvest season and the marketing of crops and, being also the end of the quarter, when rents and many other regular payments are made, this month is normally one of monetary expansion (in some countries even greater than in December). In 1938, superimposed on these normal factors, were the monetary effects of the grave international political crisis which led to the agreement of Munich.

These abnormal influences were greater in some countries than in others but in the internal credit field may be described as (a) an urge for greater liquidity not only by banks but by individuals and firms who felt the need of higher cash holdings which, in an emergency, might be utilised more easily than deposits, and (b) the necessity of extraordinary government expenditure in excess of current revenue at a time when the short-term government debt floated uneasily.

These factors naturally resolved themselves into pressure on the central bank as the lender of last resort in the internal credit mechanism and as source of the currency circulation. The extent of the calls on central banks may be appraised from the exceptional increases of the note circulation in various countries. These increases tended to be greatest in the smaller countries (40 per cent. or more in Hungary, Latvia and Czecho-Slovakia), but in Germany there was a rise of 17 and in France of 22 per cent. (against 2 per cent. in each case in 1937). In Italy the increase was of 13 per cent.

The acute phase of the crisis lasted, however, for only a few days, and in most countries relief came suddenly at the end of September. In October notes flowed back to the central banks although, in general, leaving the circulation at a somewhat higher level than before. The liquidity mechanism worked with very few disturbances. Only in Czecho-Slovakia was there a partial restriction of the repayment of bank deposits. In France bank rate was raised by $\frac{1}{2}$ per cent., and in Poland the "legal minimum" of the central bank was temporarily broken through. The mechanism worked with equal efficiency in countries with free and those with controlled currencies. No bank failures were reported and no insuperable technical difficulties appear to have arisen in finding material eligible for borrowing at the central bank. The stock of notes kept in reserve by central banks appeared to be sufficient in every case to meet the extraordinary expansion.

The events of September 1938 were a severe test of the liquidity mechanism, and the fact that this mechanism worked in abnormal conditions with so few disturbances can be imputed in part to the continuous steady adaptation of central-bank technique to changing circumstances. While the fundamental principles of central banking have been little modified by the events of recent years, the evolution of technique must continue to keep abreast of realities: the changes in central bank statutes recorded each year in this Report are evidence of the conscious efforts of the banks to be properly equipped to render their maximum service in the public interest.

Important changes were made in the statutes of the National Bank of Hungary in June 1938 when the Bank's charter was prolonged to 1963. Until such time as the price of gold is fixed in Hungarian currency the Bank is to revalue its gold and foreign exchange reserves in its returns each quarter at the average rates quoted on the Budapest Bourse during the last two weeks of the preceding quarter. The first balance sheet drawn up under this new régime was that for 15th January 1939. The original provision envisaging the gradual increase of the ratio of the gold and foreign exchange reserve to the note circulation from a minimum of 20 to an eventual $33\frac{1}{3}$ per cent. (the application of which had already been modified) was changed. In future the Bank will be bound to pay the note tax only when the monthly average of the reserve is less than 25 per cent. of the monthly average of the note circulation plus the non-State deposits.

A clearing-up of the balance sheet was made by a loan of 100 million pengö to the government with which to make repayments of short-term debts to Hungarian banks in order that these banks in turn reduce their loans from the National Bank. Further, the Bank was empowered to grant the government a short-term credit of 30 million pengö to meet inequalities in revenue collection; the credit may be taken up from 1st March in any year but must be repaid by the end of November of the same calendar year.

Perhaps the most interesting technical provision was that authorising the Bank to undertake open-market operations and to participate in a special institution formed to regulate the money and capital markets. Total amounts which might be employed for these purposes were, however, restricted to the equivalent of the Bank's capital and reserves (i. e., about 45 million pengö). Further, the scope of credit operations was extended by the authorisation to discount agricultural bills with a maturity not exceeding nine months, whereas six months was the previous limit. Other provisions introduced certain changes in the Bank's organisation and in the distribution of profits.

When the National Bank of Hungary was formed in 1924 the main object of the Bank was described as preparation for the introduction of gold payments. In the intervening years conditions have changed in the world; the gold standard which was introduced over a wide area from 1925 onwards has generally been suspended. It is interesting, therefore, to note that the amended text of the Bank's statutes requires the Bank to make such preparations as will enable it, after the restrictions on foreign exchange have been removed, to

deliver gold or foreign exchange against its notes on terms to be fixed later by law. In the meantime, the Bank continues under the obligation to see that the value of its notes remains steady in relation to currencies whose value has shown stability.

Other countries in which the central bank's gold holding has recently been revalued are the United Kingdom, France, Finland and Estonia. This question is treated in detail in the chapter dealing with gold reserves.

Authorisation to undertake open-market operations was given to the Bank of France by the decree of 17th June 1938. Purchases are to be confined to short-term paper such as bankers' acceptances, *bons de la défense nationale*, the bills of certain public bodies, etc., and are to remain within limits fixed by the Board of the Bank. Bills purchased are shown in a separate item of the return of the Bank of France which, by the end of March 1939, had grown to Fr. fcs 3,160 million.

A convention of 12th November 1938 between the Minister of Finance and the Bank of France contained new provisions regarding the calculation of taxes, royalties and share of profits paid by the Bank to the Treasury. The effect of these changes is to lighten the fiscal burden on the Bank which the fall in value of the currency had made excessive. Further, the assets of the exchange fund and the cash balances of the *rentes* fund are, on the liquidation of these funds, to be applied to the repayment of the Bank's advances to the government.

Early in 1939 considerable changes were made in the statutes of the Bank Polski on the occasion of the prolongation of the note-issuing privilege until the end of 1954. Under the old statutes the Bank had to maintain a gold reserve equal to 30 per cent. of the notes in circulation and sight liabilities in excess of Zl. 100 million. This provision is now changed, the fiduciary issue being raised from Zl. 100 to Zl. 800 million (with the possibility of a further increase by the Bank, approved by the Ministry of Finance, to a figure not beyond Zl. 1,200 million), while the minimum proportion to be held in gold was fixed at 40 per cent.

Under the old statutes certain operations were authorised up to a maximum percentage of the total discount portfolio. These limits have now been fixed in absolute figures: an upper limit of Zl. 300 million for advances against collateral of transferable securities and a maximum of Zl. 400 million for the discount of short-term transferable securities (under which heading Treasury bonds are discounted by the Bank). Certain short-term credits, granted by the Bank for the benefit of agriculture and the financing of investments effected by the National Economic Bank and the State Agrarian Bank, have been replaced by redeemable Treasury debt bearing interest, the discount portfolio being reduced by the amount thus consolidated and transferred.

Bills at nine months have been made eligible for discount if they represent advances against collateral granted by credit institutions with a view to financing the sale of agricultural products or if they originate in crop-campaign credits taken up by certain agricultural industries.

The total of non-interest-bearing advances to the Treasury has been raised from Zl. 100 to 150 million. Further, the maximum amount of securities which the Bank may purchase for its own account, in excess of the investments of the reserve and pension funds, has been increased from Zl. 150 to 200 million. A number of minor amendments to the statutes were also made, affecting particularly voting rights and the distribution of profits.

When the Bank of Canada was founded in 1935 the capital was wholly subscribed by private shareholders, although the Governor and Deputy Governor were appointed by the government. A new law was passed in June 1936 whereby the Bank remained a corporate body but sufficient new shares were issued to the Minister of Finance to give the government 51 per cent. of the capital. In 1938 the Canadian Government decided to buy out the private shareholders who owned \$5.0 million of the Bank's capital of \$10.1 million, so that the Bank should become a completely State-owned institution. The price paid was the average ruling for 1938, that is, between \$58 and \$59 for each \$50 share.

Certain changes have been made in central-bank returns. Both the Nederlandsche Bank and the Swiss National Bank used to show the proportion of their gold reserves held abroad. This indication has not been given by the Swiss National Bank since June 1938 or by the Nederlandsche Bank since the end of November 1938. On the other hand, from the beginning of 1938 the National Bank of Belgium has made several changes in its return which have the effect of disclosing the gold and foreign-exchange holding previously booked under other items than the reserve. Movements of gold in and out of the National Bank are now completely disclosed. It may be considered that, if during a period of strain the magnitude of the gold losses is great, the disclosure of the real position, though the public may be unduly alarmed, has the advantage of stimulating the monetary and other public authorities to a rapid application of the measures necessary to meet the situation.

The most important banking changes during the year have been those applicable to central banks, there being no changes of major importance in the laws regarding commercial banking. Perhaps the most significant event to record in this connection is the revision in the bank examination procedure in the United States. In this country there are four classes of commercial banks: the national banks (which become ipso facto member banks of the Federal Reserve System), the State banks (which may or may not become member banks), those non-member banks whose deposits are insured by the Federal Deposit Insurance Corporation, and lastly the non-member banks which do not qualify for insurance. These four classes of banks are subject to the examination or supervision of one or more of five authorities, the Federal Reserve Board, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Reconstruction Finance Corporation, and one or other of the forty-eight States. In addition, the U. S. Treasury has certain licensing and other powers. With such a division of spheres of authority and control there naturally arise considerable confusion and conflict. For instance,

the Comptroller of the Currency issues regulations defining and governing the purchase of investment securities by national banks. The regulations, however, are also applicable to State member banks, but not to insured non-member banks. The Comptroller of the Currency enforces the regulations with respect to national banks and the Federal Reserve Board enforces them with respect to State member banks. The condition of the laws regarding supervision and control of the banking system and the necessity for the elimination of the present confusion of authority are treated at length in the Annual Report of the Board of Governors of the Federal Reserve System for 1938.

During the year, however, after lengthy negotiations, a voluntary agreement for co-operation in examination policy was reached between the different authorities. After the message to Congress of the President of the United States on 14th April 1938, in which he expressed the hope that Federal banking supervision would be better co-ordinated, the Secretary of the Treasury initiated a series of conferences with representatives of the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System. As a result of these conferences unanimous agreement was reached on a programme which for the first time brings about uniformity in the treatment of loans and securities by the various Federal agencies in their administration of bank examinations. Revised classifications were agreed upon with regard to bank examination reports upon loans made, the principle being recognised that in making loans, whether for working or fixed capital purposes, the banks should be encouraged to place emphasis on intrinsic value rather than upon liquidity or quick maturity. Similarly, as regards securities, it was recognised that bank investments should be considered in the light of inherent soundness rather than on the basis of day-to-day market quotations. Banks' security holdings were divided into four classes, the first three of which cover bonds of an investment nature, of a speculative character, or defaulted, while the fourth class covers equities. It is estimated that 90 per cent. of the total securities held by the banks fall in the "investment" class and it was agreed that in examination reports market fluctuations should not be taken into account but such securities should be shown at their book value. "By severing the appraisal of bank investments from current market quotations, it is believed that the banks will be encouraged to purchase securities of sound business and industrial concerns, whether large or small, for their true worth and not for speculative gains", comments the Federal Reserve Bulletin.

These revisions of bank examination principles are a logical sequel to the broadening of the regulations governing the Federal Reserve banks made in September 1937 with regard to discounts and advances to member banks. These more liberal lending regulations were based on the principle, as enunciated by the Board, that experience has demonstrated that the solvency of banks is better safeguarded by careful regard to the quality of the paper they acquire than by strict observance of the form this paper takes, and that greater emphasis on soundness and less emphasis on form is a sound banking principle.

The tendency for American banks to extend their operations into other spheres than that of short-term business credits is exemplified by the growth during 1938 of country banks' loans against real estate, the total volume of which is now 30 per cent. above what it was in March 1936. The growth of these loans has been on real estate other than farm land and at the end of 1938 65 per cent. of the real estate loans granted by country banks was on residential property excluding farms.

The increased liquidity of commercial banks which is found in the great majority of countries reflects — at least in part — a decline in the demand for short-term credits by industrial and other enterprises; it naturally induces the banks to seek opportunities for new business in other lines of lending and investment. In doing so they generally meet with a keener competition from such institutions as savings banks and insurance companies, which often find difficulty in investing the larger amounts at their disposal from increased savings by people with relatively moderate incomes. In fact, the distinction between the activities of different kinds of financial institutions has become less clear in recent years. While the commercial banks generally hold more government securities and have thus become more akin in type to savings banks and insurance companies, the latter have increasingly turned to investments in mortgages to supplement the smaller yield on their security holdings. On the whole the relative importance of commercial banks in the financial structure of many countries has tended rather to decline. In these circumstances a certain relaxation can be found in the tendency so noticeable after 1929 to restrict the operations of commercial banks. And in some countries this change in attitude is clearly connected with the desire to stimulate long-term investment generally.

VII. CURRENT ACTIVITIES OF THE BANK.

1. OPERATIONS OF THE BANKING DEPARTMENT.

The balance sheet of the Bank as on 31st March 1939, examined and found correct by the auditors, is reproduced in Annex II to the present Report. It shows a total of 606.5 million Swiss gold francs of 0.2903 grammes of fine gold, against 644 million on 31st March 1938. The conversion into Swiss gold francs of the various currencies in which the Bank's assets and liabilities are denominated, is based, as in the preceding year, on the U.S. Treasury's official selling price for gold and the rates quoted for the various currencies against dollars on the date of closing the Bank's accounts. Among the leading currencies only the French franc shows an important change in value; whereas on 31st March 1938 one hundred French francs were equivalent to 9.38 Swiss gold francs, on 31st March 1939 they represented 8.08 only.

In 1938 as in the preceding year, the movements of the Bank's resources and, to a certain degree, the course taken by its activities were determined by the policy pursued by central banks with regard to their foreign currency reserves. But owing to the development, particularly of gold operations, transactions in foreign currencies represent a decreasing part of the Bank's total activities.

Thus the turnover on deposit accounts during the ninth financial year showed only a relatively small increase, amounting to some 3 per cent. compared with the preceding year. But the Bank's operations in gold (purchases, sales and exchanges, movements of ear-marked metal) increased by two-thirds against the previous financial year, compared with an increase of little over one-third in the total activity of the Bank.

The beginning of the financial year witnessed a fairly important stream of operations, which slackened, however, in May and June. In the course of the summer, while international tension was growing, the Bank's resources were slightly reduced. An appreciable increase again occurred from the second half of August to the first few days of September, at which time the Bank could have accepted more deposits had it been able to find adequate and remunerative investments.

With the week beginning 5th September the situation changed abruptly. Until nearly the end of the month, withdrawals of funds and of gold came in rapid succession. A number of central banks withdrew a considerable portion, in some cases the whole, of their deposits; the total reduction of deposits in currencies reached the equivalent of 72.5 million Swiss gold francs.

The return of relative calm in the international political atmosphere at the end of September brought a reflux of deposits, which continued, almost without interruption, until the first few days of 1939. While in December and January the Bank had a reduced volume of operations, February and, still more, March witnessed a considerable development. The financial year 1938-39 closed on a note of intense activity in all parts of the Bank's work and especially in gold transactions.

Some characteristic phases in the movement of the Bank's activity are illustrated in the following table:

In millions of Swiss gold francs	31st March 1938	31st May 1938	31st Aug. 1938	30th Sept. 1938	31st Dec. 1938	31st March 1939
Deposits of central banks for their own account (In currencies)	179.2	183.9	166.1	100.1	132.4	143.5
Gold in bars . . .	20.9	32.3	30.9	19.2	42.1	38.7
Earmarked gold . .	479.1	385.7	332.2	265.5	292.0	236.7
Total of gold held by the Bank	500.0	418.0	363.1	284.7	334.1	275.4

During the period May–December 1938 parallel fluctuations occurred, but it will be noticed that before and after that period deposits in currency and in gold moved in opposite directions; as a result of withdrawals, either for sale or repatriation, gold earmarked with the Bank on 31st March 1939 had fallen to half the amount a year earlier:

A comparison of the principal items of the Bank's balance sheet on 31st March 1938 and on 31st March 1939 calls for the following remarks:

1. Liabilities.

The depreciation of the French franc in which part of the Bank's long-term commitments is expressed has brought down this item from 259.2 million Swiss gold francs on 31st March 1938 to 255.2 million on 31st March 1939.

The table given above showed the movement of deposits in currencies of central banks for their own account, which reached their maximum on 31st May 1938 at nearly 184 million Swiss gold francs and their minimum at the end of September with 100 million.

The decrease registered during this four-month period was proportionately larger for sight than for short-term deposits, as appears from the percentage figures in the following table:

In millions of Swiss gold francs	Deposits in currency	
	At short term	At sight
31st May	127.5	56.3
30th September	76.9	23.2
Difference: 31st May to 30th September . . .	– 50.6	– 33.2
Percentage difference	– 40	– 59

Deposits of central banks for the account of third parties, which amounted to 1.8 million on 31st March 1939 against 3.3 million the previous year, fluctuated between 3.6 million and 1.5 million. Deposits of other than central banks amounted to 2.2 million on 31st March 1938. They increased gradually to 6.9 million at the end of September, after which a continuous decline set in, reducing them to 4.4 million on 31st March 1939.

Sight deposits expressed in a weight of gold remained at approximately the same level throughout the financial year, 9.6 million at the beginning and 9.7 million at the end. During this period the maximum was 9.8 million and the minimum 9.1 million. The turnover of these accounts during the year was, however, relatively large, and new depositors adopted the principle of settlements through the Bank on the basis of a weight of gold. The number of these accounts at the end of March 1938 was 14; it had risen to 19 on 31st March 1939. The operation of such accounts is particularly suited to the clearing of postal payments through the Bank; it also facilitates the distribution and payment of funds in various currencies, especially when the sums in question are small. The Bank can also transfer gold from one account to another, thus enabling sales to be effected on various markets, according to the best interests of its customers. Gold deposit accounts have further shown themselves useful in facilitating the settlement of fractional amounts entailed in sales and exchanges of gold.

2. Assets.

Gold in bars, which, on 31st March 1938, totalled 20.9 million Swiss gold francs, amounted to 38.7 million in the balance sheet of 31st March 1939. Except on 30th September, when it had fallen to 19.2 million, this item has almost always exceeded 21 million Swiss gold francs. It reached its maximum at the end of February 1939, with 51.1 million.

The Bank's stock of gold for its own account corresponds to the excess of assets in gold bars over deposits with the Bank expressed in a weight of gold. During the financial year the Bank's own gold stock has fluctuated between a minimum of 9.9 million Swiss gold francs at the end of September 1938 and a maximum of 41.3 million on 28th February 1939. Experience has shown that the maintenance of a stock averaging at least 25 million Swiss gold francs is desirable. With such a stock the Bank can ensure that gold operations entrusted to it are effected in the best conditions. In addition the Bank may itself obtain additional cash by selling gold.

After remaining for some time not far from its level of 31st March 1938 — 22.2 million Swiss gold francs — the Bank's currency reserve, held in the form of cash at central banks, increased from the end of June to 48.1 million on 31st August. After declining continuously until 28th February, at 11.9 million, it rose to 23.6 million on 31st March 1939, approximately the level reached a year previously.

The fluctuations in sight funds invested at interest were proportionately smaller: from 15.8 million on 31st March 1938 these funds declined to 12.5 million on 28th February 1939, after having remained the whole time below 20 million. At the end of the financial year a temporary increase brought the figure up to 32.7 million.

In the rediscountable portfolio there is a similar absence of marked fluctuations. From 229.6 million Swiss gold francs on 31st March 1938 the figure rose to 248.4 million on 30th June. It then declined to 197.1 million on 30th September, to regain the level of 216.9 million at the end of March 1939. In this portfolio bank acceptances and bills continue to be greater than Treasury bills. The investments of the first class increased during the financial year from 126.8 million to 142.2 million, while Treasury bills declined from 102.8 million to 74.7 million.

Despite the reduction of 37 million in the balance-sheet total, the whole of the readily available assets amounted to 312 million gold francs on 31st March 1939 against 288.5 million a year before — an increase of 23.5 million. As the figure for sight deposits on 31st March 1939 was very little higher than on 31st March 1938, the Bank's cash position may be regarded as satisfactory.

Time funds invested at interest have declined from 53.9 million on 31st March 1938 to 32.8 million on 31st March 1939. Up to the end of November the total remained close to the initial figure.

Sundry bills and investments have also declined to a relatively large extent; totalling 300.5 million on 31st March 1938, they had fallen to 258.7 million at the end of the financial year. Among these investments, those for a term exceeding six months amounted to no more than 68.5 million on 31st March 1939 against 90.7 million a year previously.

The Bank has been faced, in the course of the year, with the problems to which every international placing of funds, at the present time, gives rise.

Among such problems is the dearth of short-term investments offering an adequate return. Apart from certain categories of funds of a special character, the deposits entrusted to the Bank are as a rule expressed in the currencies of markets where few, if any, possibilities of remuneration exist. The Bank must endeavour to solve this problem of yields to the best of its clients' interests and of its own. For this reason the Bank has limited, for a number of currencies, the amounts which it can remunerate on accounts at sight or at very short term.

There are, of course, investments at medium term (six months, for instance, or a little longer) which would enable the Bank to obtain a certain remuneration. In spite of the premium to be paid for agreements enabling such investments to be remobilised should occasion arise, the yield still

remains relatively favourable. Unfortunately, agreements of this type are rare and difficult to conclude.

The necessity of being guided by the same considerations as appear to actuate the depositors — namely, avoidance of time commitments — has led the Bank to refrain from effecting investments which are not quickly realisable; in other words, to renounce the greater number of investments ensuring a substantial return.

* * *

Thanks to the marked development of its gold operations during the past financial year, the Bank has rendered to central banks services which, in the majority of cases, could have been obtained only with difficulty by direct recourse to the markets.

The methods employed for these operations have departed very little from the practice of previous years. In the main the Bank has effected conversions of gold into foreign exchange and vice versa, arranged for shipments of gold or been able to offset movements by transfers in its books. The majority of these transactions have taken the form of sales of gold against foreign currency; this accounts for the reduction in the total volume of gold earmarked with the Bank. The rate at which stocks have been replenished has, as a rule, been, much more rapid than in the past. On many occasions a saving of expenses necessarily arising from physical shipments of gold has been made possible by the Bank, either through granting advances at moderate rates or by using part of its own stock of gold in an offsetting operation. In individual cases, restrictions have at times been imposed upon the Bank's possibility of intervening by considerations as to its own cash position. Nevertheless, it has in general been possible for the Bank to carry out the task it aims to achieve, namely, to organise a centre for gold operations in the common interest of all participants.

* * *

As regards granting credits for the financing of international trade, developments have been less satisfactory, partly owing to the influence of events which have caused important operations to be abandoned. The volume of transactions in this line of the Bank's business was maintained up to November at an average level closely approximating to that at the end of March 1938, but, by the end of the financial year, it was reduced to about half of what it had been at the beginning.

As in the case of deposits in currencies, recourse to the Bank is as a rule made by its correspondents only when it offers more favourable conditions than those of the markets. Consequently, in currencies in which the Bank does not obtain facilities for refinancing from the central bank concerned, the number and volume of operations which it can undertake continues to decline.

For general reasons to which most of the central banks have, moreover, subscribed, the continued granting of these commercial facilities seems to constitute a useful activity. Naturally the commercial origin of the transactions must be established beyond doubt. The Bank has accordingly sought, by suitable technical means, to establish in each individual case the commercial character of the claims on which these operations are based. It was as hoped that in this way certain central banks might open remobilisation credits in the Bank's favour, within the limits of their statutory regulations. But, owing to the difficulties which it encountered, the Bank has not been able to meet all the demands for credit made by certain of its correspondents.

* * *

As regards the settlement of international payments of postal and of telegraph and telephone administrations, the Bank has effected further remittances in the manner described in its fifth Annual Report (p. 67), namely, by transfers between currency accounts of the central banks concerned — a system which has already stood the test of five years. In addition, the new procedure based on the employment of gold deposit accounts and described in the seventh Annual Report (p. 103), has, after examination by the interested authorities, received practical application in the year under review, with completely satisfactory results.

It may be recalled that certain payments between the administrations which are members of the Universal Postal Union and the International Union of Telecommunications are calculated in gold francs, i. e. in the money of account adopted by the Unions (in the Universal Postal Convention and in the Convention of the International Union of Telecommunications) defined as 9/31 of a gramme of fine gold, and independent of all national currencies. As early as 1934, the Universal Postal Congress in Cairo incorporated a special provision in the decree for the execution of the Universal Postal Convention, authorising the settlement of international postal payments through the central banks and the Bank for International Settlements. Since 1938 the decrees for the execution of the Convention of the International Union of Telecommunications, concerning telephone and telegraph services, have contained regulations to the same effect applicable to members of that Union. Through the accounts expressed in a definite weight of gold, which are already kept at the Bank for central banks, the above-mentioned gold-franc payments may be effected by transfers of the appropriate amount in gold from one account to the other. The procedure, elaborated in close co-operation with the International Bureau of the Universal Postal Union and authorities of the Swiss Postal and Telegraph Administration and notified to the various administrations, makes it unnecessary for creditor and debtor to agree upon a national currency in which payment is to be made, and for the gold-franc amount to be converted into that currency. No gold movements

are necessary either for the opening of the gold deposit accounts or to effect changes in them.

The main advantages of this procedure are safety, cheapness and speed. Neither gold nor cheques are remitted, alterations in rates of exchange do not affect the transactions and the Bank for International Settlements charges no fees. The payments carried out by book transfers occupy the minimum of time. Eight countries have already adopted this system of international gold-franc payments through the Bank and the favourable character of the experience which has been gained up to the present, as well as negotiations pending with a number of other countries, justify the Bank in the hope that it will be possible to render increasing service in the settlement of international payments, which it is one of its most important tasks to facilitate.

2. TRUSTEE AND AGENCY FUNCTIONS OF THE BANK.

The position in respect of the annuity payments of Germany, Hungary, Bulgaria and Czecho-Slovakia arising from the New Plan adopted at the Hague Conference of January 1930, has remained unchanged throughout the year under review and during that period the Bank has received nothing in respect of the annuity payments of those Powers.

The situation in connection with the service of the German External Loan 1924 and the German Government International 5½ % Loan 1930 has also remained unchanged during the year under review in so far as the respective Trustees are concerned; since 1st July 1934, the German Government has not furnished to the respective Trustees any of the funds required in the currencies of the various issues for the service of these Loans. Nevertheless, certain groups of bondholders have continued to benefit under special agreements concluded between the German Government and various other governments. The bondholders specified in these agreements have been able to obtain payment in the currency of their country of domicile of the whole or a part of the nominal value of their coupons. On the revision of some of these agreements during the year under review, provision has been made for a reduction in the rate of interest to be paid and for the amount thus saved to be applied to the amortisation of bonds. As regards bondholders who do not receive payment of the full nominal amount of their coupons by virtue of these agreements but have not surrendered their right to such payment, the German Government has continued to offer to liquidate the outstanding amounts by a payment in reichsmarks calculated at the Reichsbank's official rate of exchange, the employment of such reichsmarks being governed by principles similar to those regulating the use of registered marks. The Trustees for the respective Loans are not parties to any of these special agreements, have had nothing to do with their execution and have considered them as incompatible with the General Bonds and the international agreements relating thereto. The Swiss gold franc equivalent of the various currencies which were deposited in

the names of the Trustees for the respective Loans, as at 31st March 1939, is shown in Annex V.

During the year under review, the Bank, as Trustee for the Austrian Government International Loan 1930, regularly and punctually received from the Austrian Government (a) the pledged revenues, in Austrian schillings, which constituted the collateral security for the Loan, up to and including the month of April 1938 and (b) the monthly service instalments, in the currencies of the respective issues, due up to and including 1st May 1938. The definitive bond of the American issue contains a "gold coin" clause but the Austrian Government, following the practice adopted in July 1933, provided funds to pay the coupons of that issue at their nominal amount only. As a result of the union of Austria and Germany, the pledged revenues have not been passed through the account of the Trustee since April 1938 and the monthly service instalments, in the currencies of the respective issues, due on and after 1st June 1938, have not been paid to the Trustee. During the second half of the Loan year to 30th June 1938, therefore, the Trustee received only five monthly service instalments and could provide for only five-sixths of the nominal amount of the coupons, due on 1st July 1938, of the American, British and Dutch, Italian and Swiss issues. In the case of the Swedish issue, unexpended sinking fund monies were available in the hands of the Trustee who decided to draw upon them to the extent necessary to complete the payment of the full nominal amount of 1st July 1938 coupons. The definitive bond of the Austrian issue contains a "gold value" clause and the monthly service instalments for that issue paid by the Austrian Government were estimated to be sufficient to give effect thereto. When the 1st July 1938 coupons became due, however, it was impossible to give effect to the "gold value" clause attaching to the coupons of the Austrian issue, in the manner prescribed, because the Austrian schilling had then ceased to exist as an effective currency. The German authorities decided, moreover, that schilling coupons of the Loan must be paid in reichsmarks. Unexpended sinking fund monies in respect of the Austrian issue were available in the hands of the Trustee who decided to draw upon them to the extent necessary to complete the payment of 1st July 1938 coupons, on the basis of their nominal amount. The German authorities decided to pay schilling coupons of the Loan in reichsmarks calculated at the rate of 1 schilling equals 0.67 reichsmark, this being the rate which had been decreed, for all internal purposes, for the settlement of claims expressed in schillings. With regard to the "gold value" clause, the German authorities considered that it would have been satisfied by converting schillings to reichsmarks at the parity between those currencies, i. e. 1 schilling equals 0.59 reichsmark, and that, in adopting the rate of 1 schilling equals 0.67 reichsmark and effecting the payment of coupons in "free" reichsmarks, the "gold value" clause was more than satisfied. As regards the funds which stood to the credit of the Trustee's accounts in schillings, the German authorities took the position that these represented external claims and, therefore, that the rate of conversion from schillings to reichsmarks was 1 schilling equals 0.50 reichsmark. As a result of this decision, the unexpended sinking fund monies were drawn upon to a greater

extent than otherwise would have been necessary. The Trustee for the Loan has emphatically protested to the German Government against the infractions of the General Bond and the Loan Contracts by the failure to pass the pledged revenues through the Trustee's account since April 1938 or to pay to the Trustee the monthly service instalments, in the currencies of the respective issues, due on and after 1st June 1938. The Trustee has expressly reserved all its own rights and those of the bondholders.

The German Government and certain other governments have concluded agreements as a result of which bondholders, as specified therein, are able to obtain payment of a part of the nominal value of their coupons in the currency of their country of domicile. The Trustee is not a party to any of these agreements, has had nothing to do with their terms or their execution and has protested against them to the German Government as being incompatible with the terms of the General Bond. The German Government has declared that it does not recognise legal succession to the loan obligations of the former Austrian Confederation and that the service of such loans is suspended. Nevertheless, an offer has been made to the holders of bonds of those loans to issue in exchange therefor a German Reich Loan, denominated in reichsmarks and bearing interest at $4\frac{1}{2}$ % p. a. together with a redemption service of 2 % plus the interest saved.

A Statement of Receipts and Payments of the Trustee for the Austrian Government International Loan 1930, as certified by the auditors, for the last completed loan year to 30th June 1938, is appended as Annexes IVa and IVb. In addition, the Swiss gold franc equivalent of the funds relating to this Loan which were deposited in the name of the Trustee as at 31st March 1939 is shown in Annex V.

The Bank has continued to act as an intermediary for the settlement of the financial questions involved in the transfer of the Saar Territory to Germany, which took place in February 1935. The German Government undertook to repurchase the mines, railways etc. in the Saar from France for a lump sum of 900 million French francs to be paid over a period of five years, mainly through free deliveries of coal and from the exchange for reichsmarks of French francs and other foreign currencies collected in the Saar when the territory was transferred. Up to 31st March 1938, the total amount paid by Germany in this connection was 681.4 million French francs. During the year under review, a further 108.4 million French francs was paid, bringing the total payment, as at 31st March 1939, to 789.8 million French francs.

The French and German Governments continued to avail themselves of the services of the Bank in connection with the financial questions involved in the execution of an agreement for the sale of the Mundat Forest on the Franco-German frontier. During the course of the year the agreement was ratified by the respective Governments and its financial provisions were completely executed.

The Bank has also continued to act as intermediary for the service in Switzerland of the French National Security $4\frac{1}{2}$ % Loan 1937 and has regularly

and punctually received from the French Government and has transferred to the various Paying Agents, as and when necessary, the funds required to pay the coupons of the Loan presented in Switzerland.

3. NET PROFITS AND DISTRIBUTION.

It is for the present General Meeting to consider the declaration of a dividend and to make appropriations to reserves. The net profit for the year, after making allowance for contingencies, is 8,583,864.63 Swiss gold francs, the Swiss gold franc being as defined by Article 5 of the Bank's Statutes i. e. the equivalent of 0.29032258... grammes fine gold. This compares with a figure of 9,011,956.53 Swiss gold francs for the eighth fiscal year. In the balance sheet as at 31st March 1939, all currencies are valued at or below the least favourable market rate prevailing on that date and all assets are valued at or below market quotations, if any, or at or below cost.

After providing for the Legal Reserve that is required by Article 53 of the Statutes, to an amount equal to 5 per cent. of the net profits, i. e. 429,193.23 Swiss gold francs (1938: 450,597.83 Swiss gold francs) it is recommended that the General Meeting declare a dividend at the rate of 6 per cent. per annum in respect of the ninth fiscal year. The payment of this dividend requires 7,500,000 Swiss gold francs (1938: 7,500,000 Swiss gold francs). The net profits still remaining after the declaration of the dividend would amount to 654,671.40 Swiss gold francs, the appropriation of which is fixed by Article 53 of the Statutes.

Exercising the discretion vested in it by paragraph (c) of Article 53 of the Statutes, the Board of Directors has determined to place to the credit of the Special Dividend Reserve Fund provided for by the Statutes, the sum of 130,934.28 Swiss gold francs, which is the maximum amount which it is permissible, under the Statutes, to set aside for this purpose out of the net profits of the present year (1938: 212,271.74 Swiss gold francs).

After making provision for the foregoing items, you are requested, from the balance still remaining, to make an appropriation to the General Reserve Fund in the manner stipulated by paragraph (d) of Article 53, to the amount of 261,868.56 Swiss gold francs (1938: 424,543.48 Swiss gold francs). The aggregate of the Legal, Dividend and General Reserves at the end of the ninth year would then be 25,092,930.89 Swiss gold francs.

The same article of the Statutes lays down the distribution of the sum finally remaining, namely 261,868.56 Swiss gold francs, between such of the Governments or central banks of Germany and the countries entitled to share in the annuities payable under the New Plan, defined in the Hague Agreement of January 1930, as shall have maintained time deposits at the Bank subject to withdrawal in not less than five years. No central bank has such time deposits at present but the following Governments have these deposits and are entitled, in view of this minimum duration of their deposits, to participate

in the residual amount of 261,868.56 Swiss gold francs (1938: 424,543.48 Swiss gold francs) in the following sums:

Annuity Trust account deposits in accordance with Article IV (e) of the Trust Agreement:—	Swiss gold francs	
	1938/39	1937/38
France	85,270.87	133,407.30
Great Britain	33,321.91	52,132.53
Italy	17,405.10	27,230.48
Belgium	9,415.36	14,730.44
Rumania	1,644.95	2,573.54
Yugoslavia	6,846.11	10,710.82
Greece	563.98	882.36
Portugal	1,080.96	1,691.18
Japan	1,080.96	1,691.18
Poland	31.33	49.02
	<u>156,661.53</u>	<u>245,098.85</u>
German Government non-interest-bearing deposit in accordance with Article IX of the Trust Agreement	78,330.76	122,549.43
French Government deposit (Saar)	853.22	1,806.20
French Government Guarantee Fund in accordance with Article XIII of the Trust Agreement	26,023.05	55,089.—
	<u>261,868.56</u>	<u>424,543.48</u>

The accounts of the Bank and its ninth Annual Balance Sheet have been duly audited by Messrs. Price, Waterhouse & Co., Chartered Accountants. The Balance Sheet will be found in Annex II, as well as the certificate of the auditors to the effect that they have obtained all the information and explanations they have required and that in their opinion the Balance Sheet, together with the note thereon, is properly drawn up so as to exhibit a true and correct view of the state of the Bank's affairs according to the best of their information and the explanations given to them and as shown by its books. The Profit and Loss Account and the Appropriation Account are reproduced in Annex III.

4. CHANGES IN THE BOARD OF DIRECTORS.

Early in the financial year Professor G. Bachmann, President of the Direktorium of the Swiss National Bank, whose term of office as a director had expired, was re-elected for a further period of three years. Upon his appointment recently as President of the Bankrat of the Swiss National Bank, Professor Bachmann, to the regret of his colleagues, intimated his intention of resigning from the Board after the meeting to be held on 8th May 1939. Professor Bachmann has served on the Board for the past eight years. His cordial collaboration and wise counsel will be greatly missed.

As a result of the change in the Presidency of the Reichsbank in January 1939, Dr. Schacht, who had been an ex-officio director since April 1933, retired from the Board. Dr. Schacht was one of the early organisers of the Bank and took a leading part in the discussions held at Baden-Baden in 1929 which led up to the foundation of the Bank. The eminent services

which he rendered to our institution are gratefully recognised. Dr. P. Reusch, one of the original members of the Board, also resigned in January to the great regret of all his colleagues. Herr Walther Funk, Reichsminister for Economic Affairs, joined the Board as an ex-officio director upon succeeding Dr. Schacht as President of the Reichsbank-Direktorium and appointed Dr. Hermann Schmitz to serve on the Board in replacement of Dr. Reusch.

Professor A. Beneduce, Vice-Chairman of the Board, has been nominated to the Italian Senate and, under the Statutes of the Bank, will thus not be eligible for reappointment as a director. Professor Beneduce also participated in the discussions at Baden-Baden in 1929 and was one of the original members of the Board. During the past seven years he served in the capacity of Vice-Chairman. He was a member of two international committees which met at the Bank in August and December 1931 respectively and acted as Chairman of the second of these committees. The great knowledge and experience of financial questions which he brought to the service of the Bank have been of the utmost value to our institution and his retirement is greatly regretted. The Governor of the Banca d'Italia has appointed Professor Francesco Giordani to succeed Professor Beneduce as a member of the Board.

Among the Alternates of members of the Board, Herr E. Hülse and Dr. W. Vocke retired as the Alternates of the President of the Reichsbank upon relinquishing their appointments with that Bank. Both Herr Hülse and Dr. Vocke had taken an active part in the negotiations at Baden-Baden at the time of the founding of the Bank. The former was afterwards appointed as the first Assistant General Manager of our institution and later acted as Alternate of the President of the Reichsbank with Dr. Vocke, who had served in that capacity since the inception of the Bank. In replacement, Herr Walther Funk appointed Herr Emil Puhl, Member of the Reichsbank-Direktorium, as his Alternate.

VIII. CONCLUSION.

The continuously mounting volume of government expenditure for armaments and other purposes is becoming the predominating influence in every sphere of economic life and raises problems of a fundamental nature which must be faced in all countries whatever their political or economic orientation. Indeed, discussions in government and other circles, in countries large or small, show a striking similarity. The same problems are present everywhere: and it depends on the stage of development whether they make themselves felt as present difficulties or as preoccupations about the future.

In the depths of the depression men, money and machinery were unemployed; the problem was to make active use of existing productive capacity, and, even after the state of actual depression was overcome, unemployment in many countries remained high and prosperity was sectional rather than all-round. It seemed that not only were governments bound to utilise the available capacity in order to employ labour, but almost unlimited possibilities were at their disposal for increasing home production. According to differences in economic position and national temperament attention converged on extending the home market or producing at home an increasing part of what was previously obtained from abroad. Moreover, an ever-increasing proportion of the country's capacity was used for types of production which did not serve directly or indirectly the needs of the consumer.

It now appears as if the period in which the countries in the old world have to cope with the problem of excess capacity is nearing its end; in some countries it has already been definitely passed. In almost all countries the governments are forced to attach more importance to foreign trade by the inevitable logic of facts: increased home production, whether it aims at supplying the home market with more goods or with goods formerly obtained from abroad, tends to lead at a given stage to more imports. And production for non-economic purposes has in this respect a still greater effect. In each country, therefore, part of the productive capacity must be reserved for the manufacture of goods for export. The variety of methods used to further exports illustrates the prominent place now given everywhere to questions of foreign trade — a development which strongly contrasts with the concentration on domestic measures of recovery during the years 1932 to 1937. An increase in the volume of international trade should be possible without creating a clash of interests between different countries, since the need for more exports is born from increasing imports. The problem facing all countries is to find the right relation between production for home needs and for export purposes and to adapt the latter production to the requirements of the importing countries, which under the influence of the growth of home production may have changed greatly from what they were before. However, as events show, even the tendency to increased self-sufficiency is not necessarily inconsistent with an intensification of world trade.

But the acutest problem which arises in every country where the limits of productive capacity come in sight and which remains the same, whatever the political or economic structure may be and whatever the financial and economic methods with which the problem is met, is that a canalisation of production from its natural purpose of serving the needs of the consumer must have an influence on the general standard of living. It must lead to a reduction of that standard as soon as the needs of non-economic production (including production of those exports required to cover the increase of imports necessitated by non-economic production) can no longer be fulfilled by a net increase of economic activity. Whether this effect is reached by the price-raising influence of inflationary financing or by the absorption of purchasing power through taxation or government borrowing is, of course, by no means irrelevant. The psychological and social effects are very different. But the influence on the standard of living in all cases must inevitably be adverse.

Respectfully submitted,

J. W. BEYEN,
President.

ANNEXES

CENTRAL BANKS OR OTHER BANKING INSTITUTIONS POSSESSING RIGHT OF REPRESENTATION AND OF VOTING AT THE GENERAL MEETING OF THE BANK

"The ownership of shares of the Bank carries no right of voting or representation at the General Meeting. The right of representation and of voting, in proportion to the number of shares subscribed in each country, may be exercised by the central bank of that country or by its nominee. Should the central bank of any country not desire to exercise these rights they may be exercised by a financial institution of widely recognized standing and of the same nationality, appointed by the Board, and not objected to by the central bank of the country in question. In cases where there is no central bank, these rights may be exercised, if the Board thinks fit, by an appropriate financial institution of the country in question appointed by the Board." (Article 15, Bank Statutes.)

Institutions	Number of votes
Bank of England, London	19,772
Banque Nationale de Belgique, Brussels	19,772
Banque de France, Paris	19,772
Banca d'Italia, Rome	19,772
Reichsbank, Berlin	23,772
The Industrial Bank of Japan, Tokyo	19,770
The First National Bank of New York, New York	19,770
De Nederlandsche Bank N. V., Amsterdam	4,000
Schweizerische Nationalbank, Zurich	4,000
Sveriges Riksbank, Stockholm	4,000
Bank von Danzig, Danzig	4,000
Finlands Bank, Helsingfors	4,000
Banque de Grèce, Athens	4,000
Bulgarska Narodna Banka, Sofia	4,000
Danmarks Nationalbank, Copenhagen	4,000
Banca Nationala a Romaniei, Bucarest	4,000
Bank Polski, Warsaw	4,000
Magyar Nemzeti Bank, Budapest	4,000
Národní Banka Československá, Prague	4,000 *
Norges Bank, Oslo	4,000
Banque Nationale du Royaume de Yougoslavie, Belgrade	4,000
Latvijas Banka, Riga	500
Lietuvos Bankas, Kaunas	500
Banca Nazionale d'Albania, Rome	500
Eesti Pank, Tallinn	100
	200,000

* The question of the voting rights attaching to the shares originally issued in Czechoslovakia has not yet been determined.

BALANCE SHEET

IN SWISS GOLD FRANCS (UNITS OF 0.29032258...)

ASSETS			
			%
I—GOLD IN BARS.		38,745,664.44	6.4
II—CASH			
On hand and on current account with Banks		23,612,114.42	3.9
III—SIGHT FUNDS at interest. . .		32,728,172.67	5.4
IV—REDISCOUNTABLE BILLS AND ACCEPTANCES			
1. Commercial Bills and Bankers' Acceptances	142,177,214.41		23.4
2. Treasury Bills	74,739,604.64		12.3
		216,916,819.05	
V—TIME FUNDS at interest			
Not exceeding 3 months . . .		32,760,821.64	5.4
VI—SUNDRY BILLS AND INVEST- MENTS			
1. Treasury Bills.	110,349,724.56		17.7
2. Railway, Postal Administration and Other Bills and Sundry Investments	148,384,073.71		25.0
		258,733,798.27	
VII—OTHER ASSETS			
1. Guaranty of Central Banks on bills sold.	823,733.39		0.1
2. Sundry items	2,201,841.21		0.4
		3,025,574.60	
		606,522,965.09	100.0

NOTE — The whole of the short term and sight deposits in various currencies (Item IV — Liabilities) are more than covered by assets either in the currencies of the deposits or in currencies free from exchange restrictions, and of the long term commitments the French Government Deposit (Saar) and the French Government Guarantee Fund (Items III — 3 and 4) are similarly covered. The remaining long term commitments (Items III — 1 and 2) which are recorded in a restricted currency (although the Bank's commitment in respect of Item III — 1 is not clearly established), are covered by assets of the same currency, the gold value of a substantial part of which is specially guaranteed.

The Capital, Reserves and Surplus are represented to a large extent by assets in countries where exchange restrictions now prevail and do not permit of free conversion of their currencies into gold or other currencies; however, as to these assets an important part is secured by special contracts guaranteeing their gold value and in one case specifically permitting their transfer. Moreover, under Article X of the Hague Agreement of January 1930, the signatories thereto declared the Bank to be immune from any "prohibition or restriction of export of gold or currency and other similar interferences, restrictions or prohibitions".

TO THE BOARD OF DIRECTORS AND SHAREHOLDERS
OF THE BANK FOR INTERNATIONAL SETTLEMENTS, BASLE.

In conformity with Article 52 of the Bank's Statutes, we have examined the books and accounts and explanations we have required and that in our opinion the above Balance Sheet, together with the affairs according to the best of our information and the explanations given to us and as shewn by the concerned.

ZURICH, April 27, 1939.

AS AT MARCH 31, 1939

GRAMMES FINE GOLD — ART. 5 OF THE STATUTES)

LIABILITIES			%
I—CAPITAL			
Authorised and issued 200,000 shares, each of 2,500 Swiss gold francs	500,000,000.—		
of which 25 % paid up		125,000,000.—	20.6
II—RESERVES			
1. Legal Reserve Fund	4,688,205.43		
2. Dividend Reserve Fund	6,527,576.47		
3. General Reserve Fund	13,055,152.92		
		24,270,934.82	4.0
III—LONG TERM COMMITMENTS			
1. Annuity Trust Account Deposits	153,126,250.—		25.3
2. German Government Deposit	76,563,125.—		12.6
3. French Government Deposit (Saar)	808,500.—		0.1
4. French Government Guarantee Fund	24,659,184.19		4.1
		255,157,059.19	
IV—SHORT TERM AND SIGHT DEPOSITS (various currencies)			
1. Central Banks for their own account:			
(a) Not exceeding 3 months	97,248,724.63		16.1
(b) Sight	46,266,580.25		7.6
2. Central Banks for the account of others:		143,515,304.88	
Sight		1,823,023.74	0.3
3. Other depositors:			
(a) Not exceeding 3 months	32,665.03		0.0
(b) Sight	4,404,975.85		0.7
		4,437,640.88	
V—SIGHT DEPOSITS (Gold)		9,664,798.66	1.6
VI—MISCELLANEOUS			
1. Guaranty on commercial bills sold	1,455,606.77		0.2
2. Sundry items	32,614,731.52		5.4
		34,070,338.29	
VII—SURPLUS			
Profit for the financial year ended March 31, 1939		8,583,864.63	1.4
		606,522,965.09	100.0

of the Bank for the financial year ending March 31, 1939, and we report that we have obtained all the information with the Note, is properly drawn up so as to exhibit a true and correct view of the state of the Bank's books of the Bank, as expressed in the above-described Swiss gold franc equivalents of the currencies

PRICE, WATERHOUSE & Co.
Chartered Accountants.

PROFIT AND LOSS ACCOUNT
for the financial year ended March 31, 1939

	<u>Swiss gold francs</u>
Net Income from the use of the Bank's capital and the deposits entrusted to it, after necessary allowance for contingencies	10,405,268.62
 Commissions earned:—	
As Trustee (or Fiscal Agent to Trustees) for International Loans	126,862.25
In connection with special credits	118,967.53
Transfer fees	534.82
	<u>10,651,633.22</u>
 Costs of Administration:—	
Board of Directors — fees and travelling expenses	218,508.70
Executives and staff — salaries and travelling expenses	1,443,572.36
Rent, insurance, heating, light and water	110,268.85
Consumable office supplies, books, publications	91,255.32
Telephone, telegraph and postage	59,063.41
Experts' fees (Auditors, interpreters, etc.)	14,763.06
Cantonal taxation	34,211.49
Tax on French issue of Bank's shares	33,486.02
Miscellaneous	62,639.38
	<u>2,067,768.59</u>
NET PROFIT:—	<u>8,583,864.63</u>

APPROPRIATION ACCOUNT

	Swiss gold francs
NET PROFIT FOR THE FINANCIAL YEAR ENDED MARCH 31, 1939	8,583,864.63
Applied in accordance with Article 53 (a) (b) (c) and (d) of the Statutes, as follows:—	
To the Legal Reserve Fund — 5 % of 8,583,864.63	429,193.23
	8,154,671.40
Dividend at the rate of 6 % per annum on paid-up capital	7,500,000.—
	654,671.40
To the Dividend Reserve Fund — 20 % of 654,671.40	130,934.28
	523,737.12
To the General Reserve Fund — 50 % of 523,737.12	261,868.56
Remainder	261,868.56

Distributed in accordance with Article 53 (e) (1) of the Statutes, as follows:—

	Swiss gold francs
Annuity Trust Account deposits in accordance with Article IV (e) of the Trust Agreement:—	
France	85,270.87
Great Britain	33,321.91
Italy	17,405.10
Belgium	9,415.36
Rumania	1,644.95
Yugoslavia	6,846.11
Greece	563.98
Portugal	1,080.96
Japan	1,080.96
Poland	31.33
	156,661.53
German Government non-interest-bearing deposit in accordance with Article IX of the Trust Agreement	78,330.76
French Government deposit (Saar)	853.22
French Government Guarantee Fund in accordance with Article XIII of the Trust Agreement	26,023.05
	261,868.56

TRUSTEE FOR THE AUSTRIAN

Statement of Receipts and Payments

Receipts

	American Issue \$	British and Dutch Issues £
1. BANK BALANCES as at July 1, 1937	780,924.88	106,346.17. 3
2. RECEIVED FROM THE AUSTRIAN GOVERNMENT in respect of:—		
Interest coupons		
In cash	1,307,043.06	183,563. 3. 7
Accrued in bonds ceded for cancellation (see below)	6,520.69	1,106.12. 3
Bond redemption		
In cash	154,523.70	403. 2. 6
In bonds ceded for cancellation (see below)	462,470.—	84,778. 2. 6
Expenses	3,342.60	853.16. 9
3. INTEREST RECEIVED on cash employed pending application to the service of the Loan	1,188.90	277.13. 3
	2,716,013.83	377,329. 8. 1

Payments

1. INTEREST		
Matured coupons paid and accrued interest paid on bonds purchased for redemption or ceded by the Austrian Government against re- fund of cash	1,447,142.45	203,373. 9. 7
Accrued interest on bonds ceded by the Austrian Government in part-payment of service instalments (see above)	6,520.69	1,106.12. 3
2. REDEMPTION		
Drawn bonds reimbursed	—	—
Bonds purchased by the Paying Agents	138,021.25	454.—. 5
Bonds ceded by the Austrian Government against refund of cash	32,960.—	—
Bonds ceded by the Austrian Government in part-payment of service instalments (see above)	462,470.—	84,778. 2. 6
3. EXPENSES		
Commission and expenses of Paying Agents and fees and expenses of Trustee	6,203.75	1,045. 7. 6
4. BANK BALANCES as at June 30, 1938, held in respect of the items shown on Annex IVb	622,695.69	86,571.15.10
	2,716,013.83	377,329. 8. 1

NOTES — (1) The definitive bond of the American issue of the Loan contains a "gold coin" clause but since (2) As a result of the union of Austria and Germany the pledged revenues which constitute the col-monthly service instalments in the currencies of the respective issues, due on and after June 1, 1938 received only five monthly service instalments and could provide for the payment of only five-sixths of issues. In the case of the Swedish issue, unexpended sinking fund monies were available in the hands 1938 coupons.

The definitive bond of the Austrian issue contains a "gold value" clause which cannot be effective currency. The German Authorities decided, therefore, that Schilling coupons of the Loan, which is stated to be the rate applicable for the liquidation of all internal claims expressed in Schillings.

Unexpended sinking fund monies, in Schillings, were available to complete the payment of July 1, as shown in the attached Statement of Funds in the hands of Depositories (Annex IVb) — Item 1(b) — Trustee's accounts in Schillings represent an external claim, the rate for conversion of which is

AUDITORS'

We have audited the Books and Accounts of the Trustee for the Austrian Government International of Receipts and Payments is correctly prepared therefrom and, read together with the Notes thereon, June 30, 1938 by certificates obtained from the depositaries.

ZURICH, February 15, 1939.

GOVERNMENT INTERNATIONAL LOAN 1930

for the Eighth Loan Year (July 1, 1937 to June 30, 1938)

Italian Issue Lire	Swedish Issue Sw. Cr.	Swiss Issue Sw. Fr.	Austrian Issue Sch.	General Expenses	
				£	Sw. Fr.
3,197,858.20	534,461.18	789,451.86	1,988,785.03	—	—
5,223,903.37	566,907.37	1,320,474.29	3,443,750.82	—	—
32,119.50	—	5,100.29	—	—	—
5,307.50	210,752.50	271,479.20	1,513,640.94	—	—
2,435,950.—	—	332,320.—	—	—	—
26,809.20	2,542.55	6,716.16	15,736.—	300.—.—	24,492.20
8,397.98	2,988.74	2,269.87	—	—	—
10,930,345.75	1,317,652.34	2,727,811.67	6,961,912.79	300.—.—	24,492.20

5,809,471.10	628,740.—	1,475,809.43	3,789,166.03	—	—
32,119.50	—	5,100.29	—	—	—
—	216,300.—	—	—	—	—
—	—	201,947.50	—	—	—
4,120.—	—	72,100.—	630,722.56	—	—
2,435,950.—	—	332,320.—	—	—	—
32,039.60	3,406.20	8,100.63	30,227.78	300.—.—	24,492.20
2,616,645.55	469,206.14	632,433.82	2,511,796.42	—	—
10,930,345.75	1,317,652.34	2,727,811.67	6,961,912.79	300.—.—	24,492.20

July 1933 the Trustee has not received the sums necessary to give effect thereto. lateral security for the Loan have not been passed through the account of the Trustee since April 1938 and the have not been paid to the Trustee. During the second half of the Loan year to June 30, 1938, therefore, the Trustee the nominal amounts of the coupons due on July 1, 1938 of the American, British and Dutch, Italian and Swiss of the Trustee and have been drawn upon in order to complete the payment of the full nominal amount of July 1,

executed in the manner prescribed by reason of the fact that the Austrian Schilling has ceased to exist as an due on July 1, 1938 must be paid in "free" Reichsmarks at the rate of 1.50 Schilling equals 1 Reichsmark,

1938 coupons of the Austrian issue, but the amount withdrawn from the sinking fund account for this purpose, was increased by reason of a decision of the German Authorities that funds standing to the credit of the 1 Reichsmark equals 2 Schillings.

CERTIFICATE

Loan 1930 for the eighth fiscal year ending June 30, 1938 and report that in our opinion the above Statement properly sets forth the transactions for that year. We have also verified the bank balances on hand at

PRICE, WATERHOUSE & Co.
Chartered Accountants.

TRUSTEE FOR THE AUSTRIAN

Statement of Funds in the hands

The Bank Balances as at June 30, 1938 were held in respect of:—

1. (a) Unpresented matured coupons	
(b) Coupons payable on July 1, 1938	
From funds provided for interest payments	
From funds provided for the redemption of bonds	
2. Expenses accrued to June 30, 1938, but not claimed until thereafter	
Funds on hand for the liquidation of accrued or accruing liabilities	
3. Bond redemption account	
4. Other funds on hand (of which Sw. Fr. 4,908.60 is deposited with a bank, formerly a Paying Agent, which has suspended payments)	
Total balances on hand as per Statement of Receipts and Payments — Annex IVa	

Statement of Bonds outstanding

Nominal value of bonds issued	
Less: Nominal value of bonds redeemed during:—	
1. First seven Loan years	
2. Eighth Loan year	
Nominal value of bonds outstanding as at June 30, 1938 (see note below)	

NOTE: When drawn for redemption,

GOVERNMENT INTERNATIONAL LOAN 1930

of Depositaries as at June 30, 1938

American Issue \$	British and Dutch Issues £	Italian Issue Lire	Swedish Issue Sw. Cr.	Swiss Issue Sw. Fr.	Austrian Issue Sch.
19,414.50	1,382.10.—	169,055.25	—	13,650.—	46,233.98
588,456.—	83,040. 8. 4	2,370,917.24	255,850.— 51,170.—	595,126.44	1,562,415.68 395,034.94
355.53	14.15.10	12,727.30	1,729.01	3,077.25	296.12
608,226.03	84,437.14. 2	2,552,699.79	308,749.01	611,853.69	2,003,980.72
20.77	37. 2. 4	1,619.26	159,782.50	462.16	488,011.46
14,448.89	2,096.19. 4	62,326.50	674.63	20,117.97	19,804.24
622,695.69	86,571.15.10	2,616,645.55	469,206.14	632,433.82	2,511,796.42

as at June 30, 1938

25,000,000	3,500,000	100,000,000	10,000,000	25,000,000	50,000,000
4,201,200	569,500	16,340,000	1,018,000	3,983,000	7,575,500
618,000	83,400	2,369,000	210,000	608,000	478,400
20,180,800	2,847,100	81,291,000	8,772,000	20,409,000	41,946,100

bonds are repayable at 103 per cent.

INTERNATIONAL LOANS

FOR WHICH THE BANK IS TRUSTEE OR FISCAL AGENT FOR THE TRUSTEES

Funds on hand as at March 31, 1939

	German External Loan 1924	German Govt. International 5½% Loan 1930	Austrian Govt. International Loan 1930	Totals
Swiss gold francs				
FUNDS HELD IN RESPECT OF:—				
Redemption of bonds	639,334.57	697.11	1,311.94	641,343.62
Drawn bonds not yet presented for redemption	3,517.62	—	—	3,517.62
Interest coupons due but unrepresented	63,067.30	55,549.92	149,220.04	267,837.26
Miscellaneous items	292,702.37	6,306.67	85,915.05	384,924.09
TOTALS . .	998,621.86	62,553.70	236,447.03	1,297,622.59

BOARD OF DIRECTORS

Sir Otto Niemeyer, London.	Chairman.
* Prof. Alberto Beneduce, Rome.	} Vice-Chairmen.
Marquis de Vogüé, Paris.	
Dott. V. Azzolini, Rome.	
** Prof. Dr. G. Bachmann, Zurich.	
Baron Brincard, Paris.	
Pierre Fournier, Paris.	
Walther Funk, Berlin.	
Alexandre Galopin, Brussels.	
Georges Janssen, Brussels.	
Hisaakira Kano, London.	
Montagu Collet Norman, London.	
Ivar Rooth, Stockholm.	
Dr. Hermann Schmitz, Berlin.	
Kurt Freiherr von Schröder, Cologne.	
Dr. L. J. A. Trip, Amsterdam.	
Seijiro Yanagita, London.	

Alternates

Adolphe Baudewyns, Brussels.	
Yves Bréart de Boisanger, Paris.	
Cameron F. Cobbold, London.	
Emil Puhl, Berlin.	
Dott. Pasquale Troise or	} Rome.
Dott. Mario Pennachio	

EXECUTIVE OFFICERS

Dr. J. W. Beyen	President.
Roger Auboin	General Manager.
Paul Hechler	Assistant General Manager.
Dott. Raffaele Pilotti	Secretary General.
Marcel van Zeeland	Manager.
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Dr. Per Jacobsson	Economic Adviser.
Dr. Felix Weiser	Legal Adviser.

* To be replaced as Director by Prof. Francesco Giordani.

** Retires from the Board on 8th May 1939.

8th May 1939.